

## Hewitt Global Report

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### **China's Labor Contract Law and Implications for Workforce Management: Draft II**

**In late December 2006, the Standing Committee of the National People's Congress (NPC) received the second draft of the new *Labor Contracts Law of the People's Republic of China*. If passed, the law would fundamentally alter workforce management in the country. Employers would be required to review and likely revise existing employment contracts and inform and consult with trade union representatives over employment terms and conditions.**

**In February 2007, Hewitt Associates, in partnership with Baker & McKenzie, sponsored a survey designed to measure employer reaction to the second draft law; 436 companies participated. The survey highlights are included in this report.**

Employment and labor law in China underwent its last major revision in the mid-1990s, just prior to the country's rapid industrialization and urbanization. As a result of these economic and geographic changes and evidence of China's surplus labor pool, the government decided to revise existing laws to give employees greater protections with regard to the establishment and termination of employment contracts and the drafting of work rules and other employment terms and conditions.

The State Council passed the *Labor Contracts Act* in October 2005, and it underwent a first reading by the Standing Committee of the NPC. In March 2006, the government opened a one-month comment period, during which it encouraged the public to send its opinions and observations to the legislature. The comment period closed in April 2006; an estimated 191,000 comments were received. The *Labor Contracts Law* was redrafted (second draft) and presented to the Standing Committee for a second reading. Generally, a draft law must be read by the Standing Committee three times before it is approved. The third reading is expected within a few months, and the law may be passed sometime in 2007.

This report reflects the most significant aspects of the *Labor Contract Law* in its current form. If changes are made to the draft legislation and/or the government provides clarifications, updates to the report will be provided.

## **Employment Contracts**

China does not observe the principle of employ-at-will. Employers frequently offer employees short-term contracts, one to three years in length, to maintain flexibility in workforce management. In order to avoid the costs associated with the termination of an employment contract for reasons other than just cause (generally 30 days' notice and one month's pay for each year of service typically capped at 12 months' pay), employers simply wait for the employment contract to expire. The second draft of the *Labor Contract Law* would impose greater regulations on the use of fixed-term contracts, introduce new probationary periods, change noncompete agreements, and affect the way collective dismissals are handled.

Under the second draft law, employers would be required to provide employees with a written employment contract within one month of start of employment. Unless specified by contract, the employee's compensation would equal that established by collective agreement or the compensation paid to employees holding the same position. To enforce this provision, the government would require employers to pay an employee two times his or her regular compensation if an employment contract is not provided after one month of the start date. Employees with ten or more years of continuous service are entitled to an open-ended employment contract. Employment contracts would be considered open-ended unless otherwise specified.

Employees with open-ended employment contracts would remain entitled to at least 30 days' notice and one month's pay per year of service, unless otherwise stipulated by municipal regulations, collective agreement, or individual employment contract.

## **Fixed-Term Contracts**

Employers may continue to offer fixed-term contracts to employees; however, the draft law would prohibit an employer from terminating a fixed-term contract before it expires, except in the event of just or legal cause or a collective dismissal. Legal cause would be defined as the following circumstances:

- Employee swindled or menaced by the employer when concluding the employment contract;
- Conflict of interest between the employer and employee which undermines "national, social, or individual benefits and interests";
- Parties not legally qualified to conclude an employment contract;
- Employee deprived of his or her rights by the employer; and
- Other circumstances, stipulated by law and regulation.

Under the second draft law, an employer would be able to offer an employee only two fixed-term contracts. After the second contract has been completed, the employee would be entitled to request an open-ended contract.

If an employer failed to renew a fixed-term contract, the employee would be entitled to severance pay according to his or her length of service—15 day's pay for up to six months' service, one month's pay for six months to one year of service, plus one month's pay for each additional year

of service. An employer would not be liable for severance pay if a contract renewal with similar terms and conditions is extended to the employee and the employee refuses to accept it.

**Survey Results:** *When asked what are current terms of the standard employment contract, 55% of respondents reported fixed term of one to three years; 15%, fixed term of one year or less; 13%, open ended; 9%, varies by position; 4%, fixed term over three years; 3%, not applicable; and 1% other. Approximately 50% of respondents are planning to review their manpower planning strategy to identify the right mix of employment arrangement, while 33% have no plans to address this change. Some employers have already identified actions to take in order to comply with the pending law; however, no one action predominates. To date, these actions include limiting the use of fixed-term employees, hiring more employees from Labor Service Agencies, extending the typical length of the contract, and offering only open-ended contracts.*

**Hewitt Comment:** *The impact of the draft law is expected to be the greatest in companies that regularly use fixed-term contracts, as a severance obligation would be established for the nonrenewal of a contract and the use of these contracts would be limited. Employers should begin to review their employment arrangements in order to avoid additional hard costs and inadvertent labor shortages or surpluses.*

### **Part-Time Employment**

The second draft law provides a new definition for part-time work. Employees working no more than four hours per day and 24 hours per week would be considered part-time employees. An employer would not be required to provide a part-time employee with a written employment contract, and an employee would not be entitled to severance pay upon the termination of employment.

Part-time employees would not be given a probationary period. Employers would be required to pay these employees at least every two weeks (15 days).

**Survey Results:** *Two-thirds of respondents do not intend to incorporate the use of part-time employees in their workforce planning strategies if the law is passed. The remaining 33% of respondents, however, expects to hire more part-time employees or convert some full-time employees, contractors, or third-party employees into part-time employees.*

**Hewitt Comment:** *The new definition of part-time employee included in the second draft law introduces some flexibility in employment relationships. Given the proposed restrictions on fixed-term contracts and changing demography, employers should take into consideration how part-time employment might play a role in the future composition of their workforce.*

### **Shortened Probationary Periods**

The first draft law tied the probationary period to the type of job performed. Under the second draft law, the probationary period would be a function of the length of the employment contract:

- One-month probationary period for contracts up to one year in length;
- Two-month probationary period for contracts between one and three years in length; and
- Six-month probationary period for contracts longer than three years or open-ended.

An employer would not be able to rescind an employment contract during the probationary period unless there was clear proof that the employee was not qualified for the job. Employees would be entitled to receive the minimum wage for the relevant position or 80% of pay as established by collective agreement.

### **Noncompete Agreements**

Presently, employers may include a noncompete clause in an employment contract to prevent the employee from revealing “trade secrets” to his or her new employer. Both draft laws would reduce the noncompete clause from the current three years to a maximum of two years. Under the second draft law, noncompete agreements would be limited to specific groups of employees, such as employees who would be privy to company secrets, and senior managers and technical employees (these latter categories of employees are not well-defined in the second draft law). The scope, period, and geography covered would be determined by the affected parties.

Unlike the first draft, the second draft law does not specify the damages to be paid by an employer to an employee or by an employee to an employer for a breach of the noncompete agreement.

***Survey Results:** Respondents are planning to pursue a number of measures to align their current practices with the requirements of the draft law. The most frequently indicated action to be taken (33% of respondents) is to redraft HR policies to ensure compliance, followed by redrafting the contract template to ensure compliance for future employees, and redrafting existing contracts and agreements for staff.*

***Hewitt Comment:** The second draft law provides less clarity and guidance than the first draft law; greater clarity will be needed as noncompete agreements have become a standard provision in employment contracts or HR policies in order to stem high turnover rates among senior professional and managers. Currently, many of these agreements are unenforceable because they were drafted improperly. Any changes made to contracts and policies should be reviewed carefully to determine whether they are legally compliant.*

### **Collective Dismissals**

Like the first draft law, the second draft would change the circumstances under which a collective dismissal could occur and the procedures that must be followed. Under existing law, mass layoffs are permitted when major production and operational problems arise, and local governments determine the standards for difficulties. For example, in Beijing, a company must have recorded losses for a continuous three-year period; the company must be insolvent; at least 80% of the employees must have no work; and the company must have been unable to pay minimum living allowances to its employees for six months.

Under the second draft law, a collective dismissal would be defined as the layoff of 20 or more employees or 10% of total staff (the first draft law defined a collective dismissal as the termination of 50 or more employees). Employers would be required to inform and consult with the trade union 30 days in advance of implementing any change due to bankruptcy or other significant changes in economic circumstances; difficulties in production; relocation to prevent pollution; and other objective conditions that preclude the completion of the contract.

During a collective dismissal, certain employees would be afforded some protection from termination. Employees with long service records, with long fixed-term or open-ended contracts, and in families with no other wage earner could not be dismissed before other employees.

**Survey Results:** *The majority of respondents do not believe that they will be affected by the proposed new rules on collective dismissals—17% indicated that they would not be affected; 48% responded they would not be affected in the foreseeable future; 22% expect to be affected; and 13% did not know the impact.*

**Hewitt Comment:** *Given the sustained economic boom in the country and the profitability of enterprises operating in China, many companies do not appear to be anticipating a collective dismissal in the near future. Nonetheless, for any company planning to restructure its operation(s), it is imperative that the employer become familiar with the new rules, particularly their impact on employment costs and dismissal procedures. The new rules would clarify the instances that constitute collective dismissals and the objective reasons for collective dismissals.*

### **Employee Training**

Employers that provide full-time employees with professional or technical training that lasts one or more months could establish a minimum post-training service period with the employee under the second draft law. If the employee failed to fulfill the service period, the employer would be entitled to collect a penalty fee not exceeding the cost of the training from the employee.

### **Consultation With Employees and Their Representatives**

Under the first and second drafts of the *Labor Contract Law*, employers would be required to consult with trade union or other employee representatives over work rules and regulations. The second draft law marginally clarifies the proposed requirement by indicating that the rules must be related to the “vital interests of employees,” such as compensation, working time, safety and health issues, benefits, training, discipline, etc.

These rules and materials must be discussed with and reviewed by the relevant employee representatives or the employees themselves. Details on how consultations should be handled have not been provided. Unions and employees would have the right to challenge rules that they believe have been implemented improperly; these rules would also be subject to consultation.

Existing requirements for employers to give union representatives 30 days’ notice of individual terminations due to redundancy, workplace injury or illness, lack of skills, and changes in objective conditions of employment are confirmed in the second draft law. During this time, union representatives must be allowed to review the situation and issue a written recommendation.

### **Collective Bargaining**

Collective bargaining rights would be strengthened under the second draft law. Union or employee representatives, in equal number with employer representatives, would have the right to negotiate and sign a collective agreement that addresses compensation and benefits, social insurance, working time, and safety and health issues. The terms and conditions of employment included in a collective agreement could not be less favorable to employees than those established by law. Any pay agreement, for example, would be required to exceed the city minimum wage. The terms and conditions of an individual employment contract could not be less favorable to the employee than the terms and conditions provided by the collective agreement.

Unions in certain industries such as construction, mining, and food and beverage, would be permitted to negotiate and sign an industry-wide or area-wide collective agreement.

**Survey Results:** Only 33% of respondents have a formal system of employee representation; 50% indicated that they do not have a union or other system of employee representation. Even fewer companies have a collective or industry agreement: 2% of respondents are covered by an industry agreement; 9% have a company-level agreement; and 89% of respondents do not have a collective agreement. Approximately 46% of respondents have no plans or unspecified plans to address potential requirements for employee representation; 26% plan to establish an informal (ad hoc) employee representation mechanism for decision-making when necessary. Only 22% of respondents are planning for some system of formal employee representation—union (13%) and employee representative congress (9%).

**Hewitt Comment:** Given the role employee representatives would be expected to play in daily workplace affairs, it is critical for employers to review different representation systems and determine which would be best suited for their company. Employers with a system of employee representation should begin to prepare for collective bargaining.

### **Role of Labor Service Agencies**

The second draft law would introduce regulations for “labor service agencies”—agencies that hire employees for the purpose of dispatching them to other employers on a temporary basis. Since employees have a contractual agreement with the Labor Service Agency, the agency is responsible for paying the employee as well as making social security and other statutory contributions on his or her behalf. The Labor Service Agency, in turn, has a contractual agreement with employers that need additional help; consequently, employers pay a commission or service fee to the Labor Service Agency.

The Labor Service Agency would be required to sign a two-year contract with employees. Employees seconded from an agency to a specific employer would be entitled to the same terms and conditions of employment—including base pay, bonuses, and training—as other employees holding the same position. Seconded employees would also have the right to participate in union activities.

**Survey Results:** Despite the proposed changes to the use of labor agency employees, few respondents indicate that they would consider a reduction in the number of agency employees or labor agencies that they use. Respondents intend to review their manpower planning strategy to ascertain the best mix of direct hires versus seconded employees; audit their labor agencies to ensure that they are compliant with the law once it has been passed; and negotiate new agreements with vendors.

**Hewitt Comment:** Since the legal requirements and responsibilities for the “host” employer would increase substantially under the draft law, employers should begin to review and modify their onboarding, training, compensation, and communication strategies toward seconded (agency) employees.

### **Survey Participants**

Hewitt Associates, along with Baker & McKenzie, conducted a business impact survey on the draft *Labor Contracts Law* in February 2007. In total, there were 436 participants: 73% of respondents represented wholly owned foreign companies; 16% represented joint ventures; 8% were from representative offices; 2% were from nonstate-owned Chinese enterprises; and 1% represented state-owned enterprises.

**Survey Results:** *The majority of survey respondents view the second draft of the Labor Contract Law neutrally or slightly positively, when compared to the first draft of the law. Concerns arise only over a few provisions—collective dismissals, collective bargaining, and the use of Labor Service Agencies and seconded employees.*

*The majority of participants (75%) have already begun to take some preliminary actions in anticipation of the new law. Most respondents have briefed senior management about the pending law and its implications; other actions include reviewing all relevant HR policies, seeking advice from outside counsel and/or consultants, reviewing all legal documents and contracts related to employment, revising the legal and HR budgets to deal with potential additional costs, and reviewing growth plans in China.*

**Hewitt Comment:** *While the briefing of senior management is a positive first step, HR leaders should begin to brief individual business units about the potential impact of the new law on their workforce planning and budget. Since several provisions would have a clear impact on employment costs, it is also important for the HR and legal functions to revisit their budgets in order to prepare fully for the law's implementation.*

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For more information about the draft *Labor Contract Law*, employment terms and conditions in China, or the Labor Law study, please contact Christian Doeringer ([christian.doeringer@hewitt.com](mailto:christian.doeringer@hewitt.com)) in Guangzhou (+86 20 3877-3788) and Amy Zhang or Bradley Ni in Shanghai (+86-21- 2306-6688).

The Hewitt Country Profiles eGuide summarizes the statutory environment affecting employment in China, as well as other countries. You can learn more about the Country Profiles eGuide [here](#).