Paul Hastings

CHINA MATTERS

Paul Hastings Newsletter for Investing & Operating in the People's Republic of China

June 2009

Shanghai Clarifies Several Issues Under The Employment Contracts Law

In March 2009, the Shanghai High Court and Shanghai Labor Arbitration Commission issued the Opinions on Several Issues Concerning Application of the Employment Contracts Law (Hu Gao Fa [2009] No. 73) (the "Opinions"). The Employment Contracts Law ("ECL"), which came into effect on January 1, 2008, contains many ambiguous provisions left open for interpretation by municipalities and provinces. The Implementing Regulations of the Employment Contracts Law of the People's Republic of China (the "Regulations"), effective upon promulgation on September 18, 2008, provided some additional clarity with respect to unwritten practices and interpretations of the ECL and other employment rules and regulations, but they did not address some of the more controversial provisions of the ECL. The Opinions provide further clarity with respect to some practices and interpretations of the ECL for application in Shanghai. Notably, on the whole, the Opinions appear more favorable to employers. We explore some of the more significant provisions below.

Penalties for Failure to Execute a Written Contract and Termination of the Employment Relationship if an Employee Refuses to Sign a Contract

One of the key functions of the ECL is to require employers to enter into written employment contracts with their employees. The ECL provides penalties of double wages if an employer fails to execute a written employment contract with an employee within thirty days of the employee's start date. The Regulations clarify that the first month of the employment relationship is a grace period and that the double wages penalty applies from the first day of the second month of employment.[1]

Further, if an employee does not enter into a written employment contract within twelve months of the employee's start date, the employee is entitled to an open-ended employment contract as a matter of law.[2] The ECL does not distinguish between an employer who does not comply with the ECL or an errant employee who unreasonably refuses to sign a written contract, which potentially exposed employers to liability under Article 82 of the ECL.

Articles 5 and 6 of the Regulations provide employers with recourse against such employees in the latter case. An employer must provide written notice to the employee within one month of the start date that it will terminate the employment relationship if the employee refuses to sign an employment contract. If the employee still refuses, the employer may terminate the employee's employment without paying any severance, but must pay the employee for all hours worked.[3] If an employee refuses to enter into an

employment contract after working for at least one month but less than one year, an employer may terminate the employee's employment, provided it pay severance to the employee.[4]

The Opinions confirm that if the absence of a written employment contract is attributable to the employer, then the penalties for double wages under Article 82 of the ECL still apply. The Opinions set forth the factors to consider in determining whether the penalties apply. Under the Opinions, "(i) whether the employer performs the obligations of negotiation in good faith; and (ii) whether the employee refuses to sign" an employment contract bear directly on the determination of whether double wages apply.[5] If the employer has fulfilled its obligations to negotiate in good faith and the absence of a written employment contract is due to reasons that are not attributable to the employer – such as *force majeure* or if an employee refuses to enter into an employment contract, then the employer will not be held liable for the absence of an executed employment contract with an employee.

Upon the expiration of an employment contract, if an employee continues to work for the employer and both parties do not object to the arrangement, in the absence of a new written employment contract, where the employer has "fulfilled its obligations in good faith" and the employee fails to conclude a new written employment contract, the employer may terminate the employment relationship upon written notice to the employee and the payment of severance in accordance with Article 47 of the ECL.[6] If the employee refuses to sign a new employment contract and refuses to continue to work for the employer, the employee will be deemed to have unilaterally terminated the employment relationship, and the employer is not required to pay severance, but must pay the employee for all hours worked.[7]

Open-Ended Employment Contracts and Automatic Extension of an Employment Contract

Under the ECL, employers are required to provide an open-ended employment contract upon the renewal of the second consecutive fixed-term contract after January 1, 2008.[8] In Shanghai, where an employee requests that the employer enter into a written open-ended contract and the employer fails to do so despite having the obligation to do so, the relationship will be treated as if "there is an open-ended employment relationship between both parties, and both parties' rights and obligations shall be determined based on the original employment contract."[9] The "original employment contract" may derive from a written contract or a *de facto* employment relationship.

The Opinions explain that the requirement under Article 14 of the ECL to provide an open-ended employment contract upon the second consecutive renewal of a fixed-term contract refers to circumstances where the employer is renewing the employment contract for the third time and the employee requests an open-ended term.[10] This language appears to imply that the employer has the discretion regarding whether to continue the employment relationship with an employee after the expiration of the second consecutive fixed-term employment contract and has further discretion as to whether to offer an open-ended employment contract. In other words, under these interpretations in Shanghai, employers have retained the right not to renew a fixed-term contract upon the expiration of two consecutive fixed-term employment contracts.

Alternatively, where an employee qualifies for an open-ended employment contract and instead enters into a fixed-term employment contract, the fixed-term employment contract is valid and binding over both parties and will naturally terminate upon the expiration of its term.[11]

The Opinions also clarify the effect of automatic extensions of employment contracts due to special statutory reasons where, as a result of the automatic extension, the employee has worked for more than 10 years for the same employer. The ECL declares without any qualification that employees with at least ten years of continuous service with the same employer are entitled to an open-ended employment contract.[12] Previously, it was thought that such extensions might result in the employee's right to an open-ended employment contract. The Opinions, however, narrow the circumstances under which an employee is entitled to an open-ended contract by stating, "Where the law does not specify the circumstances for termination, the interpretation of the relevant provisions of the law on contract termination may not be arbitrarily expanded to include a consequence of concluding an open-ended contract."[13] Accordingly, where an employment contract is extended by operation of law, as in the case of an employee's medical treatment period, service term in connection with a training expense agreement, or pregnancy, maternity or nursing period, whereby the extension of the contract results in an employee's reaching at least 10 years of continuous service, the obligation to provide an open-ended contract will not apply.

Liquidated Damages for Incomplete Service Terms

By entering into a training expense agreement, an employer is entitled to bind an employee to a minimum period of service in exchange for an employer's provision of funding for an employee's "professional, technical training."[14] Article 17 of the Regulations provides that in this situation, an employee's employment contract will extend automatically until the expiration of the service term, unless the employer and employee agree otherwise. If an employer does not extend the employment contract, however, it is unlikely that it will be able to recover any liquidated damages referable to any portion of the service term that extends beyond the expiration of the employment contract. The Regulations clarify that employees will be liable to pay any liquidated damages if they are terminated for grounds which do not require the payment of severance, such as seriously violating the company's rules and regulations.[15] The Opinions also suggest that when an employment contract is extended to match the remaining service period, as generally required under Article 17 of the Implementing Regulations, and the employer does not offer the employee a position throughout the extension period, the employer will thereby waive the right to request performance of the remaining service period and the employment contract will terminate.[16]

Permissibility of Employer's Recoupment of Special Benefits Provided to Employees

The ECL provides that an employer may not impose liquidated damages against an employee, except in the case of a breach in a service term in connection with a training expense agreement or of a non-competition agreement.[17] This restriction suggests that employers would not be able to recoup some special benefits offered by an employer to an employee for retention purposes, for example, a sign-on bonus or housing allowance in exchange for a specified service period. A sign-on bonus or housing allowance does not qualify as "training expenses." Thus, under the plain language of Article 25 of the ECL, an employer may not require an employee to repay such a "special benefit" if the employee leaves the employer prior to the expiration of the agreed upon service term, because the repayment may be considered to be a form of liquidated damages.

Many employers seek to use retention tools such as sign-on bonuses in exchange for a minimal employment commitment by employees and needed the ability to recoup the cost of these benefits if the employees do not serve the agreed-upon service term. The potential inability to recoup these special benefits in light of Article 25 of the ECL has caused many employers to rethink whether to offer such benefits, despite the market need to

attract talent with such special benefits. The Opinions offer welcome support for employers and resolve this uncertainty and tension favorably. The Opinions set forth that any special benefit provided by an employer to an employee, such as an automobile, housing, housing subsidies, etc., qualify as "prepaid compensation." Accordingly, if an employee fails to fulfill the full service term, the employer may recoup the value of the special benefit.[18]

Contractual Obligation to Comply with Work Rules

The Opinions provide that even in situations where an employer's work rules are found to be invalid, under general "principles of legality and good faith" which employment contracts should follow, the employer may still subject employees to disciplinary actions for breach of their express or implied obligations under their employment contracts.[19] The absence of express work rules is not a defense for the employee to avoid disciplinary action.

Limitation on Employee's Right to Terminate Employment Contract, Unless Employer Demonstrates "Bad Faith"

The ECL expanded the rights of employees in a number of ways, including by codifying that employees are entitled to terminate an employment contract with no notice and with the right to severance if an employer does not make salary payments "on time and in full" or does not make the required amount of social insurance contributions.[20] The ECL contains no qualification with respect to the basis or intent of an employer's failure to comply with these obligations.

The Opinions narrow this seemingly unfettered right by recognizing that "the calculation standards for remuneration and social insurance contributions are often relatively complicated."[21] The Opinions go on to provide that "Only employers which delay or refuse payment, in bad faith, should be the targets" of this legislation.[22] Rather, under the Opinions, employees will only have the right to terminate the employment relationship with no notice and with severance if their employer in "bad faith" – and not because the payment standards are objectively unclear – fails to pay the employees properly or make the correct social insurance contributions. These Opinions therefore significantly curtail an employee's right to terminate an employment relationship with no notice and severance. It remains unclear where an employer's non-payment of overtime compensation without the requisite government approval will fall in terms of the "good faith–bad faith" standard introduced in this article of the Opinions.

Suggestion of Reasonable Consideration for Non-Compete Obligations

The ECL restricts the use of non-compete provisions to senior management, senior technical personnel and other personnel who are obligated to maintain the confidentiality of an employer's trade secrets. The ECL imposes a maximum duration for non-compete restrictions of two years and requires that an employer pay a former employee financial consideration for the non-compete monthly during the restricted period.[23] The ECL is silent regarding the minimum amount of legally sufficient consideration for non-compete agreements. Rather, the ECL provides that the amount of financial consideration is open for negotiation between an employer and employee.

The Opinions provide that where the employer and employee reach an agreement on the non-compete restrictions, but the agreement is silent regarding the payment of non-compete consideration or it fails to provide an explicit amount of non-compete consideration, the non-compete provision will still have binding effect.[24] Where the amount of the non-compete compensation is absent or unclear, or if the parties cannot agree on an amount after consultation, then the employer is required to pay between 20% and 50% of the employee's previous "regular salary" for each year that the non-compete is in effect.[25] Notably, the Opinions remain silent as to who determines the exact rate (between 20% and 50%) that the employer must pay to the employee for the non-compete to be enforceable.

Calculation of Severance

Article 21 of the Opinions confirm that in order for employers to calculate severance for employees, employers must calculate the amount separately based on an employee's service pre- and post-January 1, 2008, the effective date of the ECL. The ECL caps the average monthly severance amount at three times the average monthly wage of employees in the employer's location (as published by the local government). The ECL further limits the total severance amount to no more than twelve months' salary for service post-January 1, 2008. The ECL does not, however, impose any cap on severance entitlements that accrued prior to the ECL's effective date.[26]

For purposes of calculating severance, the ECL provides that employers must round up service periods of six months or more to one year and for service periods of less than six months, the employee is entitled to half-month's wage. However, Shanghai local rules differ, and the Opinions do not address the discrepancy between the Shanghai local rules and the ECL. Under the Shanghai Regulations on Employment Contracts ("Shanghai Regulations") that govern the calculation of severance for pre-2008 service periods, service periods of less than 6 months are rounded down to zero whereas, under the ECL, the same service period would be rounded up to half a year. The Opinions do not resolve this discrepancy regarding the proper methodology for calculation of service years which span the period both prior to and after January 1, 2008.

Penalty for Wrongful Termination

Under the ECL, if an employer terminates an employee without a legal basis, the employer is required to reinstate the employee upon the employee's request. If this does not happen, or reinstatement is not possible, the employer must pay the employee twice the severance specified under the ECL. The Opinions further impose an additional cap of three times the local average salary for calculation of penalties for an employee's pre-2008 service.[27] Not only does this provision conflict with the concept of "double" statutory severance, but under certain circumstances, the resulting penalty may equal less than the amount of statutory severance.[28]

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] Art. 6, para 2.

[2] ECL, art. 82.

[3] Regulations, art. 5.

[4] Regulations, art. 6.

[5] Opinions, art. 2.

[6] Opinions, art. 2.

[7] Opinions, art. 2.

[8] ECL, art. 14(3).

[9] Opinions, art. 4(1) (quoting Paragraph Two of Article 15 of the Interpretation of the Supreme People's Court on Several Issues Regarding Application of Laws for Trial of Labor Dispute Cases, Fa Shi 2001, No. 14).

[10] Opinions, art. 4(4).

[11] Opinions, art. 4(2) (citing ECL, art. 14 and Regulations, art. 11).

[12] ECL, art. 14(1).

[13] Opinions, art. 4(3).

[14] ECL, art. 22.

[15] Regulations, art. 26.

[16] Opinions, art. 6.

[17] ECL, art. 25.

[18] Opinions, art. 7.

[19] Opinions, art. 11.

[20] ECL, arts. 38(2)-(3).

[21] Opinions, art. 9.

[22] Opinions, art. 9.

[23] ECL, art. 23.

[24] Opinions, art. 13.

[25] Opinions, art. 13. According to our no-names consultation with the Shanghai High Court, the "regular salary" includes base salary, bonus, allowances and subsidiaries, but excludes overtime compensation because overtime is not considered to be part of an employee's "normal salary."

[26] ECL, art. 47.

[27] Opinions, art. 21.

[28] For example, consider the situation where an employee's average monthly salary is RMB50,000, and the employee's pre-2008 service period equals 2 years and post-2008 service period equals 1 year. Under the ECL's two-tier calculation method, the employee's statutory severance would be RMB109,872 (or RMB50,000x2+RMB9,872x1). However, under the Opinions, the calculation would be RMB59,232, or two times (RMB9,872x2+RMB9,872x1)). Notably, under the Opinions, the penalty equals less than the statutory severance itself.