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Executive Summary

❑ *China Prepares for Fundamental Change of Employment Contract System (p.2)*

A draft of the *Labour Contract Law* was issued for comments in March 2006, and has since received a storm of attention from employees, companies, and commercial associations. The draft, if passed in its current form, will require companies to completely overhaul their current workforce management systems, as it demands renewed consideration for many terms in current employment contracts. Key points include the following:

I. In case of disagreement over **interpretation of an employment relationship**, the employee's understanding shall prevail except where evidence to the contrary exists.

II. Employees must be consulted and must confirm **company rules and regulations**.

III. **Probation** periods are strictly limited

IV. Employees may not be asked to provide **collateral** (such as ID cards or certificates)..

V. The period of **non-competition** may not be longer than two years, and must be compensated for.

VI. **Contract termination** is severely regulated, especially for fixed-term contracts.

VII. Employers should pay **severance pay** even at expiration of a contract.

VIII. Companies are restricted from hiring employees through **staffing agencies** for more than one year. Employee obligations shall be shared between the staffing agency and the final employer.

As the law will likely be implemented early next year, companies are strongly recommended to study the current draft. Of course we will keep our readers informed of amendments and developments.

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❑ China Prepares for Fundamental Change of Employment Contract System

The *Labour Contract Law of the People's Republic of China* (Draft) (hereinafter referred to as "the Draft") was passed on 28 October 2005 at the 110th executive meeting of the State Council. As the first draft law specifically regulating labour contracts in China, the Draft was formally published for public comments on 21 March 2006. Labour contractual relationships are currently regulated by the third chapter of the *Labour Law of the People's Republic of China* (1995), and various rules and regulations at local level. With the promulgation of the Draft, expected August 2006 with effectiveness in January 2007, companies in China – including foreign-invested companies – will need to **thoroughly review and fundamentally adapt their workforce management systems to the new conditions**.

Below, we discuss some of the key issues that will have the greatest practical effect on companies that operate in China. It should be noted that the Draft in its current form may still be amended. The publication of the Draft for comments in its current has led to a barrage of criticism and queries (190,000 according to official reports), which legislators are now reviewing. Any amendments however will likely be minor, and so we strongly advise companies to make the necessary preparations.

I. Pro-Employee Clauses

Article 9 of the Draft provides that a labour contract shall be concluded in writing. If a labour relationship exists without a written contract, then such labour relationship shall be deemed open-ended (i.e. without a term of expiration) – unless the term of the labour relationship is manifested in its intention and a written contract is timely supplemented.

Moreover, where the employer and the employee have a different understanding of the existing labour relationship, the employee's understanding shall prevail except in light of contrary evidence. This is true for both written and non-written agreements.

Our comments

The burden of proof to resolve disagreements on the terms of a labour relation ship are put squarely on the shoulders of the employers. This is all the more relevant for labour relationships that have not been confirmed in writing, which shall in any case be regarded as open-ended.

These provisions make it more important than ever for employers to conclude proper employment contracts with their employees, no matter if the term of employment is expected to be temporary, short or long. The conclusion of written contracts is the only way employers can avoid the considerable risks that automatically follow.

II. Company Rules and Regulations

Article 5 of the Draft provides that where the rules and regulations formulated by the employer directly relate to employees' immediate interests, such rules and regulations shall be discussed and approved by the labour union or another employee representative body, or be stipulated through fair consultations. Such rules and regulations finally shall be announced by the employer.

According to Article 8, when the employer establishes the labour relationship and concludes a labour contract with the employee, the employer shall truly advise the employee of job content, working conditions, working site, occupational harm, conditions of safe production, remuneration and other information the employee wishes to know and directly relates to the conclusion and performance of the labour contract.

The second paragraph of Article 31 stipulates that a labour contract may be terminated where the employee materially violates the rules and regulations of the employer, and according to such rules and regulations the labour contract should thus forth be terminated.

Our comments

The employer may terminate the labour contractual relationship on the basis of the labour's severe violation of the rules and regulations thereof. However, under the provisions of the Draft, the formulation of legitimate and valid rules and regulations, especially those relating to actual interests such as dismissal, shall go through certain statutory procedures: After drafting, they shall be discussed and approved by the employee representatives, and then publicized.

Because Article 8 specifically provide for the company's obligation to advise the employees of their work conditions, the burden of proof for such obligation shall be assumed by the company when the employee presents defence for the rules and regulations on dismissal.

One way to resolve the foregoing issues may be to include the company's rules and regulations in the employment contract, or to have employees sign off on the same. Employees thereby give their consent, which can also evidence that the company's obligation to advise has been performed.

III. Probation

The Draft in Article 13 sets strict limits for probation periods, which may be agreed upon as long as the term of the labour contract is more than three (3) months, and shall be included in the term of labour contract. For non-technical posts, the probation shall not exceed three (3) months; for technical posts, it shall not exceed two (2) months; while the probation period for senior technical or highly specialized technical posts shall not exceed six (6) months. One employer may agree on a probation period with a specific employee only once.

Article 53 of the Draft provides that the probation period entered into by the employer in violation of the provisions hereunder shall be invalid, and if so the labour administrative authority will order the employer to correct the action in accordance with the provisions hereunder. Where the agreed probation period has been implemented, the employer shall pay indemnity to the employee.

Our comments

Employers will have to make reference to the new standards when entering into labour relationships with new employees. An employee may be given a probation period only once no matter whether his function is changed or not, and the maximum length of such probation depends both on the length on the contract and the position of the employee. Unfortunately the Draft does not define "technical", and "senior technical or highly specialized

technical" employees, leaving ample room for disputes.

It is interesting to note that according to the Labour Law (1994), a probation period may be specified in a labour contract but shall not exceed six (6) months. Furthermore the provisions of the *Notice of the Ministry of Labour on some Issues of Implementing the Labour Contract System* ([1996] no. 354), which set the maximum length of a probation period in relation to the length of the contract, remain in effect as well.

Contract Period	**Maximum Probation**
0-6 months	15 days
6-12 months	30 days
12-24 months	60 days
More than 24 months	6 months (*or less, as per the Draft*)

IV. Collateral

The Draft in Article 14 provides that the employer shall not request the employee to provide security or to collect money, or to detain the identification card or other certificates of the employee.

Under Article 15, if the employer violates the above provision, the labour administrative authority will order the employer to return the security, money or certificates to the employee and impose a fine between RMB 500 and RMB 2,000 per employee. Where any damage is caused to the employee, the employer shall assume liability for indemnification. The same penalty is applicable when the employee terminates the labour contract according lawfully but the employer detains the labour's files or other belongings.

Our comments

The above provisions are designed foremostly to counter common practices by some employers to detain certain documents to guarantee compliance with its own rules or labour disciplines. Such practices are confirmed as illegal, although the penalties for breach are not particularly high.

V. Non-competition

Article 16 of the Draft provides that if an employee will have access to the employer's business secrets, then a labour contract may include terms and conditions of non-competition, under which the employee shall not start his own business or hold a post with other employers that engage in manufacturing of the same types of products or operating the same types of business in competition with the current employer. The foregoing scope of non-competition shall be restricted to the geographical area where the two parties actually compete. The term of non-competition shall not exceed 2 years after the contract is terminated or cancelled, and must be compensated for in amount not less than the employee's annual income when working for the employer. Where the employee violates the provisions on non-competition, he or she shall pay a fine for breach of contract to the employer of not more than three (3) times the economic compensation paid by the employer to the employee.

The Labour Law (1994) merely and simply provides that the parties to a labour contract may agree on matters concerning keeping business secrets of the employer in the labour contract. On the other hand, depending on the

place, different local rules and regulations have been adopted limiting the maximum length of the non-competition period and minimum compensation.

Our comments

The Draft for the first time provides for a uniform approach and clear standards for non-competition agreements between employers and employees, which will replace the various different local rules currently applied. But while the Draft brings clarity, it also is much stricter than current rules, and employers shall take particular note of the following:

- Non-competition is not a statutory right, and thus can be the basis of a claim only if non-competition terms are expressly agreed upon by the employer and employee, whether in the labour contract or in a separate non-competition agreement.

- Non-competition will be legally restricted in regards to products and services, geographical area, and maximum term, but concepts such as "same types of products or services" and geographical areas of competition are not defined. Thus it is advisable to clarify and agree to such terms in the non-competition clauses, so as to avoid unnecessary disputes.

- The amount of economic compensation for non-competition may be agreed upon in advance, but it shall not be less than the employee's annual income. The Draft does not provide stipulations on how payment should be made, therefore economic compensation may likely be paid in lump-sum upon termination the contract, or monthly during the period of employment (i.e. every month the employee gets salary and compensation for non-competition).

- If an employee breaches the non-competition agreement, he or she will be liable for liquidated damages of not more than three (3) times the compensation paid for non-competition by the employer. This is severely restricting, especially because the damage to an employer may be much greater tan the maximum liquidated damages. It also compels employers to consider carefully how much compensation to pay employees in return for their commitment not to compete.

VI. Contract Termination

With relation to the term of the contract, Article 9 recognizes three types of labour contracts: fixed-term, open-ended, and expiration upon completion of a specific job. According to Article 31, employers may terminate any type of all contracts in case of mass lay-offs (under conditions set out in Article 33) or for cause under the following conditions:

(a) The employee is certified to be unqualified for employment during the probation period;
(b) The employee has severely violated the rules and regulations of the employer and the labour contract shall be cancelled in accordance therewith;
(c) The employee has caused gross loss to the employer's interests due to his or her serious dereliction of duty or engagement in fraud for private ends;
(d) The employee has established a labour relationship with another employer casting severe influence upon his

job tasks and refuses to correct the action upon request form the employer;
(e) The employee is investigated for criminal liability according to law.

Furthermore, as long as the employee is not in one of the positions listed in Article 34 (including having lost capacity to work due to work-related injury, being in medical care due to illness or injury, or being pregnant) employers may terminate an employee's open-ended labour contract if in one the below circumstances of Article 32, conditional upon 30 days advance notification in writing (or one month's salary in lieu of notice):

(a) An employee is unable to take up his or her original work arranged by the employer even after medical treatment for illness or injury not suffered at work is completed, and the parties cannot agree on modification of the labour contract;
(b) An employee is unqualified for his work and remains unqualified even after receiving training or reassignment to function; or
(c) The objective conditions taken as basis for the conclusion of the contract have greatly changed so that the original labour contract can no longer be carried out, but the parties can not agree on modification or expiration of the said labour contract.

If the employer terminates a labour contract in breach of the above provisions, the employee may demand re-instalment as per Article 42, or if the continued performed of the labour contract is not possible additional severance pay (see below).

An employee on the other hand may terminate a contract under any condition subject to a 30-day notice, or without notice under the conditions set out in Article 36:

(a) During the employee's probation period;
(b) If the employee fails to provide working condition sin accordance with the labour contract or fails to provide safety conditions in compliance with law;
(c) If the employer fails to p[ay salaries in full and on time;
(d) If the employer fails to pay social insurance premiums in accordance with law;
(e) In other circumstances prescribed by law.

Article 57 stipulates that if the employee does not give advance notice as prescribed, he shall pay compensation to the employer equivalent to twice his or her monthly salary.

Our comments

Under the above provisions, the previous practice of signing fixed-term (often 1-year) contracts is discouraged by making it more difficult to terminate such contracts before expiry. If contracts are terminated in breach of these and other provisions, then the employee can claim for re-instalment, or demand a higher severance pay. In this way, the Draft excludes the possibility of the employee to demand liquidated damages for illegal termination of the contract.

The Draft gives employees much freedom to terminate the labour contract at will. Since the employer can also not claim for damages in case of the employee's early termination, the only restriction is the 30-day notice, or two months' wages in lieu thereof.

VII. Severance Pay

Article 39 of the Draft provides that when a labour contract is terminated, the employer must pay the employee severance in all circumstances except the following:

- If the labour contract is terminated by the employee during the probation period (Article 36).
- If the employee has begun to draw old age pension (Article 37 (2)).
- If the parties agree to termination (Article 30) as long as it was not the employer that proposed such termination to the employee (Article 39 (1)).
- If the labour contract is terminated for one of the reasons under Article 31 (see above).

The amount of severance is equivalent to 15 days' pay for up to six months of service, one month pay for six months to one year of service, and one month pay for each additional year of service. The method of calculating severance pay, as per the last paragraph of Article 39, shall be specified by the labour authorities at provincial level.

If a labour contract is terminated unlawfully, i.e. under circumstances other than listed above, then severance pay shall be doubled (Article 42).

Our comments

The biggest change that the Draft introduces with regard to severance pay is that such pay should be paid even when a labour contract terminates due to expiration of its term. Thus employers are no longer able to avoid severance pay in this way. This may even be the case if upon term expiration the employee refuses to sign a new contract. One way out seems to be that severance pay need not be paid if the termination is proposed by the employee, for reasons other than as listed in Article 36 of the Draft.

Another important amendment to current law and practice, and one that is in the employer's favour, is that severance seems no longer to be calculated with direct reference to the employee's salary, but rather by a calculation to be decided by relevant authorities. One interpretation is that reference will likely be made to a particular industry or region.

VIII. Staffing agencies

The Draft introduces a complete new system on regulating "staffing agencies", defined in Article as employers that employ workers and place them to work for another company. Such agencies face high capitalization requirements, including a minimum registered capital of RMB 500,000 and a deposit per placed worker of not less than RMB 5,000.

Moreover, if an employee has been placed for one full year, the placement has to be substituted by either direct employment by the unit where he or she was placed, or termination of the placement (in which case the same position may not be taken by another employee through a placement arrangement) (Article 41).

Obligations towards the employee shall be divided among the staffing agency and the final employer as per the

terms of the placement agreement (Article 24), the contents of which a copy of which shall be provided to the employee (Article 12). In case of dispute, the staffing agency and the final employer shall bear join and several liability for the damages (Article 59).

Our comments

The provisions relating to Staffing Agencies seem to relate directly to the practices by many foreign companies to hire staff through such agencies (such as FESCO). The new capitalization requirements will make it more difficult and costly for labour agencies to operate in this business, while the involvement of a labour agency will no longer protect the actual employer from obligations and liabilities under Chinese labour law.

IX. Conclusions

The draft version of the Labour Contract Law provides so many drastic changes to the current system, that it could be described as a whole new approach to Chinese labour law management and practices. Of course it is important to remember that the Draft has not yet been promulgated, and so changes may still be possible. The great number of reactions that the Draft has provoke, including from respected chambers of commerce for example, certainly indicate the concerns that many employers in particular have regarding the provisions therein. Their application to both new and all existing labour relationships will compel many employers to drastically adapt their human resource policies and alter existing contracts, by no means an easy task.

Nonetheless, it can be argued that this Draft is needed to curb current malpractices in employment relationships, as it strengthens the position of employees versus employers. If employers find it fair or not, in any case the Draft provides more clarity on a number of points. Employers may have to approach the issues differently, but more than ever, upon promulgation of the Draft, they will be clear on how to lawfully manage employment relationships under Chinese law.

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