



Special Article

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“With my naivety, my unshakable eternal optimism, and my love of the Chinese people and nation, I resigned my position with a high paying international law firm ...”

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Does China's New Labor Contract Law Better Protect Intellectual Property Owners?

by Edward Lehman, *Attorney-at-Law*

Foolish or insightful, an idiot or a visionary, I am the very first (and so far only) foreign intellectual property lawyer to be a resident in China for twenty years (Beijing and Shanghai), and the first (and so far only) foreigner to manage a Chinese patent and trademark practice in this great nation. I moved to Shanghai from my native Chicago at the behest of a large well known "white shoe" international law firm where I began my career as an associate to establish their China presence in hopes of one day dominating the China intellectual property market. I was sent because of my many years studying the Chinese language, my legal qualifications, and my family's long time multi-generational connection to intellectual property in the United States.

Boy, was I in for a surprise! I arrived two years after the first IP laws were written and implemented and only one patent and trademark agency existed in the country (now there are thousands). Further, the new laws were not that great and few people and MNC's were interested in protecting their IP rights in China anyway as the country seemed closed to the outside world and business here seemed unimaginable for most. However, I was that unusual mixture of young, enthusiastic, ignorant, and arrogant, so I plodded onwards to make my mark in the most populous county in the world.

After a couple of years, all the foreign firms and most persons, save those working at diplomatic missions retreated from China, following the events of June 4, 1989. I stayed. The firm that sent me pulled out by canceling their operations within 24 hours (too dangerous they declared, not enough opportunity). They did as each and every foreign law firm and foreign lawyer (keep in mind, at that time there was not even a regulation to establish a foreign law firm until almost 4 years later) and vacated for the then-British Colony of Hong Kong, or even back to London, New York and Chicago. With my naivety, my unshakable eternal optimism, and my love of the Chinese people and nation, I resigned my position with a high paying international law firm (which had provided quite comfortably for me a with a large salary, return airline tickets business class twice a year, a house, a cook, a maid, a gardener, a car, and a driver).

The law firm pleaded with me to relocate to the safety of a Hong Kong office and to make that the new operational headquarters for China. I was having none of it. I voted with my feet and remained because I thought I could be a part of something special in China. I then applied for and was accepted as the first and only foreign lawyer to work as a consultant for a State-owned law firm since China's Liberation on October 1, 1949 (at the time all law firms and IP firms were owned and operated by the government).

My "legal" foreign legal consultant permission had the number 0001 etched in the upper right hand corner of the document, which I still have till this day as a keepsake. My salary at the State-owned firm was the equivalent of \$100USD a month and a room slightly bigger than two telephone booths put together and one men's bathroom down the hall that I shared with all the 20 or so other single men housed on that same floor of a dilapidated building. There was no heat in the winter (against government regulations at the time in all buildings south of the Yangtze River). There was no telephone (there was a public pay on the street). I traded in the car and chauffeur for a genuine used Phoenix "Flying Pigeon" Bicycle (you could have any color as long as it was black). I went to work in an old building that had been some Taipan's mansion built "before the revolution" and taken over by the government as the location of the law firm. I was never so happy in my whole life as I was then.

My newfound position forced me to understand every aspect of Chinese laws, regulations and policies, as they were being formed, discussed, debated and implemented. Then I had to figure out how to apply them to the advantage of the never-ending stream of the State-run law firm's clients, six days a week eight hours a day.

It was a painstaking process. There was no internet. The law office had no computer and in fact only two old, but reliable Underwood Manual typewriters for English language letter writing. There was no English language version of the laws and regulations, and no China law newsletters, or even consistent legal updates. An individual or work unit could not own or operate a fax without approval license from the post office. There were no mobile phones and to call abroad, it was a massive 12 times more expensive to call out of China than call into China. We had no foreign television, no foreign books or newspapers or periodicals.

In my job at the State-run law firm, I was forced to learn, deal with literally hundreds of clients (the cost to the clients by anybody's standards at the time was negligible) from every type of person, matter, business unit or organization. During that time I even helped to open the second securities exchange in the country in Shanghai at the special invitation of the Shanghai mayor at the time (The picture of that opening day at the securities exchange with VIP still adorns my office wall to this day).

This forced me to look at the practice of law from the totality of how to consult on a wide range of issues, and beyond intellectual property, and integrate those skills to better assist foreign and Chinese clients. When Chinese private firms were finally permitted to be established, I helped to establish one of those fledgling first private law firms, along with less than a handful of earnest and

optimistic local lawyers.

In the private Chinese law firm that we call LEHMAN, LEE & XU, I have taken what I learned in those early years in a unique environment under a special set of circumstances, and passed this on to the brilliant men and women in our law firm and taught them (whether they liked it or not) to become advocates for clients (and not drones or mouthpieces for explaining it cannot or may not be done). And in looking at intellectual property with regards to China operations in the totality of how it affects every aspect of the business from a practical perspective. I believe for that reason alone we are unique in the intellectual property field in China and why many of China's leading corporations use us, rather than the other IP firms in the worlds fastest growing economy.

“...in China and in regards to Chinese companies, one must consider the totality of the organization's goals and operations in order to best protect intellectual property rights.”

So why send a rambling missive to my fellow IP lawyers concerning the new Labor Contract Law of China? It is about letting everyone know that in China and in regards to Chinese companies, one must consider the totality of the organization's goals and operations in order to best protect intellectual property rights. IP affects many aspects of a foreign invested organization here, far beyond just prosecuting patents and trademarks. It impacts among other things, tax aspects, repatriation of funds issues (the Chinese RMB is not fully convertible), and licensing issues (one may not receive payment under a license agreement unless the underlying IP right is granted in China, and employment issues which is what I wish to discuss here).

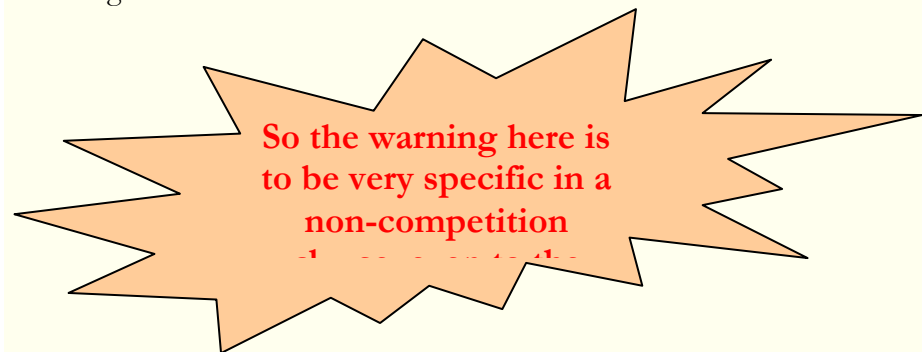
It is extremely important for those who wish to maintain manufacturing operations to enter into OEM contracts, use work-for-hire agreements, and establish sales operations or create research & development centers. The new law is yet another weapon in an intellectual property practitioner's arsenal, but it is far from a panacea or cure-all to stop the diversion of someone's intellectual property rights in China.

The Labor Contract Law was adopted and announced a few weeks ago (June 29, 2007) during the 28th session of the Standing Committee of the National People's Congress (NPC) and is certainly a "hot" topic of discussion and debate around the hot water dispensers amongst lawyers, IP portfolio managers, academics, government officials, workers & management and as well as foreign businessmen throughout the middle kingdom. Why all the fuss? This is after all a Communist country which has been striving to create a worker-peasant paradise since October 1, 1949. The answer is that this new law contains provisions to regulate both employers and employees on trade secrets and intellectual property confidentiality related issues.

Now let's take a look at what that means, Chapter Two, clause 23 of the Labor Contract Law, stipulates that employers and employees may elect to enter into an agreement regarding trade secret (read sales and distribution lists, customers lists, even the actual sales and distribution employee list at the organization) as well as intellectual property and confidentiality related issues in the labor contract (so setting it out in the employment contract in-the-alternative set of clauses under this one document).

Also employers can include non-competition restriction clauses in the labor contract with employees who are involved in trade secrets, and the parties may agree to a monthly compensation within the non-competition restriction period (for Europeans it is what is known as a "Garden Leave") upon termination of the contract. These non-competition clauses, in practice of course and according to my experience of creating what we call a legally binding "human resources package for employers", should always be included in all labor contracts. The employer may then elect to enforce the non-competition portion of the Labor agreement or not. As many employers in China know, in certain cases, employers are happy to be rid of certain lackluster employees and such employees may wish to go directly to their competitor. So then they can elect not to enforce the non-competition clause of the employment contract. Another aspect to the new labor law is that employees who violate the non-competition restriction covenant may be held liable for damages.

The Chinese NPC, in their wisdom, drafted this new Labor Contract Law to encourage innovation



on in the workplace and fair competition for all by stipulating the aforementioned non-competition restriction rule. However, keep in mind that this provision was only meant to apply to an employer's high-ranking management personnel, high-level technology personnel, and to those other employees who may be obliged to "keep trade secret". So the warning here is to be very specific in a non-competition clause, even to the point of naming your key competitors in the provision clause. As the more specific you are the more likely courts will enforce these non-competition agreements. Do not forget to set a specific formula for compensation to the employee (say 40 percent of last annual income plus insurance, and welfare benefits). This too makes it easier for lawyers, courts and/or employers to enforce these clauses. The scope, region, and duration of the non-competition restriction must be agreed between employers and employees, and such covenant may not, of course, violate national laws, policies and regulations (again depends upon the industry sector, scope of the business license, and the nature of the employer's organization, so use professional help when drafting the agreements on a case-by-case basis to assure employer-clients are best protected). In any event, the duration the concerned personnel may be restrained from working with competitors, or set up their own businesses in the same trade, may not be longer than two years after the termination of the current labor contract. This is a change from the former laws, regulations and policies, which allowed for up to three years for the enforcement of employees non-compete period, Score one for the employees.

It seems that a lot of these provisions come as no surprise and that these rules, were as a matter of practice, available before this law was promulgated becomes effective on January 1, 2008. For example, years ago, one of our large MNC clients enforced a non-compete clause we had drafted, where the employee subsequently and flagrantly breached by going to work for a competitor who had just entered the China market. The court upon hearing the evidence over a three-day period, strongly suggested that the party who induced the employee to breach his contract to settle the matter with our client for \$500,000 USD in damages. They did settle rather than receive an adverse judgment, which would have produced publicity that would have affected that company's price per share on the NYSE at the time. Nonetheless, it was disclosed that the competitor had enticed and conspired with this industrious Chinese gentleman to abruptly quit our client's organization and then proceed to take the entire sales force from one company to the other, along with the clients, purchasing orders, system software, client lists, sales reports, P&L statements, know-how and trade secrets. As a result of this encouraged judicial settlement, our client/the employer was then able to "buy out" the competitor's entire China operations and that competitor has never returned to China (seems their price per share to a beating from the launch and failure here in China).

We are forever reminding our clients to "hope for the best, but prepare for the worst" especially when it comes to intellectual property protection. If clients wish to protect IP, they should be the "first to file" (in Chinese & English along with all devices) for their trademark rights (it takes twelve to twenty-four months to get the trademark granted after examination and an opposition period). In the case of patents, designate China in a PCT application (thereafter you have 30 months to enter the national phase), or in the alternative, should you fail to file the PCT, try and bring the filing under the Paris Treaty within twelve months from the country of origin initial patent application. If you have developed software, make sure that employees execute a separate work-for-hire agreement and meticulously seek software recordal at the soonest time possible.

However, we advise our clients to file a copyright recordal only after you discover a violation otherwise it is too costly to file everything first. Then once you have the granted copyright recordal right, the rights holder has prima facie evidence that they are indeed the owner copyright owner in a Chinese court. Yet another aspect that many overlook is the filing of a "Customs Recordal" once you have a granted IP right. This will allow you a "sword" to prohibit an infringer from importing or exporting a product to or from China and to work with the Customs. Your law firm can track the infringing product so that it may be seized at the port. This remedial action certainly gets the attention of an infringer as it hits them right in their pocketbook.

So in a nutshell that is the new labor contract law as it may impact IP rights. As I have written, it is not a panacea but rather a clarification that the protection of IP is important even under employment situations. We have been honored to be awarded with labor and employment work with the biggest and the best companies in China over the years. We draft the agreements and later we actually have to enforce these agreements for the employer, so we have learned by experience what works and what does not work on a practical level. That is why, even with the new Labor Contract Law soon to be in place, we would

further recommend that any employer create a set of contracts in addition to the labor contract to more practically serve their interests and further their company's protection goals.

Additionally we still recommend that the following be created to complement a well drafted labor contract namely: an employee handbook, an anti-corruption contract (which complies with the USA FCPA, the EU corruption act and China's anti-corruption act), a separate non-competition contract (which could possibly survive should the employment contract have been terminated and then an employer discovers a breach at a later date), a separate non-disclosure agreement, and a work-for-hire agreement (for the same reason in both instances, so that this contract may survive the termination of the labor contract and the employer late discovers a breach, as well as the fact that sometimes it is better to bring a breach of these contracts straight to the attention of the intellectual property courts rather than before a less experienced judge which handles primarily labor issues only). We also recommend an expense report procedure contract in order to establish a reason for dismissal for cause and thereby avoid paying out severance salary for one month for each year the employee worked for the employer.

This Special Article is a publication of Lehman, Lee & Xu and is intended to provide valuable insights and information for readers. This publication does not create nor intend to create any attorney-client relationship nor should it be regarded as legal advice. For more information, please email: mail@lehmanlaw.com or contact any of our Corporate Practice Group members.



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