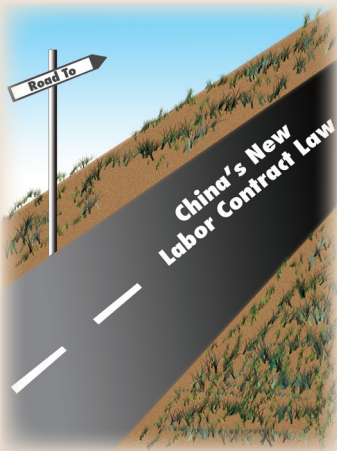


# By letter or by spirit?

## Interpreting China's new labour contract law



*With major changes to China's labour contracting laws on the horizon, questions remain about the intent of the provisions. Can the authorities ensure consistent interpretation and application of the new law?*

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It has been over five months since the National People's Congress approved China's new Labor Contract Law, and as of mid-December 2007, questions still persist regarding how this law is to be implemented. On paper, the new legislation marks a significant change in PRC employment law, by expanding employee protections and strengthening collective rights through the promotion of unions and employee representative congresses. In practice, however, the impact of this law will depend on how diligently and uniformly the Chinese government (at the central and local levels) enforces it, and how the government chooses to interpret the law. Will it focus on the 'letter' or the 'spirit' of the law?

So far, it is hard to tell. The law will take effect on January 1, 2008, and as of this writing there are still no implementing

regulations promulgated to further clarify the law. There are hints of continued internal 'discussions' among regulators and interested parties about the 'intent' of certain provisions. And some attempts to implement the law have already been publicly denounced by the government. Most surprising is the fact that the targets of the government's denunciation thus far have been large Chinese companies; one such company attempted to take advantage of a legalistic loophole, but was told such action was contrary to the 'spirit' of the law. It is now our understanding that the implementing regulations will be issued after January 1, by the Legislative Affairs Office of the State Council (not the Ministry of Labor and Security).

Whether the government will make it a priority to ensure consistent interpretation and application of the law throughout China is currently unknown. Regardless, the law – by its mere enactment – has resulted in higher costs

for employers arising from the need to abide by the 'letter' of the law, and may continue to result in further costs as the 'spirit' of the law becomes more apparent. Regarding this latter point, it is unclear from its text whether the law applies to 'representative offices' of foreign enterprises. Moreover, it remains uncertain whether employment contracts concluded prior to the implementation of the new law are grandfathered. Even officials who participated in drafting the law are of different minds on certain provisions, such as the procedures for formulating an employer's internal rules and changes to the labor dispatch regime. Implementing regulations might or might not shed light on these and other questions.

Needless to say, it is difficult to implement the new law without knowing the answers to these questions. This is why it is important to understand where potential pitfalls might exist between the 'letter' and 'spirit' of the law. Counsel who are experienced at navigating the ambiguities of the Chinese legal system can best understand -- and perhaps even take advantage of -- the fact that the most crucial requirement in providing counsel on full implementation is to determine the 'spirit' behind the 'letter' of the law. To survive in China one must fully comprehend the intermingling of law and policy.

This article identifies some of the issues that need to be resolved in determining the direction that full implementation of the new law will take.

### **Company Rules/Codes of Conduct /Employee Handbooks**

The law requires that the process of adopting company rules, codes of conduct, or employee handbooks must entail:

- consultations with all employees or an employee representative congress, and opportunities for all employees or an employee representative congress to comment and/or to submit new proposals;
- negotiations with labor union or employee representatives to 'improve' employment rules; and
- public announcements or other such notifications to make employees fully aware of such rules.

In short, employees now have increased opportunities to participate in the development of employment policies, such as compensation, work hours, safety and health, rest and leave, insurance, training, benefits, and any matter that arguably has a 'direct bearing on the immediate interests' of the employees. These provisions foreshadow

greater government intervention in management-labor relationships, as labor unions in China are quasi-governmental organisations established at various levels in parallel with government agencies. Failing to follow these procedures places the employer at risk of having its policies deemed invalid. Moreover, an employer's decision to dismiss an employee based on rules that were not formulated according to the above so-called 'democratic negotiation procedures' may be considered illegal, thus subjecting the employer to liabilities. However, it is unclear what would constitute proper 'democratic negotiation procedures,' although more than a few officials believe that the law will continue to allow employers to maintain control over formulating and amending employment policies.

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### **Individual Employment Contracts**

The law requires written contracts. The basic terms that must be explicit include the term of the contract, the job description, remuneration and benefits, and enumerated protections in working conditions and against occupational hazards, among others. Three sections that must be included in the labor contract if an employer wants to take advantage of them are the term of probation, the penalty for the employee failing to work for the employer following employer-paid training, and the penalty for failure to maintain confidential secrets. These contracts must be well-drafted at the outset in order to ensure sufficient flexibility to allocate resources as necessary, as any subsequent change to the contract will be subject to further negotiation between worker and employer.

The law also stipulates penalties for various failures to

implement the written employment agreements. If no employment contract is signed within one month of commencement of an employee's work, for instance, the employee is entitled to double wages. If a term agreement is signed but the employee was entitled to an open-ended agreement, the employer will also have to pay double wages. An employee can recover damages if any failure by the employer to include the appropriate language in the labor contract causes him harm. Finally, if the contract is not signed within one year of commencement of the employee's work, the parties are deemed to have signed an open-term contract (see below). With these and other stipulated penalties, employers face increased pressure to sign or renew contracts in a timely manner.

#### Fixed-Term versus Open-Term Contract

The law distinguishes between three types of labor contracts: fixed-term, open-term, and contracts based on the completion of an assignment. Employers often prefer the fixed-term employment contract because it gives them more control over their ability to remove a worker who is not performing adequately. Employees, on the other hand, strive to acquire an open-ended contract because it provides significant job security. Contract termination laws generally favor the employee. The law takes a pro-employee approach, and limits an employer's ability to conclude multiple fixed-term agreements. It stipulates that, after an employee has completed two fixed-term contracts, or if an employee has worked for the same employer for at least 10 consecutive years, an open-term contract shall be concluded. Also, this new law establishes that the employee is entitled to receive severance pay upon expiration of a fixed-term contract.



Illustration: Johnnie Au

#### Non-Compete Restrictions

Non-compete restrictions may be included in employee contracts, but they are limited to a maximum term of two years following employment termination, and may only be incorporated in contracts with senior management, technical personnel and employees with a 'confidentiality obligation.' Further, non-compete restrictions may be limited to geographic regions. Consistent with current practice, the new law stipulates that any non-compete clause shall include financial compensation to be paid by the employer in

monthly installments during the post-termination, non-compete period. The law further states that wages paid during active employment cannot be deemed to be financial compensation for a post-employment obligation, although it does not dictate any formula for determining this amount of contribution. Given the lack of detail, it is likely that local regulations may apply.

Similarly, the law contemplates that contracts may include clauses requiring employees post-employment to protect trade secrets and other intellectual properties. It appears that such provisions are separate from non-compete clauses, and thus not subject to the two-year or the senior management rules. Although no further details are provided, pursuant to the PRC intellectual property laws, the length of the 'confidentiality' obligations imposed on employees could be equivalent to the protected terms of the intellectual property rights in question.

#### Termination of Employment

Employees may be terminated under any of the following conditions:

- when the worker is unable to work in either his original capacity or following the prescribed period of medical care for an illness or non-occupational injury;

- when the worker is incompetent even after training and adjustment of his position;
- when a major change has occurred in the objective circumstances on which the labor contract was negotiated, and the employer and employee cannot reach a new agreement following negotiations;
- in certain circumstance set forth under the law for 'economic' reasons, such as when the employer is re-organised according to the bankruptcy law, or when the employer makes important technological renovations or adjusts the form of business operations; or
- at the conclusion of most fixed term contracts. In these circumstances, the employee must be given a 30-day written notice, or one month's wage in lieu of notice.

Employees may also be terminated without severance pay and without notice in the following circumstances:

- the employer 'proves' that the employee did not meet the conditions of employment during the probation period;
- the employee 'materially' breached the rules and regulations of the employer;
- the employee's actions resulted in a 'serious dereliction of duty,' or is considered the practise of 'graft', causing 'substantial damage to the employer';
- the employee engages in activities that conflict with the interests of the employer and does not seek to rectify the situation;
- the employee uses 'deception' or 'coercion' to conclude the employment contract; or
- the employee commits a crime.

Many of the terms used in these provisions are undefined.

In cases of unilateral termination, even though notice to the employee is unnecessary, the employer must still notify the labor union in advance of the termination, and provide it with the reasons for the decision. The union may review the circumstances and demand that the employer follow the law, if the union believes the employer has not done so. It is unclear, however, whether notice is required for companies that do not have labor unions (such as foreign-invested enterprises).

### **Labor Dispatch Services**

Under the prior law, representative offices of foreign businesses were required to secure their local employees through FESCO. The text of the new law, however, appears to provide that representative offices will be able to employ their

staff directly, and may only be required to use FESCO to fulfill 'temporary, auxiliary, or substitute positions.' However, FESCO has taken the position that it will continue to be the sole 'labor dispatcher' for representative offices, despite the language of the law. And after much debate, this now indeed appears to be the case. Moreover, it appears that representative offices will now be required to undertake

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certain obligations directly related to their FESCO-dispatched employees, such as providing working and employment-protection conditions as required by the new law, and providing welfare and treatment according to the employees' posts. Furthermore, the conditions under which representative offices may dismiss their FESCO employees are much stricter than the conditions for normal employers (for example, the representative offices cannot dismiss employees for 'economic' reasons, noted earlier). In addition, the new law stipulates that, should FESCO violate the law which result in damages to an employee dispatched to a representative office, the representative office shall assume joint liability. Taken together, the new law appears to put representative offices in a weaker position than before when dealing with employment affairs.

In sum, the only thing that is clear about the new Labor Contract Law is that it is not entirely clear how to implement it. It behooves employers in China to consider an ongoing implementation strategy that takes into account the 'letter' of the law, while continuing to seeking counsel regarding the evolving views of the 'spirit' of the law.

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