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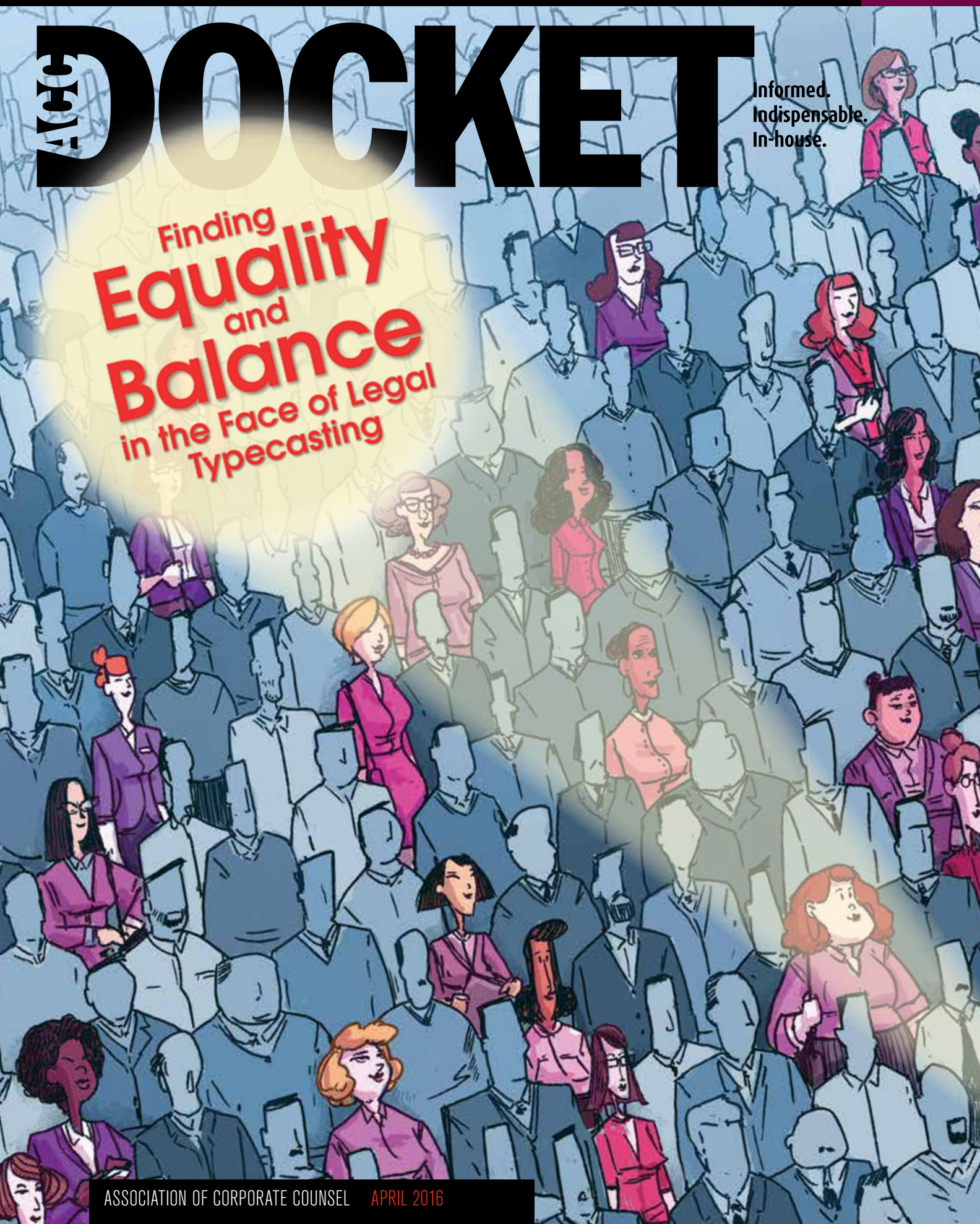

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AVOIDING EMPLOYMENT TRAPS IN CHINA

By Catherine LaChapelle, Joseph Deng, and Jonathan Isaacs

As demonstrated by the recent market volatility, regulatory changes, and slowing growth, China continues to be a challenging market in which to do business, but remains one with great growth potential. In 2015, the Chinese government initiated several measures designed to boost the nation's economy with its 13th five-year plan. The goal is to achieve a more balanced economy, transitioning from export-led growth toward more domestic consumption and services. To succeed, multinational employers entering into and doing business in China must sharpen their employment-related business strategies to leverage opportunities and mitigate risk. We examine six common labor and employment traps and how to avoid them.

Understanding the landscape

When doing business in China, it is critical to understand the landscape. First, China, like the rest of the world, differs from the United States because it does not recognize the "at-will" employment concept. Under China's employment contract system, employees must be engaged pursuant to a written employment contract, and termination during the contract term is difficult. This system has led to adversarial employee-employer relationships, with employees often challenging employers to retain their positions.

Second, the State and, in particular, the Chinese Communist Party, play an essential role in every sector of society. There is no separation of powers in China; all levels of power are expressly subordinated to the State, including the National People's Congress, the courts, labor unions, labor bureaus, labor arbitration tribunals, and other enforcement bodies. Thus, it is critical for multinational employers to monitor developments related to the central government's policies, including its five-year plan and corresponding local and industry plans. In particular, labor relations are integrally connected to the central government's goal of economic rebalancing, which requires higher wages and increased social services to encourage household consumption. As a result, companies in China are seeing greater experimentation with employment and labor relations reforms at the municipal level, leading to an increasingly varied landscape.

Finally, a new demographic megatrend is driving business decisions, market decisions, and public policy — China's baby boom is turning into a baby bust. Notwithstanding the recent change in the country's family planning policies that now allow a married couple to have two children, the "demographic dividend" from the one-child policy that resulted in a large number of working-age employees with few children is rapidly coming to an end. Economists are predicting a substantial decline in the working population that will exacerbate the already tight labor market for skilled workers. At the same time, younger workers are more aware of social issues and workplace rights, creating pressure for increased enforcement, as well as the potential for labor unrest. It is also worth noting that the Chinese Communist Party and government place a high priority on social and political stability, and labor unrest is viewed as a direct threat to that stability. The labor authorities at all levels keep a watchful eye on any labor dispute that could lead to a labor protest, and may pressure the parties to compromise before the disputes grow into something larger.

With an omnipresent state and rapid legal and demographic changes, China can be a difficult place to navigate.

Trap #1: Failure to sign written employment contracts

Employers in China must conclude an individual written employment contract with each full-time employee. If an employment contract is not signed with an employee within one month of the employee beginning to work for the employer, the employer must pay double salary to the employee from the second month of employment until the contract is signed, or until the one-year anniversary of the commencement of employment. If no employment contract is signed within one year of the employee's commencement of work, then the parties are deemed to have concluded an open-term employment contract, which is very difficult to terminate. This can be a common trap, particularly in the M&A context. To minimize exposure to claims, the acquiring company's labor due diligence should ensure the target company has entered into valid employment contracts with employees.

More broadly, employers should think strategically about how to document the employment relationship to maximize their flexibility and minimize costs and legal risks. Written employment contracts can include key terms such as probationary periods, working time arrangements, and wages and benefits. Additional terms and conditions, such as intellectual property rights assignments and restrictive covenants, including confidentiality, non-competition, and non-solicitation agreements, should also be put into writing.

Trap # 2: Improper use of contingent workers (labor dispatch)

As in many other jurisdictions around

Catherine LaChapelle is chief counsel, employment, immigration and data privacy, for Koch Companies Public Sector LLC. She has served as in-house labor and employment counsel for Koch Industries, Inc., since 2005. During this time she has provided support on both domestic and international labor, and employment and compliance matters. *catherine.lachapelle@kochps.com*

Joseph Deng is a partner in Baker & McKenzie's Palo Alto office and part of the firm's global employment and labor law practice group. He represents multinational employers in global and domestic labor employment law matters, and related business transactions. He previously worked in the firm's Shanghai office and is admitted to practice law in California. *joseph.deng@bakermckenzie.com*

Jonathan Isaacs is a partner based in Baker & McKenzie's Hong Kong office and heads the firm's employment law group practice in China. He is experienced in advising multinational companies on labor unions, collective bargaining, overtime compliance, termination issues, and data privacy issues, as well as the employment aspects of M&A transactions in the PRC. He is the co-author of the book, *Employment Law & Practice in China. jonathan.isaacs@bakermckenzie.com*

the world, when it comes to the use of contingent or "dispatched" workers, companies in China can be caught between the relatively strict requirements of the law and their business needs and market practices. Historically, when foreign companies were first allowed to enter the Chinese market, they were required to hire their employees through a third party "labor dispatch" agency. Even today, representative offices of foreign companies are prohibited from hiring Chinese national employees directly, and must still engage their staff through a third party staffing agency such as the Foreign Enterprise Service Corporation (FESCO).

For a variety of reasons, the government now encourages companies (but not representative offices) to hire their employees directly and reduce the use of "dispatched" labor. In 2013, amendments to the China Employment Contract Law restricted the use of labor dispatch to certain positions: (1) temporary — positions lasting no more than six months; (2) auxiliary — supporting positions that serve those positions core to the business; and (3) substitute positions that cover permanent staff during certain times of absence (e.g., vacation or maternity leave).

On January 24, 2014, the Ministry of Human Resources and Social Security issued the Provisional Regulations on Labor Dispatch providing additional guidance on key issues. Key provisions include:

- Companies are restricted to only hiring up to 10 percent of their workforce through labor dispatch arrangements. Companies that use dispatched workers exceeding this maximum ratio have a two-year grace period that expired February 28, 2016.
- Companies must go through an employee consultation process (but are not required to reach an agreement with employees) when defining which job positions will be considered "auxiliary."
- Companies can return dispatched workers back to staffing agencies when they undergo significant restructuring, face severe economic difficulties, or decide to liquidate.
- Representative offices will not be covered by the restrictions on labor dispatch.
- Companies are prohibited from discriminating against dispatched workers in benefits and other terms and conditions of employment.

While these clarifications are helpful, uncertainty remains. For example, the Labor Dispatch Regulations are silent on whether open-term contract rules apply to dispatched workers, whether dispatched workers hired outside the allowable scope can claim de facto employment with the host entity, and how outsourced labor will be regulated in the future.

Notwithstanding the lack of guidance in some areas and irregular enforcement across regions (and even districts), the long-term direction is clear — companies cannot hide behind the veil of a labor staffing agency to avoid the relatively strict requirements of the Employment Contract Law. Recent cases underscore this trend. In a June 16, 2014 case report, the Binhu District People's Court in Wuxi, Jiangsu Province ruled against an employer that hired an employee through a labor dispatch agreement. The individual had worked at the company for one year without an employment contract before the company formally hired him through a third-party staffing agency. After being terminated, the employee sued the company. The court ruled that because the company had failed to enter into an employment contract with him within a year of his commencement of work, an open-term employment had been formed between the parties. In addition, the employee's job position did not fall within the "temporary, auxiliary, or substitute" job position categories for which labor dispatch was allowed.

Some companies still prefer to use the labor dispatch arrangement to enhance flexibility, reduce costs, and avoid regulations relating to social insurance, non-fixed-term contracts, and severance pay. Employers should review their workforce policies, determine the proportion and positions of dispatch workers, and ensure a plan for compliance. Labor authorities already have been requesting companies to provide rectification plans. Those companies over the 10 percent limit have several options: (1) convert workers to direct employees; (2) eliminate the dispatch labor positions when the contract expires or offer a severance package; or (3) if the positions are auxiliary, transfer workers to a service company and sign a bona fide service agreement. If not rectified, companies can be subject to fines of CNY 5,000-10,000 per employee and liability for compensation of the dispatched worker.

Determining your dispatched employees:

In many companies, determining which employees or how many employees are hired through an outside agency can be difficult, since the dispatched workers who are hired through a staffing agency contract do not show up as headcount, and are not managed by the company's HR department. In such cases, you may need to resort to indirect means to determine which of your "workers" are hired by an outside agency, such as counting the number of name badges, keycards, log-in identification numbers or email addresses that are used by "workers" on the company premises, or who log into the company's networks.

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Trap #3: Failure to safeguard confidential information and IP rights

For many multinational employers, intellectual property (IP) is their most important asset. As in other countries, understanding "who" creates IP and "how" to effectively ensure assignment of IP is core to a company's success in China. There are several key steps which multinationals in China can take to protect confidential information and IP rights before, during, and after employment. Ensuring strong IP protection provisions is particularly critical in view of the high levels of worker turnover in China. Although the government has taken steps in recent years to strengthen IP rights and enforcement actions, companies doing business in China have traditionally been concerned about the theft of IP and relatively weak enforcement regime in China. There are a number of steps that companies can take now to safeguard their confidential information and IP rights in China.

First, employers should make sure that all employees who have access to confidential information execute a confidentiality agreement requiring them to keep confidential information and trade secrets confidential during and after the termination of their employment absent prior written consent for the information to be disclosed and limiting their use of confidential information and trade secrets to work-related purposes. Significantly, injunctive relief is now available for theft of trade secrets in China. In January 2014, the Shanghai No. 1 Intermediate People's Court issued the first-ever pre-litigation injunction (the equivalent of a temporary restraining order) against an ex-employee in a trade secret case in China. The TRO was issued with 48 hours of the company showing that the ex-employee had downloaded 879 sensitive documents just prior to his resignation to join a competing company. The employee was enjoined from using or disclosing the documents, and a lien was placed on his personal residence in Shanghai. The employee had signed an employee confidentiality and IP rights agreement that provided for such relief.

Second, employers should provide that all IP developed by employees belongs to the company. Under China's Patent Law, the assumption is that IP belongs to the employee, unless the invention was completed while the employee carried out a task assigned by the employer or while using the employer's material or technical resources. The IP rights assignment should clearly state the employer's ownership of patents and patent improvements, prohibit unauthorized use, and require employees to disclose all inventions they have created. Employee IP should normally be assigned first to the onshore entity in China before being transferred up to an entity outside of China. Entering into an agreement with the US parent could potentially trigger joint employer liability, as well as permanent establishment tax exposure. It could also result in ineffective assignment of IP, as applicable local laws typically provide that IP vests with the local employer and not with another group company.

Third, companies should provide for patent remuneration awards in the IP rights agreement and/or company handbook to override Chinese statutory payment requirements. Under the Implementing Regulations of the Patent Law, inventors are entitled to a lump sum payment when the patent right is granted and remuneration when the patent is exploited. The Implementing Regulations, however, expressly permit an employer to contract out of the statutory scheme. Companies should thus set up an inventor's award scheme in a policy for their employees.

Significantly, draft amendments to the Patent Law would expand employee's IP rights, including the scope, award, and remuneration statutory default amounts. Under the proposed revisions, employers would have to compensate for other IP (e.g., computer software and trade secrets), not just patents. It is unclear whether companies could provide for compensation below the proposed statutory amounts.

Finally, employers should use non-compete and non-solicitation provisions as appropriate. Non-competes are generally enforceable in China if they: (1) apply to senior management personnel, senior technical personnel, and others with non-disclosure obligations; (2) do not exceed two years; and (3) are supported by separate post-termination consideration (usually 25-60 percent of the employee's pre-termination pay, depending on local regulations and practice) paid on a monthly basis during the non-compete period. The employee's salary, incentives, bonuses, and equity awards will normally not meet the separate consideration requirement.

Preliminary injunctions for breach of non-competition agreements are now available under Amended Civil Procedure Law (2014). Chinese law also generally requires employees in breach of their non-compete obligations to pay damages to their employers. In a recently reported case, the Taizhou Intermediate People's Court affirmed the lower court ruling ordering an employee under a post-termination

non-compete obligation with her former employer, a commercial bank, to terminate her current employment relationship with a competitor bank and pay liquidated damages in the amount of CNY 80,000. There, the employee had signed a confidentiality and non-compete agreement that restricted her from working at any other bank or similar organization for a period of two years. The bank agreed to pay non-compete compensation, the annual amount of which equaled one third of the employee's total annual income in the last year of employment. The non-compete agreement further stipulated that in the event of a breach, the bank had the right to demand the employee to continue to perform the non-compete obligation by leaving her employment. Thus, at least some courts are willing to vigorously enforce non-compete restrictions if the clauses (e.g., the definition of competitor company, the amount of non-compete compensation, and the remedy) are well drafted.

Non-solicitation agreements (of employees, customers, vendors/suppliers) are also generally enforceable if they are reasonable in geographic scope (such as where the company does business) and duration (e.g., two years).

In sum, companies worried about their employee-created IP portfolio in China can put effective and enforceable documentation in place to maximize IP protection, including provisions relating to confidentiality, ownership rights, remuneration, non-compete, and non-solicitation.

Trap #4: Failure to adopt comprehensive disciplinary policies

From the US perspective, one of the oddest (and most frustrating) issues is that general employee misconduct (even of a serious nature) is not in and of itself an allowable ground for termination of employment. This is a serious issue for companies operating in China, because employee misconduct is widespread and oftentimes the greatest danger to a company's business comes from its own employees.

In the event of misconduct, the company will need to fit that misconduct into one of the allowable statutory termination grounds; the most common ground used in the event of misconduct is "serious violation of company rules." In order to terminate on this ground, the company must have a written set of company rules (usually in the employee handbook or a separate code of conduct), specifically stating what type of misconduct would be considered "serious" and may lead to summary dismissal.

Therefore, it is essential to adopt comprehensive written company rules addressing potential consequences (including dismissal) for serious misconduct. Furthermore, such company rules must be adopted through an employee consultation procedure stipulated in the Employment Contract Law. The consultation should be conducted with the union, or absent a union, with the workers' representative council, or absent a worker's representative council, with representatives selected by employees from each department and/or business group. Although not strictly required, the employee disciplinary policies, along with the handbook and/or code of conduct, should be translated into Chinese. Failure to conduct such consultations, and to obtain and retain written records of such consultations, can render the disciplinary policies unenforceable.

Lack of company rules

In a case in Beijing in 2013, a sales employee was summarily dismissed for submitting false receipts when claiming reimbursements for business expenses. The amounts involved were not large, but the company had zero tolerance for any fraudulent actions by its employees and wished to send a message that this type of conduct would not be tolerated. However, the employee was able to successfully challenge the termination because the company had not adopted a specific company rule that submission of false receipts or fraud would lead to summary dismissal. The court reasoned that therefore the breach could not have been that serious and that a warning should have been given instead.

Companies operating in China too often fail to appreciate how important it is to have a well-drafted employee disciplinary policy, and may instead just include a high-level summary of corporate values and principles that will not be very helpful when an actual instance of employee misconduct occurs. Further, many companies do not know about or put much emphasis on ensuring that the written company policies are validly adopted through an employee consultation procedure.

Trap #5: Failure to pay overtime

Wage and hour issues remain a challenge for employers in China. As the workforce becomes more sophisticated, employers are seeing more wage and hour claims by employees, including for misclassification and non-payment of overtime. Accordingly, as with contingent workers, companies are faced with the conundrum of strict compliance versus prevailing business practices.

Chinese regulations provide for a Standard Working Hours System of eight hours per day and 40 hours per week. Employees who work over these limits are entitled to overtime at a rate of 150 percent of normal wages for workday overtime, 200 percent of normal wages or compensatory time-off for rest days, and 300 percent of normal wages for statutory holidays. Significantly, unlike in the United States, China does not exempt managerial employees from overtime requirements; rather, almost all employees are entitled to overtime

payments. Before having employees work overtime, however, employers must consult with the employees and the labor union (if any). In addition, overtime hours generally should not exceed one hour per day (or three hours per day under special circumstances) and no more than 36 hours per month.

Recognizing that the Standard Working Hours system may not be practical for certain employees, Chinese law allows employers to adopt alternative working hours under certain circumstances. Under the Flexible Working Hours System, an employer may require workers who need flexible schedules (e.g., senior managers, field personnel, travelling sales persons, certain types of shift workers, and long distance transport personnel) to work in excess of 40 hours per week without paying overtime compensation. Before implementing this system, employers generally must secure approval from relevant authorities. If the approval lapses, employees can make claims for back payment of overtime compensation. In addition, the Flexible Working Hours System does not relieve employers of other wage and hour requirements, which can vary city by city and even district by district. For example, in Shanghai, employers are required to provide employees with one day of rest time every seven days. In Shanghai and Shenzhen, employers must pay 300 percent of an employee's normal wages for holiday time.

Under the Comprehensive Working Hours System, employers may require employees to work longer hours without paying for overtime so long as the average hours worked in a certain period do not exceed the standard working hours for that period. Before implementing the Comprehensive Working Hours System, an employer must obtain permission from the local labor bureau to implement the system and for each job position that will be subject to this system.

Companies worried about their employee-created IP portfolio in China can put effective and enforceable documentation in place to maximize IP protection, including provisions relating to confidentiality, ownership rights, remuneration, non-compete, and non-solicitation.

To avoid wage and hour liabilities, employers should ensure their use of alternative working hours systems is consistent with legal requirements. While the Flexible Working Hours System eliminates the need to pay most overtime (with some exceptions) and the Comprehensive Working Hours System permits daily and weekly hours to vary, these exemptions require government approval, actual compliance, and supporting paperwork. Companies acquiring a target in China should review its wage and hour practices and assess liabilities for overtime pay.

Trap #6: Failure to understand the Chinese labor union environment

Unlike in the United States, where labor unions continue to experience a steady decline in numbers and influence, multinationals in China should be prepared to respond to greater unionization collective bargaining pressures, and labor unrest.

The All-China Federation of Trade Unions (ACFTU), which is the only legal union organization in China, is actively organizing and pressuring companies to establish collective bargaining mechanisms, with a goal of 95 percent unionization of Fortune Global 500 companies and 80 percent of all companies. The ACFTU is using various tactics against companies that resist unionization, including "naming and shaming," direct communications with employees, sending notices to all area companies, organizing visits by local ACFTU and tax officials, and lobbying local authorities to initiate compliance investigations or withhold regulatory approvals.

National, provincial, and municipal governments are similarly putting pressure on both national and foreign owned companies to unionize and enter into collective agreements. Some labor authorities are attempting to impose a trade union establishment-preparation fee on companies without a union equivalent to 2 percent of the total wages of all of their employees. Guangdong recently passed regulations increasing the labor union's involvement in the collective bargaining process. Other provinces and cities have likewise issued or are considering similar regulations promoting collective bargaining initiatives.

Unionization, however, does not necessarily mean increased worker activism. Labor rights are more limited in China than in the United States. Workers are prohibited from organizing an independent union and do not have the right to strike. While the number of reported strikes and labor protests in China reportedly doubled to more than 1,300 in 2014, these incidents — with rare exceptions — are not organized by the ACFTU. Instead, unions in China are tasked with preserving social harmony and prohibiting social unrest. Similarly, "collective contracts" still tend to be mild documents not recognizable to most labor relations managers in the United States. They generally do not have wage increase, seniority or job classification requirements or other onerous terms.

There are signs, however, that this is changing. Unions are not always passive, particularly in the case of

a factory or store closure. For example, when a major US retailer announced the closure of its Changde store last year, the store labor union sided with the employees' demand for more generous severance packages. The requirements for collective mechanisms also have gone beyond empty slogans. In the past, the terms of most contracts negotiated with employees were very general and, in many cases, merely a recitation of basic legal requirements and/or the company's existing compensation and benefits policies. Now, according to a Working Plan released by the ACFTU, the terms of the collective contract should be detailed enough to be easily performed.

While a "delay and defer" strategy can still work to avoid unionization, employers should have a plan as to how they will respond to pressures to unionize or to enter into a collective contract. In particular, companies should consider what union structure makes sense for their presence in China; closely monitor developments in the region, including industry and local wages; and ensure their operations are compliant with labor and employment laws to minimize labor unrest.

Conclusion

This is a remarkable time for labor and employment law in China. The Employment Contract Law, which became effective on January 1, 2008, significantly changed the relationship between employer and employee to bring China more in line with international standards. At the national level, numerous specialized regulations and notices have followed the promulgation of the Labor Law. The Labor Law and national regulations are further supplemented by local regulations, with major cities (such as Beijing and Shanghai), special economic zones (such as Shenzhen), and other municipalities and provinces adopting their own employment regulations. The overall effect has been to increase individual employee rights, as well as to strengthen the structures for collective employee representation. It has also led to greater variation in the employment landscape, raising new compliance challenges for multinational employers.

To capture opportunities in China, multinational companies must continuously monitor the changing landscape and proactively address labor and employment risks. Identifying basic steps to avoid unexpected pitfalls and focusing on the highest areas of liability are critical to successfully manage a workforce and labor costs. Failure to do so can lead to significant financial, legal, and reputational risks. **ACC**

Case study: Overtime claim by a senior manager

In a case in Shanghai, a senior manager came to work regularly on Saturdays, even though the regular work week was Monday to Friday. Her employment contract stated that she was not entitled to any overtime pay, and that her monthly salary covered any overtime hours worked. When the manager's employment was terminated, she successfully sued for back payment of overtime compensation, based on written testimony from fellow employees who confirmed that they saw her coming to work on Saturdays. The court also ruled that the contractual clause was invalid, as the company had never received approval from the local labor bureau to implement the Flexible Working Hours System, so by default she was working under the Standard Working Hours System.

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