China Employment Law

Client Alert

People's Republic of China | Baker & McKenzie

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China's Draft Labor Contract Law – Major Changes for Employers on the Horizon

A draft of *The Labor Contract Law of the People's Republic of China* was passed by the State Council in October 2005 and is scheduled for the second reading by the Standing Committee of the National People's Congress. It could become law in the second half of this year. The Law, if enacted in the current form, likely will cause employers, including foreign-invested enterprises, to review and restructure their labor contracts and human resources policies.

The most significant aspects of the Draft are discussed below.

Shortened Probationary Periods

The Draft stipulates that labor contracts with a term of three months or above may include a probationary period. Under the Draft, the length of the probationary period will depend on the type of work conducted by the employees: workers in non-technical areas may have a probationary period of up to one month, employees who work in technical fields up to two months and lastly the probationary period for high-tech workers may last up to six months.

Fixed-Term Contracts Less Attractive

China does not recognize at-will employment. Currently, all labor contracts can be terminated, but only in limited circumstances. The current practice is to use short-term contracts: if an employer wishes to let the employee go but has no sufficient termination ground, he could simply let the contract expire, without the need to pay severance.

The Draft does not outlaw fixed-term contracts, but it strongly discourages using them through the following measures:

(1) fixed-term contracts cannot be terminated early, except for cause and in the case of mass lay-offs;

(2) severance is payable if a fixed-term contract expires and is not renewed.

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Mass-Layoffs – Union Consent Required

The Draft includes revised procedures to reduce headcount. Under current law, mass lay-offs are possible when the employer is on the verge of bankruptcy or where the employer experiences major difficulties in production. The Draft replaces this requirement by using a "change of objective circumstances" test. This has been interpreted to include relocation of an enterprise, absorption of an enterprise through merger or the transfer of major assets. It would appear that a mere downsizing would not justify mass lay-offs.

If more than 50 employees are to be laid off, the company must negotiate an agreement with the labor union or all employees. Failing to do so makes a unilateral lay-off decision voidable.

There is also a new requirement concerning the selection of employees. The company must retain, to the extent possible, employees with longer service years with the company.

Compensation for Unlawful Dismissal Clarified

Current rules and practice are unclear as to how to calculate the amount of compensation payable for unlawful dismissal. This made terminations potentially very expensive.

The Draft simply doubles the severance payable for lawful dismissal. Severance is calculated as one month's salary for every year of service. Therefore, in case of unlawful termination, the compensation will be two months' salary for every year of service.

Severance is calculated not on the basis of the salary of the affected employee but the formula shall be determined by labor authorities at the provincial level. This may mean that an average salary of employees in a particular industry or geographical area will be used. In any event, it is likely that it will become cheaper and more predictable for employers to terminate employees in cases where the termination grounds may not be sound.

On the other hand, an unlawfully terminated employee appears to have higher chances than under current rules to get reinstated into his/her previous position.

Non-Competition Provisions

The Draft reduces the permissible duration for a post-termination non-competition restriction from the current three years to two years. New is that non-competes must have geographical limitations.

Most importantly, under the Draft the former employer must pay the equivalent of no less than one hundred percent of the employee's annual salary to make the non-compete restriction enforceable. The Draft is silent

on the payment mode. A previous draft fixed the payment at 50% of the employee's salary; it is therefore possible that this requirement will be subject to further discussions.

New is a provision on liquidated damages payable by the employee for a breach of the non-compete clause. The Draft limits the damages to three times the amount paid by the employer to enforce the non-compete restriction. It is not clear whether this would be three times the amount already paid by the company at that time, or three annual salaries of the employee.

Employee Handbooks and Company Rules

Under current rules, employee handbooks, employment manuals, work rules etc. must undergo an ill-defined "democratic procedure" to become enforceable.

The Draft requires that company rules must be discussed and approved by the labor union or an employee representative body. Rules that are unilaterally issued by the company are void. Especially US-based companies, driven by Sarbanes-Oxley concerns about corporate governance, will need to examine the status of their handbooks and manuals for China.

Role of Labor Unions Strengthened

The Draft confirms an existing requirement that employers notify labor unions (which are similar to Work Councils) prior to terminating a labor contract for any reason, even for cause. The employer must seek and consider the opinion of the labor union, and issue a written explanation of its final decision to the labor union. Several Shanghai courts have ruled that foreign-invested enterprises that have not established labor unions must notify the union at the next higher level; failure to do so would make a unilateral termination voidable.

The Draft further strengthens the union's right to engage in collective bargaining and enter into collective contracts. It provides generally that any act taken unilaterally by the company without required union consultation is void, and that the matter shall be handled in accordance with a union proposal instead.

Pro-Employee Provisions

The Draft includes many provisions that favor employees. Ambiguous labor contract terms should be construed in favor of the employee in the event of a dispute. The Draft also stipulates that if a labor relationship exists without a written labor contract, the term of the contract is deemed to be open-ended rather than fixed.

Please contact the listed attorneys of Baker & McKenzie if you have any questions regarding issues raised in this alert.

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Moreover, the Draft does not provide grandfathering for fixed-term pre-existing labor relationships. This may mean that such contracts cannot be terminated other than for cause when the Draft becomes law.

Representative Offices

The Draft provides that labor relations between representative offices of foreign companies and their employees shall be governed by reference to the Labor Contract Law. This provision could potentially herald the end of secondment arrangements through labor service agencies like FESCO. In any event, this provision makes it clear that even if an agency remains involved, the representative office will not be able to avoid the application of general labor law rules.

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