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Conducting M&A Labor Due Diligence in China

By David Yu and Wayne Chen

For M&A deals, performing a labour due diligence is an important aspect of any transaction but is often overlooked. The cost of employee arrangements in the acquired company should be taken into careful consideration, especially those for state-owned companies. There are, however, some practical problems involved in performing labour-related due diligence. This article will give some introduction and explanation to those issues.

Generally speaking, performing a due diligence in a merger or acquisition (**M&A**) deal is an opportunity for the acquiring company to examine and audit the legal, financial, management and other important aspects of the target company at the beginning and throughout the entire process of an M&A deal. After a thorough examination and audit, the acquiring company can better estimate the possible risks involved in acquiring the target company.

In a legal due diligence, the lawyers of the acquiring company are often entrusted to examine the relevant documents and analyze the legal issues, including the establishment and existence of the target company, its qualification certificate and the state of its management, as well as its assets, important contracts, credit and debt, tribunal or arbitration claims, employment conditions and other legal risks of the target company for which it might bear liability.

In the commercial realities of M&A deals in China, the acquiring company often pays special attention to the asset value (the land, factory building and equipment) of the target company, which is testament to the importance of an asset due diligence. Meanwhile, performing a labor due diligence is often overlooked. As a matter of fact, probing into the employee arrangements of the acquired company (especially state-owned enterprises) should be an important stage in any M&A deal, and the cost of such arrangement must be taken into consideration. A thorough and complete labour due diligence should be done to allow the acquirer to analyze any potential labour-related risks involved in the acquisition.

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The Checklist for a labor due diligence

Before formally carrying out a legal due diligence, the lawyers of the acquiring company present the target company with a checklist of questions about the due diligence. The corresponding primary labour issues to be checked and analysed are as follows:

(i) *Statistics*: A list of the names of the employees (including the age of every employee and years spent in the target company), a list of the employees under unfixed-term labour contracts and the number of retired employees and total wages;

(ii) *Contracts and documentation:* The employment regulations of the target company, employment agreements (including those for managers) and collective employment agreements, non-competition agreements, and confidentiality agreements and others concluded between managers, key persons and the target company;

(iii) *Instructions and explanations*: Instructions from the target company regarding trade unions, the payment of trade union fees, the conditions of employee representation, the welfare of employees and labour-related illegal acts; and

(iv) *License and certification*: Social insurance registration certificates, social insurance premiums payment certificates and so on.

The above checklist can be adjusted to comply with the commercial intent of the transaction, as every M&A deal is unique. For instance, if the target company is a high-tech enterprise, the labour due diligence may additionally refer to employees' intellectual property rights or stock option incentive plans.

The Classification of Employment

Due to the different categories of employment relationships in China, it is important to classify the employment relationship of the target company when carrying out a labour due diligence. A description of the four main categories of employment relationships follows below.

First, in the most common type of relationship, employees conclude an employment agreement with the target company to establish the nature of their relationship. In these circumstances, the number of employees under unfixed-term employment agreement should be the key point considered in the labour due diligence.

Secondly, for employees recruited by a professional labour service company, the target company, as the actual employer, usually concludes a labour agreement with the labour service company rather than with the individual employees.

The third case involves those employees who have already retired once having reached the mandatory retirement age. Such personnel are re-employed by the target company.

The last scenario concerns employees who are in medical treatment for work-related or other injuries (such as illness). On this occasion, employees who are in medical treatment stop working while the employment relationship remains intact.

A final consideration is that, if the target company is based in Shanghai, attention should be paid to the issue of migrant labourers since the government adopts different social insurance policies on migrant labourers by implementing a registration system.

It is clear that a thorough examination of the different classifications of employment relationships is important for evaluating and analyzing whether the current arrangement of human resources is reasonable and valid, as well as for assessing the corresponding liabilities that might be likely under different employment relationships. For example, the target company is not liable to pay social insurance premiums for the employees in the second and third categories above. However, in Shanghai, there is a special employment relationship between such employees and the target company based on certain policy documents, and the target company should implement these policies with reference to the working hours, worker protection and minimum wage standards.

The actual labour relationship between employees and the target company should also receive attention in a labour due diligence. It is hard for the lawyers to uncover such relationships from the documentation provided by the target company. Consequently, the acquirer may ask the acquired company to submit special descriptions or descriptions of the actual labour relationships.

Social Insurance

In a labour due diligence, it is important to find out whether social insurance premiums have been fully and duly paid by the target company. The company that fails to fulfil this obligation shall bear the liability according to relevant laws. During the due diligence process, we can ascertain the types and exact amounts of the social insurance premiums (endowment insurance, health insurance and unemployment insurance) through related documents provided by the target company. However, it is hard to determine whether the target company has fully and duly paid the social insurance premiums. As a result, special instructions from the target company on paying social insurance premiums should also be required by the acquirer.

In reality, some target companies claim that employees are unwilling to pay the social insurance premiums or have commercial insurance, as an excuse for not paying the social insurance premiums for these employees. According to the labor laws of the PRC, all employers and employees have an obligation to take part in the social insurance schemes and pay the premiums. Consequently, it is the duty of the enterprise to pay social insurance premiums without the employees' willingness being a condition. That is to say, signing up for commercial insurance is a matter of choice, while taking part in the social insurance plan is compulsory.

Examination of the Employment Agreement

The examination of the employment agreement during the labour due diligence is different from the examination carried out by the legal consultants for the company. Lawyers can only apply the universally applicable standard agreements if there are too many employees in the target company. As for the employment agreements of managers and other key persons, it is best to examine each agreement individually and to check whether there is a provision on special compensation (e.g., additional compensation to be paid by the company when the employee retires or leaves the job) or a service-term provision.

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