

## Employment Termination in China - Compensation and Unfair Dismissal -

Termination of employees demands a careful assessment of the situation, as the employee's interests enjoy stronger protection compared to other jurisdictions, and failure to comply with labor regulations may trigger rights for unfair dismissal compensation.

*Victoria Lei and Lukas Steinberg*

Termination of employment contracts is a natural process in almost every company's lifecycle. Whether the reasons for dismissal of an employee are linked to performance issues, restructuring or relocating of the business, or even financial struggles of the enterprise – there are noteworthy characteristics of Chinese employment law that concern every employer's preparation for a termination. It may come as a surprise to foreign managers that Chinese employment law is generally considered 'pro-employee'. Contrary to common belief and perception in other countries, the level of legal protection of employees in termination disputes exceeds that of many western countries, as termination is only allowed on certain grounds stipulated in the relevant legal regulations. Hence, companies are usually obligated to make a severance payment to the terminated personnel.

### Calculation of Severance Payments

The calculation of severance pay is based on the duration of the employment. For each year of employment, the employee may receive one month of salary (or half a month's salary if the employment period was shorter than 6 months). The actual sum is capped where the monthly salary exceeds three times the average monthly salary in the respective city.

In accordance with the law, in these cases the calculation will be based on three times the average local monthly salary, to be paid for no longer than 12 years of employment. However, termination circumstances that fall under unfair dismissal are not only subject to double economic compensation, but frequently end up in employment disputes that have to be resolved in labor arbitration or court.

Generally, no income tax has to be paid on the compensation (exception: severance payment after expiration of work contract) unless the sum meets the legal threshold of three times the average local annual salary of the past year, in which case only the part below the threshold is exempt income tax.

It should be noted that termination of a foreign employee may be subject to different calculation of the compensation depending on local regulations. Many foreign employees earn significantly higher salaries than their Chinese coworkers, and in most cases, a cap based on three times the average monthly local income would easily be exceeded. In Shanghai, for example, severance payments for expatriates are not calculated based on the regulations of the PRC Labor Contract Law, but rather on individual agreements in the expatriate work contract.

## Termination Grounds without Severance

Employers may dismiss personnel without being subject to the severance payment requirement during the probationary period, where the employee to be dismissed is prosecuted by law, and in cases where the employee severely harms the business' interests or seriously violates (contractual) company rules agreed upon employment. Therefore, both parties should agree on what behavior is considered 'harmful to business interests'. This is best achieved by both a detailed work contract and an employment handbook that clarifies internal company rules (confidentiality, anti-competition, tasks, tardiness, sick leave, use of company resources etc.) and secures the employer against unreasonable claims in labor disputes.

## Termination Circumstances that Require Severance

Other circumstances than the above stated require severance payment and notification of one month prior to dismissal. Even when the parties mutually agree upon termination, the employee is still entitled to claim economical compensation. For cases that constitute unfair dismissal under the law, the employee may even claim reinstatement of the former position and, if reinstatement is impossible (e.g. the employer already appointed a new employee for the position), additional monetary compensation.

Labor arbitration is almost free of charge for employees in China, and is therefore widely made use of. It can be difficult to reach a settlement that is acceptable for both sides. Since the burden of proof lies entirely on the employer, certain conditions need to be met in order to avoid unfair dismissal claims according to the law. Some circumstances are automatically considered unfair dismissal, such as pregnancy, termination during maternal leave as well as termination sick or injured employees (both occupational and non-occupational diseases/injuries). The only exceptions are dismissals during probation period or for the causes stated above.

## Dismissal on Grounds of Underperformance

A common reason to terminate the employment relation is underperformance. Sometimes employees fail to meet changed expectations after adjustment of internal management structures or business goals, and in other cases individual performance does not develop as prospected after providing sufficient training. The employer is obliged to provide sufficient evidence of underperformance to oppose claims for unfair dismissal. Basically, the employee concerned must be given a chance to improve. This can be achieved by training or reappointment to new tasks. Usually, the employee will not agree to a salary adjustment when transferred to another position, and adjusting salary levels could risk a labor arbitration dispute. Since the goal is to ultimately meet the requirements for dismissal on grounds of underperformance, it may be advisable to remain flexible in this respect. Should the employee fail to improve in spite of the training or transfer, the employee must be informed in an assessment meeting.

## Downsizing on Terms of Economic Hardship Or Transfer of Assets

Dismissal of a large group of employees is either permitted on grounds of economical hardship, e.g. necessary restructuring during bankruptcy proceedings, or when major circumstances under which the original labor contract was signed have changed significantly, and thus performance of the contract is no longer possible. The procedure of downsizing demands for close cooperation with the labor bureau and hearings with the labor union and all staff of the company. It is also important to remember that the Chinese Labor Contract Law does not provide for automatic transfer of employees in a merger or acquisition.



## Conclusion

Termination of employees demands a careful assessment of the situation, as the employee's interests enjoy stronger protection compared to other jurisdictions, and failure to comply with labor regulations may trigger rights for unfair dismissal compensation. It is not unusual for Chinese employees to claim for high sums of economic compensation, and with the availability of free labor arbitration for everyone, reaching a reasonable settlement can oftentimes be a time-consuming affair. A good employment contract and a detailed employment handbook as well as careful steps before termination can avoid a lot of trouble and help put the employer in a favorable position.

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**Victoria Lei and  
Lukas Steinberg**

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