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## **China's New Labor Contract Law**

Effective January 1, 2008

### **Overview and Recommended Action Steps for Employers**



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**PREPARED BY**

Edward J. Epstein, Managing Partner  
Troutman Sanders LLP  
23/F CITIC Square  
1168 Nanjing West Road  
Shanghai 200041  
86.21.6133.8989 tel  
86.21.6137.8189 fax

[www.troutmansanders.com](http://www.troutmansanders.com)



## China's New Labor Contract Law

On June 29, 2007, the Standing Committee of the PRC National People's Congress adopted the PRC Labor Contract Law. The Labor Contract Law will come into effect on January 1, 2008 and will restate, supplement and make many sweeping changes to Chinese employment law, which has been settled over the last 17 years by the PRC Labor Law ("Labor Law") and local labor regulations.

The new Labor Contract Law is the product of two years of drafting deliberations. Three drafts have been publicly circulated and comments were submitted by a wide variety of interested parties (including foreign chambers of commerce) in a consultation process that is rarely seen in making of Chinese law.

There is no question that the new law has changed many well-established rules and filled loopholes that have long been considered too favorable to employers. It is also apparent that the law will continue the inexorable trend towards unionization of foreign enterprises and strengthen the power of union representatives. But the immediate result could have been far worse for employers and the response to the Labor Contract Law from some employer lobbies has been positive.

Here are highlights of some of the important changes to the well-settled rules of employment in China:

- Currently, an employee has no right of renewal of a fixed-term contract but under the Labor Contract Law, the employer must renew the contract on the same terms or pay severance
- The maximum probationary period for labor contracts between 1 and 3 years has been reduced to 2 months (from 3 months)
- The employer must notify the labor union in advance of its decision to terminate an employee and if the labor union believes the termination would be unlawful, it may request the employer not to terminate; the employer must respond to the labor union's request in writing
- Employees no longer need to request permanent employment terms after they have satisfied the requirements and permanent employment now appears to be a right after two fixed-term contracts rather than after 10 years of continuous employment
- Labor contracts must still be in writing but failure of the employer to sign a contract after one month of commencement of employment will require payment of double salary and after one year will result in a permanent employment
- Non-compete agreements are recognized but non-compete period is reduced from 3 to 2 years and compensation for the non-compete must be paid monthly after termination
- Liquidated damages payable under training agreements cannot exceed the training costs prorated over the agreed period of service after training
- Company rules and regulations are not binding unless negotiated and agreed by employee representatives
- Liquidated damages for breach of labor contract are invalid (except for training contracts)



### 1. Company Rules and Regulations

The Labor Contract Law requires that company rules and other important issues which relate directly to employees' interests, such as compensation, work hours, rest and leave, labor safety and hygiene, insurance and welfare, training, labor discipline and workload management, shall be negotiated between the employer and employee representatives or labor union. It is unclear how the court or labor arbitration will interpret this provision but it is likely that after January 1, 2008 company rules not negotiated with labor union or employee representatives will be unenforceable. This could be a serious impediment to terminating an employee in serious breach of company rules. Under both the Labor Law and the Labor Contract Law, an employer may terminate its employee without notice and without paying severance where the employee is in serious breach of company rules.

**Action:** *Prepare to negotiate with employee representatives the company rules to be effective after January 1, 2008.*

### 2. Written Labor Contract

The Labor Law requires employment contracts to be in writing as evidence of employment. The Labor Contract Law further requires that an employer must sign a written employment contract with its employee within one month after the employee commences employment or the employer will have to pay the employee double salary until the employment contract is signed. If a written employment contract is not signed after one year, the parties will be deemed to have entered into a permanent employment relationship.

**Action:** *Ensure that all employees are under written employment contracts by January 1, 2008.*

### 3. Probationary Period

The Labor Contract Law has shortened the length of the probationary period:

Employment Term	Probationary Period
1) Less than 3 months or not fixed but expires upon completion of a certain job	No probation period
2) 3 months – less than 1 year	≤ 1 month
3) 1 year – less than 3 years	≤ 2 months
4) 3 years and non-fixed term	≤ 6 months

The Labor Law only provides that in no event should a probationary period exceed six months and detailed rule on probationary period are provided in local labor regulations which vary from place to place.

The Labor Contract Law also requires that employees' salary during the probationary period shall not be less than either the lowest salary applicable to employees working for the same employer in the same position or 80% of the agreed salary stipulated in the employment contract. In no event should employees' salary during the probationary period be below the minimum wage where the employer is located.

**Action:** *Amend standard employment contracts to be entered into after January 1, 2008 so that the probationary period complies with the Labor Contract Law.*



#### 4. Permanent Employment Contract

The Labor Law requires an employer to enter into a permanent employment contract with its employee when the employee has been working for the employer continuously for 10 years and the parties agree to renew the employment.

This has been modified by the Labor Contract Law to include situations where:

- a) Two fixed-term contracts have already been completed; or
- b) (Where the employer is a state-owned enterprise) the employer starts implementing an employment contract system the first time or the employment contract has to be resigned upon restructuring of a state-owned enterprise, and the employee has been working for the employer consecutively for over 10 years and will retire in the next 10 years.

Under the Current Labor Law, a permanent employment contract is required to be entered into only if the employee so requests. However, this loophole has been removed from the Labor Contract Law and now as long as the above condition precedents are met, an employer must enter into a permanent employment contract with its employee unless the employee requests a fixed-term employment contract.

**Action:** *Investigate which employees have been working for the employers continuously for 10 years by January 1, 2008.*

#### 5. Non-compete

The Labor Law does not regulate employee non-compete agreements but there are various circulars issued by the Ministry of Labor and Social Security and local labor regulations, which cap the employee non-compete period at three years. There are no detailed national rules on consideration payable for employee non-compete. In some places in China, local regulations have minimum requirements on compensation for employee non-compete but in other places, there is no such requirement and therefore the amount of the compensation is subject to negotiations between an employer and its employee.

The Labor Contract Law limits the employee non-compete period to two years and the compensation for employee non-compete shall be paid monthly within the non-compete period. Other terms and conditions of the non-compete (scope, term, geographic restrictions etc.) are subject to negotiations between the employer and the employee.

**Action:** *Amend non-compete clauses in standard employment contracts to be entered into after January 1, 2008 to comply with the Labor Contract Law.*

#### 6. Training and Service Period Agreements

Under the Labor Law, where an employer incurs expenses to provide training or other special treatment (e.g. housing) to its employee, the employer may require the employee to sign an agreement whereby the employee is bound to continue to be employed by the employer for a period of time up to three years. In addition, the employer may enforce liquidated damages against the employee where the employee breaches the agreement.

Under the Labor Contract Law, an agreement for a service period can be entered into only where an employer provides professional or technical training to its employee against specifically allocated training funds, which is not defined. In addition, the total amount of agreed damages for an employee's breach of the service period agreement is limited to training costs incurred by the



employer for that employee and liquidated damages paid by the employee shall not exceed the amount prorated over the service period.

**Action:** *Prepare new training contracts or amend training clauses in standard employment contracts to be entered into after January 1, 2008 to comply with the Labor Contract Law, especially provisions on the maximum service period and prorated liquidated damages.*

## 7. Agreed Damages

The Labor Contract Law specially provides that an employer is not allowed to enforce liquidated damages against its employees except where the employee is in breach of a training agreement or non-compete agreement.

This may prove to be a short-sighted employee protectionist rule that could create havoc for employers who rely on fines for breach of workshop disciplinary rules, such as non-smoking violations, that are effective in maintaining safety in the workplace. Perhaps if such fines are agreed with employees as part of the company rules, they may still be enforceable.

**Action:** *Assess whether liquidated damages and fines practices comply with the law and amend their standard employment contracts and company rules to be used after January 1, 2008.*

## 8. Invalid Contracts

Under the Labor Law, an employment contract is deemed to be void if:

- a) the employment contract violates laws and administrative regulations; or
- b) the employment contract is entered into by fraud or coercion.

The Labor Contract Law further provides that an employment contract under which the employer excludes its statutory obligations or the employee's rights shall also be void in part or as a whole.

**Action:** *Amend standard employment contracts to be entered into after January 1, 2008 to comply with the Labor Contract Law.*

## 9. Termination of Employment Contract

### 9.1. Additional grounds for termination of employment

The Labor Contract Law has added the following grounds for termination of employment:

#### (1) Employee's rights to terminate

Where the employer fails to pay the social security contributions for the employee or the company rules of the employer violate laws and administrative regulations and are detrimental to the employee's rights and interests.

#### (2) Employer's rights to terminate with immediate effect

Where the employee has entered into another employment relationship and this substantially affects the employee's ability to perform his work for the employer or the employee refuses to rectify after the employer so requires.



## 9.2. Additional restrictions on termination of employment

Under both the Labor Law and the Labor Contract Law, an employer is allowed to terminate its employee with 30 days' notice under certain circumstances. There are restrictions on the employer's exercise of such rights under the Labor Law (for example, when the employee is in the statutory medical treatment period, the employee has lost all or part of his capacity to work due to work related disease or injury, the employee is pregnant or is on maternity leave or breast-feeding leave). The Labor Contract Law has extended such restrictions to include:

- a) Where the employee has been engaged in work that may result in occupational diseases and has yet to go through health examination prior to termination, or the employee is suspected of having suffered occupational disease and is currently under diagnosis or medical observation;
- b) Where the employee has been working for the employer consecutively for over 15 years and will retire within the next five years.

In addition, the Labor Contract Law requires that where an employer decides to terminate its employee, the employer must notify the labor union of the grounds for such termination in advance. The trade union may request the employer not to terminate the employee if the trade union believes that such termination violates laws, regulations or the employment contract and the employer must respond to the trade union in writing.

There are similar requirements in the current PRC Trade Union Law but such requirements have never been strictly enforced by the court and labor arbitration tribunal.

**Action:** *Amend standard form employment contracts to be entered into after January 1, 2008 to comply with the Labor Contract Law.*

## 10. Right to Extend a Fixed-Term Employment and Severance

Under the Labor Law, an employer does not have the obligation to renew a fixed-term employment contract and if the employment contract expires and is not renewed, the employer is not required to pay employee severance.

Under the Labor Contract Law, however, an employer is required to pay its employee severance if the employment contract expires and is not renewed unless the employer has offered to renew the employment contract on the same terms and conditions but the offer is rejected by the employee.

Under the Labor Contract Law, the severance is calculated based on one month's salary for each year of employment completed by the employee and is capped at 12 months' salary or 12 times 300% of the average monthly salary of the previous year at the place where the employer is located, whichever is lower.

## 11. Unlawful Termination

Under the Labor Contract Law, in the case of unlawful termination of the employment contract by the employer, the employee is entitled to require reinstatement. The employer is required to pay damages to the employee if the employee does not require reinstatement or it is impossible for the parties to continue to perform the employment contract.

The amount of the damages shall be equivalent to twice the severance which would be payable by the employer if the employee had been lawfully terminated. Such severance is calculated by reference to the employee's actual monthly salary or 300% of the average monthly salary, whichever is less. (see Section 10 above)



## **12. Lay-offs**

The Labor Contract Law provides that where an employer needs to lay off more than 20 employees or an employer needs to lay off less than 20 employees but such employees constitute 10% of the employer's entire labor force, the employer must disclose the lay-off plan to and consult with the labor union or all of its employees 30 days before the lay-off plan is executed. In addition, the employer is not allowed to execute its layoff plan until the lay-off plan has been reported to labor authority.

The Labor Contract Law further provides that the lay-off provided above can take place only upon the occurrence of the following events:

- (1) Where the employer is going through a restructuring in accordance with the enterprise bankruptcy law; or
- (2) Where the employer has encountered serious operational difficulties; or
- (3) Where the employment contracts cannot be performed due to substantial change of the circumstances under which the employment contracts were entered into; or
- (4) Where the employer is changing its product lines, going through substantial technology renovation or adjustment of business operations, and it is still necessary to lay off employees even after employment contracts have been amended.

The last provision is new grounds for lay-offs but the other grounds are basically the same as those provided in the Labor Law.

According to the Labor Contract Law, the employer shall retain the following employees in the following priority in a lay-off:

- a) Employees who are under long term employment contracts;
- b) Employees who are under permanent employment contracts;
- c) Employee who need to support old and underage family members but do not have other family members who are currently employed.

## **13. Labor Unions**

The Labor Contract Law allows labor union to play a bigger role in terms of employment in China. A labor union may negotiate collective employment contracts with employers on behalf of employees. At the county level, labor unions may even represent employees of an entire industry to enter into collective employment contracts. Where an employer breaches a collective employment contract, the labor union may require the employer to rectify and may eventually apply for labor arbitration or start law suits against the employer in its own name.

## **14. Secondment of Employees**

Secondment of employees is not currently regulated under the Labor Law.

The Labor Contract Law now provides that secondment of employees can be done only through a licensed labor service company and the labor service company must enter into an employment contract with a term of no less than two years with an employee to be seconded. As a result, after January 1, 2008, labor service companies such as FESCO or CIIC may require each employee to be seconded for a term of at least two years.



In addition, the Labor Contract Law provides that employees can be seconded only for temporary, ancillary or replaceable positions. However, it is unclear how this will be interpreted.

Foreign representative offices and branch organizations of foreign organizations cannot directly employ their local staff and must use employees seconded through a labor service company. It is interesting that earlier drafts of the Labor Contract Law proposed to allow foreign representative offices to employ their local staff directly but this threat of loss of business must have resulted in lobbying by the major labor services companies, which are all state-owned.

Is it possible that foreign representative offices will be able to employ long-term employees directly? If so, the customary one year, fixed-term employment contract term will remain unchanged. If not, the introduction of a two year term plus the right to renew will greatly reduce the flexibility of employment in foreign representative offices. Moreover, foreign invested enterprises who now outsource handle HR and payroll management to a labor service company may find it desirable to bring this function in-house.

**If you have any questions please contact:**

Edward Epstein - [edward.epstein@troutmansanders.com](mailto:edward.epstein@troutmansanders.com)

John Xia - [john.xia@troutmansanders.com](mailto:john.xia@troutmansanders.com)

Sanford Hausner - [sanford.hausner@troutmansanders.com](mailto:sanford.hausner@troutmansanders.com)

Coburn Beck - [coburn.beck@troutmansanders.com](mailto:coburn.beck@troutmansanders.com)

Also see [www.troutmansanders.com](http://www.troutmansanders.com)

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