My company is a foreign-invested enterprise, how do I ensure that when I terminate an employment contract I can avoid costly labour disputes and penalties?

How do I terminate an employment contract in China?

The international perspective

Disputes over dismissal are amongst the most common labour disputes in China. In order to save time and avoid costly court proceedings, it is important to understand the legal and practical approach to termination and put in place sound HR management.

Termination

The right to unilaterally terminate employment is limited under Chinese labour law. Employers may unilaterally terminate employment only with reasons and only under the limited statutory situations that are exhaustively listed in the *PRC Employment Contract Law* (中华人民共和国劳动合同法).

The few situations that allow for dismissal without prior notice and without statutory severance payment are mainly related to a gross misconduct of the employee and often damage must be proved. During the probation period, reason is necessary for a dismissal, but at a lower threshold than after the period is up. Therefore, it is important that companies effectively make use of this period and against a well-drafted job description monitor the employee's performance and whether he actually meets the conditions of employment.

Apart from this, probably the most relevant aspect since employers can – and must – take an active role, is when employees materially breach the employer's rules and regulations. It is important that these policies are validly implemented. Generally, a catalogue of disciplinary measures should be included in an employee handbook, which must be drafted with the participation of the employees.

There are just three statutory situations that allow dismissing an employee with 30 days' written notice or payment *in lieu*. Where an employee's poor performance is the issue, a comprehensive assessment must be conducted before and after relevant training or position adjustment. In case of prolonged sickness, where an employee cannot resume work even after adjustment of the position, medical subsidies must be provided in addition. In case of major change in objective circumstances, mainly M&A or relocation, contract amendments must be negotiated first.

Restrictions

When unilaterally dismissing an employee, the company must also consider that certain groups of employees may not be dismissed, e.g. those on sick leave or pregnant. The additional requirement to hear the labour union before a unilateral termination leaves many companies with a risk for dismissals, since they haven't established a union. Statutory severance, which generally is due if employment is terminated due to a situation attributable to the employer, including dismissal with notice (but also non renewal of fixed term contract or termination agreement initiated by the company) generally amounts to one monthly average salary on the number of years the employee has worked at the current employer (with a cap of three times the local average salary since January 1 2008, for a maximum of 12 years).

Practical considerations

With these strict requirements and the burden of proof being with the employer, companies are often scared away from unilateral terminations. Another risk is that employees may initiate labour arbitration within one year of termination, asking for reinstatement or double severance and often adding overtime or bonus claims. If there is a doubt regarding the legal basis, e.g. due to incorrectly implemented company policies, or lack of evidence, companies might prefer to mutually terminate the employment. Since the labour market is still an employees' market, during negotiations that require thorough preparation, by showing appreciation and taking a face saving approach, often a termination agreement can be reached. The payment of an adequate severance in these circumstances is often easily compensated with the added safety that the termination is valid. It will also be helpful to sensibly make use of fixed term contracts to have default endings. In any case, having sound HR management in place is absolutely essential when considering termination in order to mitigate the risks.

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The domestic perspective

Chinese labour law is strict on termination by employers as employment contracts can only be terminated under a limited number of circumstances. The most commonly cited legal reasons for termination are breach of the company's rules, serious negligence of duty (both subject to immediate termination without severance pay), incompetence and a material change of circumstances (both subject to advance notice and severance pay).

If the employee materially breaches the employer's rules, the employer must prove that the rules were legally established, the breach took place and that the breach was material. Strong employment contracts and a detailed staff handbook are usually instrumental.

If the employee seriously neglects his duties or engages in graft for personal gain, causing a substantial loss to the employer, the employer must prove that the negligence was serious and that the loss was substantial. Terms like serious and substantial have no legal definition and therefore should be defined in the staff handbook.

If the employee is incapable of performing his or her tasks and remains incompetent after training or adjustment of their position, the employer must prove the tasks of the employee (e.g. in the employment contract). It must also be able to document that the employee cannot perform them adequately and that it has searched for ways to remedy the situation.

If there is a material change in the objective circumstances relied upon at the time of concluding the employment contact, and renders the contract impossible to perform, and the parties are unable to agree on amendments, this clause can be used to cover such circumstances as restructurings and major business trends, but it is intentionally vague. Labour arbitration tribunals have discretion when considering this cause.

In some instances, there is no argument on whether there is sufficient cause and so it is relatively easy to calculate severance pay (if any) and reach a settlement agreement. However, in many other situations due cause is arguable. In this case there are two options:

- The company is able to convince the employee to reach a settlement and the parties sign a termination agreement (or resignation letter) to avoid any risk of a dispute; or
- If no settlement is reached, the employer will usually proceed to terminate the employment contract unilaterally.

In the case of unilateral termination, the (former) employee has the opportunity to file a claim for labour arbitration. If the employee can prove that the company had insufficient cause to terminate the employment relationship unilaterally, then he or she may succeed in either getting reinstated or collecting economic compensation.

Economic compensation is often not very high – the basis for calculation is capped and so large pay-outs are rare. Therefore, most employees will first demand reinstatement. Even if they do not really want to have their old job back, the nuisance value of reinstatement is the greatest, making this the best way to force a company to compromise. There are various ways for a company to respond: besides arguing due cause, the company's lawyer can also try to prove that reinstatement is not practical, for example, because the position is no longer available or (in the case of expatriates) that the employee no longer has a work permit.

Employers that want to terminate an employment relationship can generally follow these steps:

1. Collect information on the employee's performance and obtain legal advice on whether the collected evidence is sufficient to prove due cause for termination and if so, proceed with termination.
2. If evidence is insufficient, consider whether or not to wait until stronger evidence of due cause can be collected.
3. If terminating the employment relationship is a priority (often the case), devise a strategy to confront the employee and try to negotiate a quick settlement. In practice, quick settlements are usually low settlements. If this is successful, have the employee sign a termination agreement or resignation letter to avoid further risk.
4. If a settlement cannot be reached, proceed with unilateral termination.
5. If the employee files a claim for labour arbitration, defend the claim, but keep in mind the option to settle the case during arbitration to avoid the risk of reinstatement (or a big pay-out). Labour arbitration tribunals will often prefer a settlement and will mediate between the parties, this can be used to press the former employee to be reasonable.

Finally, disputes (and their related costs) are best avoided, but not at all cost. Every company should balance the costs to defending a claim and the risks of losing at labour arbitration, with the downside of settling at a high amount.

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