During the past five years, China has experienced a marked increase in labor dispute cases. This increase coincides with the beginning of the slowdown in the Chinese economy and with the country’s surging average income amounts, which continue to rise every year.

These two occurrences, both separately and in conjunction with one another, have been the cause of many foreign invested enterprises (FIEs) choosing to rethink their China strategy. In the past year, Dezan Shira & Associates have serviced numerous clients looking to restructure their China operations for precisely these reasons. Two important aspects of this process, which can exponentially add to the cost of a restructuring if not conducted correctly, are HR disputes and the labor arbitration proceedings that can arise from them.

In this issue of China Briefing, we discuss how best to manage HR disputes in China. We begin by highlighting how China’s labor arbitration process – and its legal system in general – widely differs from the West, and then detail the labor disputes that foreign entities are likely to encounter when restructuring their China business. We conclude with a special feature from Business Advisory Manager Allan Xu, who explains the risks and procedures for terminating senior management in China.

As we enter a new year, making informed HR decisions to protect your China business’s bottom line will be critical. With our extensive experience in labor dispute management in China, we at Dezan Shira & Associates can work with interested parties to ensure that such changes don’t turn into costly labor arbitration cases.

With kind regards,

Adam Livermore
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The Unique Characteristics of Chinese Labor Arbitration

By Dezan Shira & Associates
Editor: Steven Elsinga

Labor arbitration was introduced in China in 1993, when the first regulations on labor dispute resolution for enterprises were enacted. The system consists of four steps. First, employer and employee are encouraged to settle their differences amongst themselves, without involvement of government agencies. Should this fail, an employee can go to the Labor Dispute Arbitration Committee. Such committees are set up by the municipal or district government, which also appoints the arbiters. The committee will first try to mediate between the parties, urging them to come to a settlement. Only if this is unsuccessful will the committee move to an arbitration hearing. This hearing is legally binding upon the parties, and can be enforced through the courts. If either party disagrees with the ruling, they can take the matter to court. Parties cannot go to court immediately; they initially need to go through the above procedure before their case is admitted. If the employer and employee have not been to arbitration yet, the court will not accept the case.

Labor arbitration is less formal and faster than a regular court case in China, and therefore the costs of the procedure are lower. At every stage of the process, parties are encouraged to settle instead of going for a ruling. The labor arbitration rules were refined in 2008, providing more clarity on procedural issues. The new regulations make it easier for employees to seek an arbitral award, and have led to an upsurge in cases brought before and settled by arbitration committees.

An underdeveloped legal system
Being only recently introduced, China’s regulations on labor dispute resolution are not as fully developed as in most Western nations. In fact, the notion of having a legal system with laws, judges and lawyers has only recently taken root. The very idea that one can go to court because of a labor dispute is relatively new.

Like most reforms, China approaches the creation of a legal system carefully – crossing the river by touching the stones. Legal rules in the west have grown to the complexity of today because practical experience over sometimes hundreds of years showed that they were necessary. China only embarked upon the establishment of rule of law – in the Western sense of the word – in 1979, after the country opened up to the world.

As such, many rules and regulations in China are somewhat simplistic, incomplete, or lack precision. This has left many lacunae in the law, which can only gradually be filled in.

Many Western observers are unaware that between 1949 and 1979, there was no legal profession in China. When law schools were opened again after the Reform and Opening up of 1979, the first students had to be taught using 1940s textbooks that professors had hidden during the Cultural Revolution. China is therefore still recovering from its lack of trained legal practitioners, lawyers, judges and academics. As such, laws aren’t always interpreted correctly or uniformly across the country.
Poor implementation

For instance, when an employer establishes or amends internal HR rules, such as an Employee Handbook or Code of Conduct, it has to follow a fixed procedure. First, the employee’s representatives need to be heard on the suggested changes. During these discussions, the labor union or employees may raise their concerns with the employer over the new rules. After these hearings, the employer needs to announce the new or amended rules to the employees.

This rule did not exist before the implementation of the Labor Contract Law 2012. Courts across China agree that any internal HR regulations that were in force before the law was implemented, but haven’t gone through this procedure, are valid nonetheless. However, official interpretation and practice differs per province on the validity of internal rules that companies have implemented incorrectly, i.e. without going through the procedure of consulting employees and labor representatives.

The validity of the rules matters a lot. Breach of internal rules is an often-used tool to legitimately terminate an employee. Employees can only be terminated for a fixed number of statutory grounds. Of these, a breach of internal rules offers the employer the broadest margin of appreciation.

Courts in Zhejiang and Guangdong hold that, generally, internal rules that have not been established correctly cannot be held against the employee. However, if at its core the new rules are not unreasonable, in violation of the law and do not appear to be clearly unreasonable, breach of them can still be sufficient grounds for dismissing an employee.

Jiangsu, however, appears to take a narrower view. If the company announced the rules and discussed them with the employees and labor representatives, who subsequently reject the rules, they are still valid – provided they are not considered unreasonable or violate laws.

We see the same fragmentation with paying lost wages. If an arbitral committee or court rules that an employee was wrongly terminated, and the employee chooses to be reinstated, the company needs to compensate lost wages. However, the law doesn’t provide what ‘compensation’ means, leading to a range of different interpretations per province or even city. For instance, in Shanghai it is the employee’s average monthly salary before being terminated, but in Hubei province, compensation is interpreted to mean ‘living expenses’ and is much lower.

Emphasis on employee protection

With China’s legal system still modernizing, labor dispute resolution may work differently from what foreign investors are accustomed to in Western countries.

The high level of legal protection for employees often comes unexpected. We already discussed that internal HR rules need to go through consultation and be publicized to employees in order to be valid. Firing an employee for breach of an incorrectly established rule is unlawful termination. Chinese courts by and large agree on this. An unlawfully terminated employee may either request to be reinstated, or demand double the amount of severance pay – enforceable by court order.

Employees can only be terminated based on a limited number of statutory grounds, one of which is breach of a valid internal rule. In any case, the burden of proof is on the employer, and evidence is reviewed rather strictly.

For instance, emails may only be used as evidence if the employee gives consent to the company viewing all work emails. It is recommended to make employees sign such a statement when joining
**Labor Dispute Resolution Procedures**

<table>
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<tr>
<th>Action</th>
<th>Stipulations</th>
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<tr>
<td>Termination</td>
<td>Only on statutory grounds</td>
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<tr>
<td>Informal consultation between employer and employee</td>
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<tr>
<td>Mediation by arbitral tribunal (voluntary)</td>
<td>• If successful, parties can sign a binding agreement not to take the matter further. The tribunal then won’t take up the case</td>
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<tr>
<td>Arbitration hearing (formal)</td>
<td>• Binding upon the parties, enforceable by court order</td>
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<td>• Can rule in absence of a party</td>
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<td>• Low costs, less formal procedural rules</td>
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<td>Procedure before the Civil Court</td>
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<td>• Stricter and clearer rules of evidence</td>
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<td>• Costs of legal council may discourage the employee</td>
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<td>• While employee may obtain favorable ruling, enforcement can be uncertain</td>
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the company. If not, the company breaches the employee’s privacy, making the emails inadmissible. Another ground for termination is if the employee was hired while giving false information, such as forging a resume – a common occurrence in China. This too is interpreted pro-employee. Even if an employee’s resume contains falsehoods, the employer has to show these are essential for the position in order to justify termination.

**Contraction of the Chinese economy**

As China’s economy slows down from its former double-digit growth, lay offs are becoming more commonplace. While the temporary loss of livelihood is never pleasant, being terminated can be particularly distressing for Chinese employees. Because the economy has been growing at such incredible rates for years now, large-scale lay offs have until recently been relatively rare. A downsizing often comes as more of a shock to Chinese workers than it would in mature capitalist economies.

On top of that, there isn’t much of a social safety net in China for sacked employees. This is especially true for employees who are not native to their workplace. Each Chinese citizen has a hukou – a kind of domestic passport or visa. The hukou determines where an individual is able to draw social security benefits, send children to school, get a passport and many more practical matters. Receiving the limited welfare benefits a Chinese employee is entitled to from a different province can be difficult in practice.

Even then, welfare benefits are not of the levels in the west. Faced with rent, school fees, the risk of high medical costs and the need to save for retirement, dismissed employees are inclined to put up a fight to get a higher severance payment. The Chinese attitude to litigation has changed rapidly in recent years. Suing an employer is becoming socially acceptable. The Chinese government is encouraging this, especially in labor matters, where a lot of effort has been made to educate workers about their rights. Fired employees who receive a severance payment are less of a financial burden to the government.

This does not mean the cards are stacked against the employer. Since the introduction of the 2008 labor dispute regulations, the number of pro-employee rulings has fallen by ten percent.
Common Labor Issues Encountered During an FIE Restructuring

By Dezan Shira & Associates
Editor: Qian Zhou

Labor issues encountered during the reduction of a business’ operations

Changing location
During a downturn in the Chinese economy, shifting operations to a less expensive location in order to reduce the impact on profits can be particularly attractive for foreign investors. Invariably, however, not all employees will be willing to be relocated, and problems often arise as a result. For example, an employee may show strong dissatisfaction by delaying relocation, or may request remuneration – sometimes of unreasonable amounts – to terminate a contract.

Can the company terminate the labor contract unilaterally if the employee refuses to move to the new workplace?
In this situation, the employer is able to terminate the labor contract unilaterally, but certain conditions must first be met.

Article 39(2) of the PRC Labor Contract Law, which stipulates that an employer is entitled to cancel a labor contract where an employee has committed a serious breach of company rules, offers the first possibility of unilateral termination. This is typically dependent on whether the employer has supplied an employee handbook which identifies the penalty for absenteeism, and whether the employee’s behavior constitutes a serious breach of the rules contained in this handbook. Where the company provides countermeasures to minimize the inconvenience of a change of location for its employees – such as transportation, accommodation, catering and personal accident insurance – and the employee still refuses to accept the relocation, the court tends to consider continuous absenteeism as a serious breach of company rules. However, whether the countermeasures are sufficient and reasonable is still decided on a case-by-case basis. If the company successfully achieves unilateral termination by using this method, the employee is not entitled to any severance payment.

If there is no breach of company rules by the employee, Article 40(3) offers another possibility for the company. According to this Article, if ‘significant changes’ are made to an employee’s labor contract, and an agreement cannot be reached on the changes made, the employer can terminate the contract by providing a written 30 day notice or by making an additional remuneration payment of one month’s salary. Additionally, the employee is entitled to severance payment.

In judicial practice, employees facing termination often try using this Article as an argument to get more compensation. However, when an employer provides reasonable countermeasures to minimize the inconvenience of a location change, the court tends to view relocation as an insignificant change. For employers, fully preparing for the change of location is therefore critical in order to lower the risk of a hefty pay-out.

Reducing staff
Simply reducing staff is a more straightforward method of minimizing company expenditure. However, the process for doing so in China is both complex and difficult. Here, we discuss the options available.
When an employer considers terminating an employee’s employment contract, the first question the employer should ask is whether the term of the employment contract is about to expire. If it is, the employer can choose to not renew the employee’s contract for a second term. As stipulated by Article 46 (5) of the PRC Labor Contract Law, an employee whose fixed-term labor contract isn’t renewed is entitled to a severance payment.

Notably, following expiration of a second fixed-term contract, the employer is obliged to accept if an employee requests to sign a new open-ended employment contract. Under such a contract, the option of termination upon expiration is no longer available to the employer.

Termination upon expiration

Early Termination

If a labor contract is not terminated upon expiration of the first first-term contract, it is classed as an early termination. Generally speaking, the best way to achieve early termination is through mutual agreement, which will safeguard against an arduous and costly labor dispute. If it is the company that proposes this, the employer generally provides additional remuneration to obtain the employee's consent.

Can a company achieve early termination by attributing “financial difficulty” as the “significant change”? Unfortunately, financial difficulty is not considered sufficient to use Article 40(3) as a termination cause.

If a company is experiencing financial difficulty...
and is no longer able to maintain its labor bill, the employer must find other causes to terminate its staff. Considering the nuanced and idiosyncratic nature of China’s labor law, it’s highly recommended that companies in this situation seek professional help to mitigate the risk of wrongful termination.

Calculation of Severance Payment:

\[
\text{Severance Payment} = \text{one month’s salary} \times \text{years of service}
\]

For one month’s salary:
Calculated as the employee’s average monthly salary during the last twelve months.

Severance payment restriction:
For any period after January 1, 2008, where the employee’s average monthly salary is more than three times the average monthly salary in the location of employment, the latter will be used to calculate severance pay.

This rule does not apply to the period prior to the enactment of the PRC Labor Contract Law.

For example, in Shanghai, the average local monthly salary in 2014 was RMB 5,451; three times this amount equates to RMB 16,353. Thus, an employee whose employment is lawfully terminated in Shanghai can only receive up to RMB 16,353 as severance for each year of employment after January 1, 2008.

Calculation of years of service:
For a working period that is less than one year:
Between six and 12 months: the working period is counted as one year and one month salary must be paid as severance.

Less than six months: the working period is counted as half a year and half a month’s salary must be paid as severance.

For example, in the case where an employee has worked for 13 months for the same company, this can be counted as 1.5 years of service. For the 12 months, severance pay received will amount to one month’s salary. The one month portion can count as half a year and the employee will receive 0.5 month’s salary as severance payment. In total, the severance payment is 1.5 months’ salary.

Total amount restriction:
Severance is limited to a maximum of twelve months’ average salary, even if the employee has worked for a company for over 12 years.

Other considerations

Certain groups of people are protected from early termination by labor law, even during a company downsizing. These include:

- Employees suspected of having occupational diseases and awaiting diagnosis;
- Employees completely or partially incapable of labor due to occupational disease or work injuries;
- Employees who are pregnant or on maternity leave;
- Employees who have worked continuously for the employer for more than 15 years and have five years left before retirement.

Where an employer looks to terminate 20 or more employees, or where the number of employees to be terminated make up 10 percent or more of overall staff, this is classified as a ‘mass lay-off’. Under this circumstance, reducing staff is subject to the additional following procedures:

- An employer is required to explain the situation to the labor union or to all staff 30 days in advance;
- An employer must report the detailed mass lay-off scheme to the labor administrative authorities.

Detailed downsizing procedures are stipulated in the provisions for “Reduction of Staff for Economic Reasons” (Lao Bu Fa [1994] No.447) and other local-level legal documents. If the procedures are not properly executed, the employer will not only be unable to perform the mass lay-off, but will also potentially receive a penalty from the labor administration bureau.

Common labor related issues during company divestiture

Part Sale
When a company sells part of its assets to another company, dealing with employees closely related to this part of the asset can pose a challenge. With the sale completed, the original labor contracts between the selling company and its employees can no longer be honored, and the purchasing company is not obliged to employ these staff.
Where the purchasing company refuses to accept these employees, the selling company bears the potential labor dispute risks itself. Generally, the company has the same three options discussed previously: termination by mutual agreement, termination upon expiration, and termination under Article 40 (3) of PRC Labor Contract Law. If the purchasing company decides to employ previous staff, it should have them sign new employment contracts. Furthermore, the purchasing company should pay close attention to the issue of “length of service”. According to Article 10 of Implementation Regulations for PRC Labor Contract Law (State Council Decree No. 535), where an employee is transferred to a new employer for reasons out of their control, their length of service is calculated continuously. This effectively means that if this employee is terminated by the new employer at a later date, the new company should take into consideration the employee’s length of service in both the original company and in the new company when calculating severance payment.

Conversely, if the original employer has paid severance payment to the employee upon termination, then the length of service shall start over and not include the employee’s length of service with the original employer. In practice, if the employee was transferred from the selling company to the purchasing company without receiving severance payment, it is likely that the length of service will be calculated continuously. From the perspective of the purchasing company, it is therefore better to confirm that transferred employees have already been compensated to mitigate any risk.

### Whole Sale

Strictly speaking, when a company transfers all or part of its equity to another company, there is no impact on its existing labor relationships in legal terms. The reason for this is stated clearly in Chinese law: equity transfers only change the shareholder structure of the acquiring company and not the nature of the acquired labor contracts. That said, an equity transfer can still have far-reaching effects on labor. For example, if the acquiring company obtains the majority or all of the equity of another company, then it has the right to ask the acquired company to reduce business, transfer assets, or even de-register and close the company. Under such circumstances, the labor structure of the acquired company will inevitably have to change.

### Common labor issues during a company closure & de-registration

During a company closure and de-registration, labor contracts in place will automatically be terminated. Affected employees are entitled to severance payment. Foreign companies that close their China operations have to submit an employee settlement plan to the relevant labor bureaus that clearly details how employees that are laid off will be compensated. Without settling these labor issues, a foreign company will be unable to lawfully deregister its China business.
When it comes to hiring and firing in China, foreign managers and investors should not hold preconceived ideas about the strictness of China’s laws. Highly publicized cases of worker exploitation might give the impression that China unambiguously favor employers, but this is not so. In fact, China’s laws for firing employees are considerably more rigid than those in the U.S.

Firing senior managers is an especially complicated process in China that requires a thorough understanding of the country’s laws. Even before a decision to fire someone has been made, proactively preventing risks related to HR is important.

If an employer wishes to terminate a contract of a senior manager, there are a set of specified reasons for them to be able to. These include, but are not limited to:

- The employee materially breaches the employer’s rules and regulations
- Gross negligence by the employee causes substantial damage to the employer
- The employee has criminal liability imposed against them

These causes are stipulated in Article 39 of the PRC’s Labor Contract Law. If the case is taken to labor arbitration and the employer is found to have wrongfully terminated the employee, the employee can either demand their old job back or demand compensation that is double the compensation rate of a normal, lawful, termination.

Accordingly, a company looking to fire senior management should expect to have to show strong evidence in support of their lawful decision to terminate. As part of this, the company should have a handbook of company regulations signed by all employees.

The Company Stamp

Chinese commercial law attaches high legal importance to the company stamp; its use is a necessity in many business operations.

There have been cases where outgoing employees have taken the company seal to paralyze the company and effectively take it hostage. This is an extraordinarily difficult situation, especially if the perpetrator was once the company’s official legal representative in China.

If a company seal is lost or stolen, an announcement must be made as soon as possible in an official journal; this makes it possible to cancel the seal and register a new one.

Companies should set up an internal application process for using the seal: staff members wishing to use it must submit a request to management, clearly stating their reasons for doing so.

For a free consultation on how DSA can assist companies in safeguarding their seals, contact the professional at Dezan Shira & Associates at china@dezshira.com.
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