

# The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 15, No. 12

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December 2007

## China—Law Firms

# China Passes New Labor Contract Law In Effort To Achieve Its Goal Of Maintaining A “Harmonious Society”

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The comprehensive Labor Contract Law (LCL) was passed on June 29, 2007 by the Chinese Standing Committee of the National People's Congress (the highest legislative body in China) and will take effect starting January 1, 2008. Although the LCL includes some provisions that have appeared in the previous legislation, what makes this new law different is the Chinese government's willingness to enforce mandates to protect employees' rights. Under the LCL, employers are required to give employees written labor contracts, the use of temporary labor is restricted in certain ways, and firing employees becomes more

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difficult and costly. Collective bargaining for wages and benefits is also allowed under the new law. Despite the foreign investors' complaints that the new law makes it more difficult to do business in China, and that it erodes the mainland's low-cost labor advantage, the Chinese government has pursued this new law as its latest step in its campaign for a “harmonious society.”

The updates of this new law can be summarized by the following key points:

### **Noncompete Agreements**

Articles 23 to 25 of the LCL provide that contractual parties may decide on specific geographic restrictions and compensation for violation of noncompete clauses, but the term of the agreement may not exceed two years. Noncompete clauses, however, may be included only in contracts with senior management and technical personnel and employees with a confidentiality obligation.

### **Written Labor Contracts**

The LCL requires that an employment relationship be based on a written labor contract and that the relationship commence on the employee's first day on the job.

Under Article 10 of the LCL, if an employee starts working before a written labor contract is executed, such a labor contract must be executed within one month of the employee's first day on the job.

Also, in the event that an employee signs a labor contract prior to the start of his or her employment, the employee's start date shall be the actual date the employee

begins work, as opposed to the date the labor contract was executed. Note that this date will be important for purposes of calculating such time periods as the probationary period and the period for calculation of severance.

### **Probationary Periods**

Articles 19 to 21 of the LCL provide that the contracting parties may decide on a probationary period for new employees, the maximum duration of which is determined by the length of the contract. The period may not exceed one month if the contract is for less than one year, two months if it is between one and three years, and six months for fixed-term contracts of more than three years or for open-ended contracts. Employers may not terminate employees during the probationary period unless they can prove that the employee did not meet employment conditions. What constitutes adequate proof, however, is not provided in the new law.

### **Training Costs**

Article 22 of the LCL allows employers that incur training costs for particular employees to require a fixed term of service from those employees who receive such training benefits, and permits employers to collect damages from employees when they are in violation of their term of service.

### **Role Of Labor Unions**

Compared to the current labor law, the new law grants labor unions a greater role in negotiations and decision-making than the existing labor law. Employers are required to consult with their labor unions or “employee representatives” on an “equal

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basis” in setting policies regarding labor compensation, work hours, rest and leave, labor safety and health, insurance and benefits, training, and labor discipline and quotas, among others things. The LCL, however, does not include language on dispute resolution if the “consultations” between employer and labor union or “employee representative” do not work out.

### Invalid Labor Contracts

Article 26 of the LCL provides that a labor contract shall be invalid in any of the following circumstances:

- The employee’s consent to enter into or alter a labor contract is obtained through threat or other forms of duress;
- The employer eliminates its own statutory obligations or excludes the employee’s statutory rights through negotiation; and
- The labor contracts contain terms which are contrary to the statutory provisions of the laws and the administrative regulations.

The second circumstance is a new provision under the LCL. Under the law, the employer must be mindful when seeking waiver from an employee for any statutory right, for example, overtime work payment or severance payment for early termination of a labor contract.

It is also worth mentioning that, as observed by many commentators, even though the employer obtains the employee’s written agreement to waiver, the employer is still at risk that such waiver will be deemed invalid by a labor arbitration commission or court.

### Terminating A Labor Contract

#### Severance pay

Article 46 of the LCL requires severance payments in the following circumstances:

- An employee terminates the labor contract for legal reasons, for example, where the employer fails to pay salary to the employee on time or for the correct amount, or fails to contribute social benefits for the employee, or the internal rules of the employer violate laws and regulations contrary to the interests of the employee, as provided in Article 38 of the LCL;
- The employer terminates the labor contract and reaches mutual agreement with the employee for the termination, as provided in Article 36 of the LCL;
- An employer terminates the labor contract for cause, because the employee is not competent to perform the job, or the objective circumstances at the time of concluding the labor contract have materially changed such that the labor contract cannot be performed, as provided in Article 40 of the

LCL;

- The employer will restructure according to the PRC Enterprise Bankruptcy Law, and must lay off employees, as provided in Article 41 of the LCL;

- The employer terminates the fixed-term labor contract when the contract expires, as provided in Article 44 (1) of the LCL;

- The employer will dissolve, cease its business, go bankrupt, lose its business license or be ordered to close, as provided in Article 44 (4) and (5) of the LCL; or

- Other situations as may be stipulated by laws and regulations.

The amount of severance pay is set at one month’s salary for each year of employment, up to 12 years. For employment lasting less than one year but more than six months, severance pay shall be treated as if for one year. For employment lasting less than six months, severance pay shall be paid in the amount of one-half of the employee’s monthly salary.

#### Lay-offs

The LCL identifies the following four grounds for economic lay-offs:

- Bankruptcy-related reorganization;
- Serious difficulties in operation of the business;
- Change in the business, such as a major technical innovation or change in operational models; and
- Change in the objective circumstances of the company.

Lay-offs in these circumstances can only take place if an enterprise needs to lay off either 20 or more employees, or fewer than 20 employees but the number of laid-off workers accounts for ten percent of the total number of employees. In addition, the employer must consult with the labor union, listen to the opinions of the employees or the union, and report the intent to lay off employees to the labor authorities.

In addition, the LCL provides that when the employer lays off its employees, the employer should give priority consideration to retaining the following employees:

- Those with long-term, fixed-duration labor contracts with the employer;
- Those with non-fixed duration labor contracts with the employer; and
- Sole-income providers or those with elderly relatives or children.

### Will Foreign Investors’ Interests Be Harmed By The New Law?

The LCL is really aimed at changing unfair labor practices in China. However, the inadvertent consequence of the new law will be an increase in the cost of doing business in China, particularly for companies with large staff requirements or skilled

workers with high salaries. Companies currently transitioning their workers from labor agents to direct hires should be aware of the new law, and should draft their labor contracts in anticipation of complying with the new law in the coming new year.

Organizations representing firms doing business in China have objected to certain provisions they deem unclear and are concerned that they will make the foreign investments more difficult in China. In response to that, on June 29, 2007, Ms. Xin Chunying, the deputy chairwoman of the National People’s Congress Law Committee, tried to allay the fears of foreign companies. “If there were some bias,” she said, “it would be in favor of foreign investors because local governments have great tolerance for them in order to attract and retain investment.” On July 3, 2007, China Xinhua News released a comment from Mr. Liu Jichen (director of the law department at the All-China Federation of Trade Unions) that the newly approved LCL will not undermine the investment environment even though it will better protect employees’ interests and rights. Mr. Liu denied that the law is biased toward employees. “It not only protects employees’ interests and rights, but also equally protects employers’,” he told a press conference. As an example, he said that the employers can sign noncompete contracts with their employees, with a maximum noncompete period of two years to encourage innovation and ensure fair competition. So an employer can rest assured that an employee who signs such a noncompete agreement cannot walk out at the end of the contract period and join a direct competitor without paying damages to the employer.

### Impact On Current Employment Contracts

The current employment contracts shall remain in effect and not be affected until January 1, 2008. Under Article 97 of the LCL, employment contracts entered into before January 1, 2008 and still effective then will continue to be effective under their original terms. However, the then-existing employment contracts that are not in written form must be put in writing within one month after the effectiveness of the LCL, in other words, before February 1, 2008.

For employment contracts that are entered into before January 1, 2008 but are terminated after the LCL takes effect, the LCL shall be the basis for compensation calculations when compensation is required under Article 46 of the LCL.

The key challenge for the LCL right now, as said by many observers, should be enforcement by the Chinese authorities.