Paul Hastings

CHINA MATTERS

Paul Hastings' Newsletter for Investing & Operating in the People's Republic of China

May 2008

Long-term Incentives and Golden Handcuffs in the PRC: A Mix that Encourages Employee Loyalty

With the increasing influence of the People's Republic of China ("**PRC**" or "**Mainland China**") in the world's economy, many multinational companies ("**MNCs**") are viewing Mainland China as a strategic place for developing and expanding their business. Within the PRC, many PRC-based companies are emerging as regional or even global players. For example, more than 130 Chinese companies are listed on U.S. stock exchanges[1] and many others on other overseas exchanges. This globalization of Mainland China has brought more and more competition for top talent within the PRC – placing a premium on how companies encourage the performance and loyalty of their key employees.

In many western countries, employers have found that employees respond positively to compensation structures that apply "golden handcuffs" through a combination of:

- converting cash bonuses into long-term incentives that have a value tied to the employer's success; and
- using forfeiture of an employee's long-term incentives to penalize the employee for the violation of loyalty protections, such as protecting employer trade secrets or not joining a competitor after leaving employment.

Golden handcuffs are essentially contractual protections for an employer and may be attached to stock option grants, restricted stock awards, or cash-based awards under which payments are delayed until an employee's termination of employment. Regardless of the form, the general premise is "you remain, you gain; you leave, you lose." The challenge comes with implementation because the use of golden handcuffs in Mainland China takes careful planning, well-written contract provisions, and attention to certain legal requirements under PRC law.

1. Golden Handcuff Alternatives

The most common vehicle for golden handcuff protections comes from including them within written award agreements that document the terms and conditions of stock options, restricted stock, or restricted stock units. The same contract principles that apply to stock awards also apply to cash bonus awards that an employer in the PRC agrees to pay in Renminbi ("**RMB**"), the official currency of the PRC. This is important because the PRC's State Administration for Foreign Exchange ("**SAFE**") has established a registration and approval process that listed MNCs must satisfy before making stock awards to PRC employees, as discussed in more detail below. It is common, as a result, for MNCs to work around SAFE's rules by making awards that are payable to PRC employees solely in RMB. Because these awards typically have a value tied to the MNC's common stock, but without any right of the employees to receive common stock, they are referred to as "phantom" or "RMB-settled" awards.

There is an alternative to phantom equity awards, namely, performance-based awards that involve either an immediate cash bonus payment or delay of

the payment until some future date (such as the employee's termination of employment). The delayed payment approach is popular among MNCs for use with executive employees, because the MNCs may impose golden handcuff protections on the delayed payment.[2] Performance plan awards tie the level of executives' future compensation directly to how the company performs relative to key business goals and strategic priorities, rather than the performance of its stock. Such plans do not involve awards of foreign stock or options and therefore require no approval and registration with SAFE, as long as the compensation is paid out in RMB to the PRC executives.[3] Such performance awards may be of particular interest to PRC executives, because while a strong correlation between an MNC's Mainland China operations in the and its overseas stock performance may not be apparent, using PRC market parameters may be more direct than overseas stock incentives.

Regardless of whether an employer chooses to award RMB-based phantom equity awards or performance-based compensation, the award itself basically involves the use of a simple plan (setting forth rules of general application) and the granting of contract rights to specific PRC employees – through an award agreement entered into between the employer and the PRC employee. For employers who want to impose "golden handcuffs" on their employees, these award agreements merely need to include understandable provisions, such as employer protections that may require forfeiture of the employee's rights under the award if the employee violates loyalty covenants such as an agreement:

- not to solicit the employer's customers or employees; or
- not to join a competitor of the employer for some stipulated period after the employee leaves employment.

Other Types of Handcuffs

Although stock grants, phantom awards and deferred compensation provide direct incentives for solid employee performance, employers may customize other types of compensation to the specific needs or desires of the executives. These may include home or vehicle purchase loans that the employer forgives over time, as well as an employer's payment of educational costs for the employee or the spouse or children of the employee. Special employer-provided life insurance is also a possible benefit for key employees. If the benefits are paid out in RMB, then the foreign exchange control issue under SAFE does not exist. The design of these incentives nevertheless requires advance planning, such as for tax consequences, followed by thorough written documentation.

2. Legal Considerations

The use of long-term incentives and golden handcuff protections for PRC employees raises several legal issues, whether the awards involve equity-based awards, phantom awards, or performance awards with deferred payment terms. A few of the main PRC considerations are as follows.

Employment Law Considerations

While providing lucrative benefits (which is the "gold" for the employees), an award with a "handcuff" is designed to ensure the employee stays loyal to the employer, which is realized through imposing non-compete and non-solicitation conditions on receiving the "gold." The method for enforcing a loyalty protection can occur through cancelling an award, forfeiting future payments that would have occurred, or requiring the repayment of amounts the employee had received (this is known as a claw-back).

The enforceability of such provisions depends on several factors under current PRC law. For awards that have not been earned or vested, forfeiture should not be problematic. However, the forfeiture or claw-back of vested awards could be viewed as liquidated damages – which are allowed only in limited circumstances; to wit, in the event of an employee's breach of non-compete obligations or training expenses agreement.[4] PRC law requires payment of separate consideration in monthly installments to employees in return for non-compete obligations of the employees during the non-compete period in order for the non-compete provision to be enforceable,[5] and restricts the type of employees who can be subject to non-competes to senior mangers, senior technicians and other employees who have access to business secrets.[6] In addition, although national laws do not prescribe the minimum amount of the consideration required, employment regulations of many local districts do require minimum amounts of such consideration be paid or provide guidelines on this issue. If the employer fails to meet its require-

ments for an enforceable non-compete agreement, the employee will no longer be bound by the non-compete obligations; neither will the employee be subject to any liquidated damages.

Depending on local regulations, a golden handcuff provision may, for instance, be designed along the following lines:

Step 1 – employee accumulates performance awards on a delayed payment basis while employed.

Step 2 – after employee leaves employment, the employee collects 5% of the total delayed payment amount for each month of honoring the non-competition and other loyalty covenants (the employee would collect 60% of his or her delayed payment account over 12 months, assuming that is the length of the loyalty protection period).

Step 3 – at the end of the loyalty protection period, the employee would collect the remaining 40% of the delayed payment amounts. This would serve like a performance bonus for fully honoring all post-employment commitments.

Note that PRC employers should be very careful to study local employment laws before implementing golden handcuff provisions such as the one described here. That said, well-considered golden handcuff protections can work under PRC employment laws.[7]

Tax Consequences and Withholding

China has issued fairly specific rules regarding how PRC employees are taxed on the income they receive from stock/option awards as well as other bonus or delayed payment plans. As a general matter, taxation occurs when employees collect their benefits (for example, when they exercise stock options or when they receive RMB to settle phantom awards). In 2001, the Beijing Local Tax Bureau audited one of the world's largest high-tech MNCs for non-compliance with tax withholding requirements for stock incentives awarded to its PRC employees. The employer was forced to pay significant back taxes.[8] Employers should familiarize themselves with the tax rules associated with any incentives that they provide to employees, and should be sure to make necessary tax withholdings to avoid problems with the PRC tax administration.

PRC Securities Laws

PRC securities laws and regulations do not regulate either the permissibility for PRC citizens to hold foreign stocks or options, or whether granting foreign stocks or options to PRC employees falls under the purview of Mainland China's securities regulations. In practice, the China Securities Regulatory Commission ("CSRC") has not challenged the granting by MNCs of stock options or other equity awards, and the CSRC's pre-2003 review of overseas IPO (initial public offering) applications (including the employee stock option plans contained in such IPOs) by PRC companies has focused on whether the plans are in compliance with China's foreign exchange control rules.[9] Under current rules and practice, it is unlikely that a foreign stock/option plan for Chinese employees would raise a PRC securities law question, even if the award includes golden handcuff features.

MNCs and the Currency Control Problem

Usually, a foreign stock/option plan requires outward remittance of foreign currency from Mainland China (for purposes of paying for the stock price or option exercise price) and inward remittance of foreign currency into the PRC (for providing the PRC employee with the cash benefit of their option exercise or resale of vested restricted stock). However, Mainland China imposes strict controls on foreign currency exchange, and the PRC safeguards make a traditional foreign stock/option plan difficult to implement for PRC employees.

In early 2007, the SAFE established clear rules by which MNCs could provide for the participation of PRC citizens in their equity-based compensation plans. SAFE's guidance is titled Implementing Rules for the Administrative Measures Governing Foreign Exchange of Individuals, and was followed soon afterward, on March 28, 2007, with SAFE's internal Circular 78 [10] – which specifies the process for obtaining SAFE's approval of an MNC's equity award plan.

Basically, Circular 78 requires that MNCs submit their equity-based compensation plans to SAFE for approval and registration prior to the making of awards to PRC employees. Circular 78 requires that MNCs open special foreign exchange bank accounts for the purpose of inward and outward remittances

of foreign currency required for exercising stock options and purchasing stock, as well as receiving the funds for payment to PRC employees. All foreign currency needs for such purposes must come from onshore in RMB and be converted into foreign currency and remitted overseas through that special account subject to SAFE's approval. In addition, using foreign currency obtained or held offshore to exercise options or purchase stock is prohibited. All funds received overseas on behalf of PRC employees are prohibited from being retained overseas or used for other overseas investment and must be remitted back to the special onshore foreign exchange account for transferring to the employees' individual bank accounts.

Although deemed the official opening of a channel for implementing foreign equity-based compensation plans in China, Circular 78's approval and registration process is complicated and time-consuming. This is principally because Circular 78 requires that employers not only submit detailed proposals for the approval of equity-based compensation plans in advance for SAFE's review, but also file quarterly reports with SAFE on the status of pending plan applications. To date, only Procter & Gamble and ABB have navigated the SAFE process and received full approval to implement their employee stock ownership plans in the PRC.[11] Going through Circular 78 procedures for equity-based compensation plans may, therefore, be impractical for many MNCs if only a few PRC employees are eligible.

Based on no-name basis consultations with the Beijing and Shanghai Offices of SAFE, we understand that the SAFE has informally indicated that these RMB-based workarounds are lawful because they avoid the need for any foreign exchange of funds. SAFE's rules do not, however, apply either to stock awards that are settled in shares of a PRC company's common stock, or to incentive awards that are settled in RMB rather than in common stock of the MNC.

Conclusion

With proper design, PRC employers and MNCs should be able to provide PRC employees with significant incentives that reflect business goals, either through having a value tied to the employer's equity, or through performance-based terms, and in each case through adding a golden handcuff feature. Employers should consider the variables of possible awards and golden handcuffs depending on the specific goals to be achieved, and should carefully consider the wide range of PRC laws prior to implementation.

NOTES:

1 See http://www.acstock.com/StockList.aspx.

2 According to a survey released on April 14, 2008 and conducted by the Wall Street Journal and Hay Group, performance-based pay plans overtook stock options for the first time as the most popular form of long-term incentive compensation for chief executive officers among the 200 largest U.S. public companies. See Performance-Based Pay Plans Gain Favor Against Stock Options Among Top 200 Firms, Pension & Benefits Daily, Vol. 08, No. 75 (BNA, Inc., Apr. 18, 2008).

3 A currency conversion restriction still exists if the compensation is paid in foreign currency from overseas.

4 Employment Contracts Law of the People's Republic of China, promulgated on June 29, 2007, effective Jan. 1, 2008, art. 25.

5 Id. art. 23.

6 Id. art 24.

7 For more discussions on the requirements for the enforceability and key drafting strategy of non-compete provisions under PRC law, please see Non-Compete Agreements in the PRC: Clarity Amidst Uncertainty, by K. Lesli Ligorner, China Business Review (July/Aug. 2008) (pending publication).

8 In the PRC, the tax authorities may recover unpaid taxes and penalties from either the employee or the employer, as the tax withholding agent. Often the tax authorities take the path of least resistance and collect any amounts owed from the employer.

9 See http://law.cec-ceda.org.cn/files/info_3199.html. In April 2003 the requirement of prior review by the CSRC of privately-owned Chinese companies' overseas IPO projects was abolished.

10 The circular is entitled Operating Rules for Foreign Exchange Control of Onshore Individuals' Participation in Employee Stock Holding Plans and Stock Option Plans of Offshore Listed Companies, Hui Zong Fa [2007] No. 78. Circular 78 is employed by SAFE in administering approval of foreign stock/option plans; however, SAFE has not yet officially released Circular 78 to the public.

11 According to SAFE itself, it has approved the foreign stock/option plans of five PRC companies and two MNCs (i.e., P&G and ABB) and accepted the applications from two other MNCs under the new rules. http://www.safe.gov.cn/model_safe/news/ts_detail.jsp?ID=20500000000000000,34).

Paul, Hastings, Janofsky & Walker LLP is a global law firm with over 1,200 lawyers in 18 offices in Asia, Europe and the United States. Paul Hastings has one of the largest, full service, multi-jurisdictional legal practices in Asia with over 220 legal professionals in Beijing, Hong Kong, Shanghai and Tokyo. In addition to being named "Global Management and Employment Law Firm" in 2006 and 2007 by the International Who's Who of Business Lawyers, Paul Hastings has also recently been nominated as "International Law Firm of the Year" at the forthcoming International Financial Law Review Asia Awards.

For further information about this article, please contact:

Beijing
Monica Debiak: monicadebiak@paulhastings.com

Shanghai
Lesli Ligorner: lesliligorner@paulhastings.com

Hong Kong
Michael Downey: michaeldowney@paulhastings.com

U.S.
J. Mark Poerio: markpoerio@paulhastings.com
Erika Collins: erikacollins@paulhastings.com
Marjorie Culver: marjorieculver@paulhastings.com

Paul, Hastings, Janofsky & Walker LLP is licensed in the People's Republic of China as a foreign law firm permitted to advise clients on certain aspects of their international transactions and operations. Like all foreign law firms operating in China, we are not authorized to practice Chinese law. You are hereby advised that this document and prepared by us is based on our experience in advising clients on international business transactions and operations and on research and inquiries we deemed appropriate, and is not intended to be used (and cannot be used) as an opinion on the laws of China. To the extent you require such an opinion or the assistance of a qualified China lawyer, we would be pleased to assist you to identify an appropriate domestic China law firm. The author of this document does not hold a lawyer's license in the People's Republic of China. Paul Hastings is a limited liability partnership. Copyright © 2008 Paul, Hastings, Janofsky & Walker LLP.