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**A SURVEY OF
CERTAIN LEGAL ISSUES RELATING TO
REAL ESTATE INVESTMENT IN THE
PEOPLE'S REPUBLIC OF CHINA**

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A Brief summary of Chinese Real Estate Law

Foreign investors may only obtain a land use right, rather than outright land ownership, since all land in China belongs to the state or the collectives.¹ Urban land generally belongs to the state, while rural land is generally owned by the collectives.²

However, a land use right can be transferred.³ Although there is some debate among the commentators regarding whether land use rights can be considered a true “property right,” as that term is generally understood in capitalist societies,⁴ the law does explicitly state that a land use right, properly transferred, itself is a “civil right”.⁵

In theory, anyone can buy land use rights under current Chinese law. No legal restrictions prevent a foreign party from purchasing land use rights in China (although as discussed below, at this time certain types of investments must be made in a joint venture with a Chinese party).

Local Land and Resource Bureaus either “allocate” or “grant” state-owned land use rights to a user. “Granted” land use rights, which were first introduced in 1988, are limited in time against payment, while “allocated” land use rights are usually given for free and without allocation of time. Allocated land can be used only for a specific purpose, cannot be assigned, and can be expropriated under certain circumstances. “Allocated” land is generally no longer directly available to foreign investors, although it can become part of the land contributed to a joint venture by the Chinese party (see joint venture discussion below).⁶ Granted land use rights are protected from expropriation without compensation.

¹ Administrative Law of Land of People’s Republic of China, art. 2 (June 25, 1986, amend. Dec. 29, 1988 and Aug. 29, 1998).

² Article 10 of the 1982 Constitution.

³ Article 2 of the Constitution Amendment Act of 1988, amending article 10 of the 1982 Constitution.

⁴ See, e.g., Randolph, “Legal Forum Network,” <http://www.enstarsw.co.uk/document.asp?id=32> (last visited October 2, 2005)

⁵ General Principles of Civil Law, Article 80.

⁶ An investor considering a manufacturing joint venture in China will do well to conduct careful due diligence if the Chinese JV party proposes to contribute “land use rights” to the JV, given the substantial difference between “allocated” and “granted” land use rights.

The discussion in this paper focuses upon land use grants.

A developer seeking to undertake a new commercial real estate project must first obtain granted land use rights. The direct grant of land use rights from the government is referred to as the “first-class” real estate market. Such rights can be granted through auction, bidding, or listing.⁷ Grants are awarded strictly on condition that the recipient must invest in, develop, and use the land for a specific purpose in accordance with the instructions issued by the authorities. The developer must therefore sign a land use right grant contract with the appropriate governmental entity.⁸ The grant contract will generally only allow the land to be used for specific purposes, usually as set forth in the local urban construction plan.⁹ If the grantee does not comply with the terms of the grant contract, the local government can issue a warning, impose a penalty, or even revoke the transfer.¹⁰

The land use right holder must undertake active efforts to use the land. The grant contract, particularly in connection with infrastructure and housing projects, will generally specify a deadline by which construction must begin. If the grantee does not start construction within one year after the deadline, the State Land and Resources Bureau is entitled to collect an “idleness fee” of up to 20% of the land grant fee.¹¹ If construction has not begun within two years of the deadline, the State Land and Resources Bureau can retake the land without compensation, unless the delay is due to force majeure events, government action, or necessary pre-construction preparatory work.¹²

Granted land use rights can be transferred (the “second-class” real estate market), leased (the “third-class” real estate market) or mortgaged. The parties to the transfer must sign a land use right transfer contract.¹³ The contract must be

⁷ Administrative Law of Urban Real Estate of People’s Republic of China at art. 12 (Jan. 1, 1995) [hereinafter Urban Real Estate Law].

⁸ Urban Real Estate Law, art. 14.

⁹ Urban Real Estate Law, art. 9. These use-descriptions are, however, usually fairly broad and are similar to what might be found in a typical US zoning code.

¹⁰ Interim Regulations on Grant and Transfer of State-Owned Land in the Urban Areas of People’s Republic of China (“Grant and Transfer Regulations”), art. 17. (May 19, 1990)

¹¹ Urban Real Estate Law, art. 25.

¹² Urban Real Estate Law, art. 25.

¹³ Grant and Transfer Regulations, art. 20.

filed with the appropriate land use bureau, which will issue a land use certificate in favor of the transferee. Land use rights cannot be assigned if the land has not been developed according to the original grant contract. The documents that prove land use rights and title to the improvements on the land are separate. In most cases land use rights and the improvements on the land must be transferred concurrently.¹⁴

China has a system of registration that permits identification of the owners of land use rights. The state has decreed that there shall be unrestricted public access to these land records nationwide.

Collective land owned by a farmers' collective is generally not permitted to be transferred for non-farming purposes, unless the state intervenes. Thus the investor must undertake careful due diligence in an effort to ensure that the land is not owned by a collective. This is not always easy, given the turbulent history of China's land policy during the Cultural Revolution.

The State Land Management Department monitors all transactions involving land in China. Authority limits are set for each level of government concerning the sale and transactions of land. For example, at county level, the authority limit is only 3 mu¹⁵ for cultivated land and 10 mu for other land. Any contracts that exceed these authority limits are automatically void, unless approved by the appropriate higher level of government. In such instances, the proceeds from the contract will be confiscated.

The maximum term of a land grant ranges from 40 years for commercial usage, to 50 years for industrial purposes, to 70 years for residential use.¹⁶ If the grantee makes a subsequent transfer, the term acquired by the new transferee is the period remaining from the original term.¹⁷ When the land use right expires, the person holding the land use right at that time must apply to renew the term, in order to continuously have a valid right.

Because land use rights are limited in time, and because building ownership is in theory severable from land title, there is an unresolved issue regarding what happens to the ownership of a building after the land use right has expired? This

¹⁴ Grant and Transfer Regulations, art. 23.

¹⁵ One mu equals about 667m² or 0.16 acres.

¹⁶ Grant and Transfer Regulations, art. 12.

¹⁷ Grant and Transfer Regulations, art. 22.

issue has yet to be resolved. The real property law will most likely be reformed in the next several years in order to clarify issues like this.

Legal Entity Vehicles for Real Estate Investment in China

Foreigners can generally invest in Chinese real estate by investing in a company which has land use rights, or by direct purchase.

Until recently, equity joint ventures (“EJV”) and cooperative joint ventures (“CJV”) were the only means for foreigners to invest in real estate.

Equity Joint Venture. An EJV under PRC law is a separate legal entity and involves each party contributing defined percentages of the EJV's start-up capital, and sharing the profits strictly in accordance with the initial percentages. An EJV has distinct advantages and disadvantages:

(a) Advantages

- Typically used for large-scale manufacturing projects
- No maximum term
- Government’s preferred investment vehicle
- Detailed rules available
- Can have branches or subsidiaries outside of China.

(b) Disadvantages

- Inflexible structure – *e.g.*, must use limited liability company; profit/loss allocated according to % of ownership¹⁸
- Types of capital contribution limited (generally right to use technology won’t be considered a contribution)
- Long time to negotiate & set up (*e.g.*, arguments over valuation of in-kind contributions)
- Can’t withdraw initial capital investment during life of JV contract
- Consensus-style management; this can lead to problems because the two parties may have divergent opinions on how to run the company and what the best interests of the JV are
- Winding up unsuccessful EJV can be difficult

Cooperative Joint Venture. A CJV is a significantly more flexible entity. However it, too, has advantages and disadvantages:

¹⁸ Equity Joint Venture Law of People’s Republic of China, art. 4 (July 8, 1979, amend. Apr. 4, 1990 and Mar. 15, 2001).

(a) Advantages

- Better for smaller-scale projects
- Subject to negotiation, the foreign party can control the management completely
- Can be either a partnership or a (Chinese) limited liability company; JV contract will spell out management structure and profit/loss allocation. Profit/loss allocation can be different from % of capital contributed¹⁹
- “Cooperative terms & conditions” (e.g., technology transfer) can be an acceptable contribution
- Can withdraw initial investment before termination of JV (assuming agreement provides for this)
- MAY be able to avoid creating a permanent establishment for the investor in PRC for tax purposes
- No minimum investment by the investor required, except 25% needed if the JV will be a limited liability company.

(b) Disadvantages

- Not very popular ... the “road less traveled”. This may be due to the fact that the contractual terms, allowing for more flexibility, result in more uncertainty as to how a Chinese court or arbitral tribunal would enforce them.
- Contract must provide for a fixed term for the JV (can be extended by agreement and with regulatory approval)
- Unless the foreign investor is willing to put up the 25% in capital needed to create a limited liability company, the JV will have to be a partnership. This means the foreign investor is potentially exposed to liability not only for its own work but the Chinese party’s work as well.

WFOE. Recently, wholly-owned foreign enterprises (“WOFEs”) have become a potentially attractive means for real estate investment. A WOFE has some advantages over a CJV or an EJV. For one thing, the structure avoids the necessity of dealing with the interests of a local partner. However, a WOFE also has certain drawbacks.

The WOFE structure may not be permitted in certain cases, and it is subject to restrictions in certain kinds of real estate development. Whether a WOFE can be utilized depends on the type of project. The Catalogue for the Guidance of Foreign Investment Industries (“Catalogue”) divides foreign real estate investment into a number of categories. Each category is treated differently. Projects listed as “encouraged” or “permitted” can be undertaken by a WOFE.

¹⁹ Cooperative Joint Venture Law of People’s Republic of China, art. 2 (Apr. 13, 1988, amend. Oct. 31, 2000).

For “restricted” projects, only an EJV or CJV is allowed; the regulations do not specifically mention the percentage of foreign equity needed for such a venture. Thus, under the Catalogue, ordinary residential buildings are “encouraged projects” and a foreigner may invest through an EJV, CJV or WOFE. In contrast, the development of raw land, the development and management of premium hotels, villas and office buildings, and international conference /exhibition centers are “restricted projects” and generally can only be developed by EJVs or CJVs. WOFEs are not permitted to develop so-called “high standard” real estate projects²⁰ such as apartments and office buildings, but they are allowed to develop and own luxury hotels.²¹

In a few cases WOFEs have been allowed to invest in restricted projects. With WTO accession, it is expected that these restrictions may be gradually lifted but, for the time being, they remain impediments to the WFOE structure.

Finally, the WOFE of course must acquire the land on its own since there obviously is no Chinese party who can contribute land to the venture.

Practical Aspects of Real Estate Development

Some foreign investors may wish to acquire real estate through an offshore company. Using this method, the investor may be able to sell the offshore company, thereby potentially avoid Chinese taxes on the transaction. An offshore company is not, however, permitted to manage real property located inside China. The investor must, accordingly, establish a management company in China.

An investor may also choose to acquire a existing project that is already under construction. The transaction must meet the following criteria in order to be transferred:

- (a) the land use right has been obtained through a grant and the land grant premium has been paid in full;
- (b) the land use right has been registered with the State Land and Resources Bureau or its local branch and a property certificate has been issued;

²⁰ “High standard” projects are projects with construction costs per unit more than two times the average construction costs per unit in the same city.

²¹ “Luxury” hotels are considered different from “premium” hotels. The PRC has a highly-detailed “star system” for different types of hotels.

- (c) at least 25% of the total investment for the project has been paid; and
- (d) the construction planning and construction permits have been obtained.²²

Some cities require that the transfer of an existing, under-construction project must be approved by the local branch of the State Land and Resources Bureau. The purchaser must follow the original construction planning permit. If it wishes to change the use of the project, the proposed transferee must obtain a new construction planning permit before carrying out any work which is beyond the scope of the original permit.

Financing Real Estate Development

Financing methods for real estate projects have typically included bank loans, pre-sale contracts, equity investments, real estate investment trusts and IPOs.

Until recently bank lending constituted the major channel for real estate financing. According to some estimates, through 2003 over 80 percent of funding for land purchase and property development came from bank lending directly or indirectly.²³ Bank loans are, however, becoming more difficult to obtain, since (under prodding from the central government) banks are becoming more prudent in granting corporate loans to real estate developers, and foreigners can no longer obtain mortgage loans from Chinese banks.

Although mortgages can be transferred and are in theory alienable from the underlying property (at least if there is a separate promissory note),²⁴ mortgage securitization is, at present, virtually unheard of in China. With the tightening of lending practices, a variety of other methods may need to be considered for a financing transaction:

- The presale of to-be-constructed buildings is a common way to obtain financing, particularly for housing projects. However, before a presale method can be legally adopted, the developer must have several documents in hand: a land use right certificate, a planning permit for use

²² Urban Real Estate Law, art. 38.

²³ Liu Tinghuan, Deputy Governor of the People's Bank of China, "China's Real Estate Finance and Policy Implications," speech to the 1st Jiangxi High-level Forum on Real Estate Development and Financial Support organized by the Land Institute and the Financial Institute of Jiangxi Province June 26, 2004.

²⁴ Contract Law (1999), art. 79; Security Law, art. 75.

of land, a planning permit for the construction project, a certificate of commencement of construction, and (for a housing project) a presale permit.

- As mentioned earlier, an investor can also sell its equity in the project in exchange for foreign currency. Using this procedure, an offshore company is established. This entity owns the domestic company that is undertaking the project. By transferring ownership of the offshore company to another investor, the developer can obtain additional capital to invest in the Chinese company which is developing the project.
- Real estate investment trusts are also becoming more common. Individual investors deposit funds in trust and investment companies, which in turn invest the money in real estate. Trust investments called “land trusts” are also used in raw land development. Under this arrangement, the government’s land reserve center contracts with the land trust. Then, the land trust retains a professional development company. The development company engages in the preliminary development of the entrusted land, “san tong yi ping”.²⁵ The trust company must raise the funds needed to finance the preliminary development. Like in the case of real estate investment trust, the trust company enters into contracts with individual investors. After the preliminary development is finished, the land use rights will be granted through bidding, auction or listing. The individual investors’ earnings are then paid from the premiums earned from the sale of the right.

Generally, the typical trust transaction is relatively small. At present real estate trusts mainly serve as “bridge loans,” providing early-stage funding for real estate projects which cannot qualify for bank loans.²⁶

- Public stock listings are currently little used by Chinese real estate developers due to investors’ concerns regarding project viability. For a foreign company, stock exchange listing is quite difficult due to the stricter governmental review. Completing the IPO process is time

²⁵ Land is said to be “san tong yi ping” when it is leveled and has been furnished with basic infrastructure or services. Ping means that the land is flat or has been leveled. Whatever investment vehicle is used, it is important to make sure that the flat or leveled land is the way the investor wants it because flat or leveled land may mean land that is below road or flood level, which could require expensive backfilling before the site can be used. Tong means “through”, in this context meaning that the basic infrastructure has been “connected through” to the site. These are: water supply, electrical power, road, telecommunications, sewer connections, drainage, gas supply and steam supply. Again, it is vital to verify what is provided and what is not.

²⁶ Liu, *supra*.

consuming and costly. A limited liability company must be first converted into a “foreign-invested company limited by shares” before an IPO listing can be undertaken. The requirements for forming such an entity are significantly more rigorous than those for domestic companies.

Resolving Disputes

Given the fast-paced changes in the real estate industry, as well as the reported general lack of sophistication among Chinese judges regarding real estate issues,²⁷ it is essential that investors endeavor to include international arbitration clauses in their investment contracts. Frequently-used (and generally accepted by Chinese parties) arbitration venues include The China International Economic and Trade Arbitration Commission (“CIETAC”), The Singapore International Arbitration Centre, and the Hong Kong International Arbitration Centre.

Recent Changes to the Regulations

In recent years the PRC government, in an effort to cool down the economy, has introduced regulations aimed at tightening control of land supply, increasing restrictions on mortgages and pre-sales, and implementing less advantageous loan policies. Given the rapid growth in the market, however, the government is always struggling to catch up. There is at present no special regulatory framework for real estate finance and development. A complex web of national and local decrees, regulations, and court decisions now governs real estate investment in China, involving entities as diverse as the Ministry of Construction, the Ministry of Land and Resources, and the Ministry of Finance. Each ministry has detailed regulations regarding licensing procedures and categories, encompassing such issues as the type of assets that can be valued, guidelines for property size and type, fee structure, and geographical considerations.

A summary of some of the more recent developments includes the following:

- In 2002, the Ministry of Land and Resources issued rules regarding land use right transfers.²⁸ Under the new rules, grants of land use rights for business purposes must be conducted through bidding, auction or listing

²⁷ Real estate cases are heard by the Civil courts, rather than the Economic courts. *See*, 1992 Circular of the Supreme People’s Court on Issues Concerning the Hearing of Real Estate Cases.

²⁸ Regulation on Grant of State-Owned Land Use Right by Auction, Bidding and Listing (May 9, 2002). This regulation took effect on July 1, 2002 and it is also referred to as Decree No. 11 of the Ministry of Land and Resources.

on an authorized exchange floor.²⁹ The ostensible purpose of the decree is to help reduce the current inequalities caused by corruption. But, almost as soon as the auction requirement was enacted, exceptions to the rules crept in that preserved the options of local officials in “special cases.”

- In 2003, the PRC government issued a “notice” regarding development of the real estate market.³⁰ The notice states that the land supply must be strictly controlled and that the examining and approval authority for land grants may not be undertaken at a level any lower than provincial government.³¹
- Numerous local governments have promulgated similar regulations in an effort to bring their laws in line with national policy. For example, the Beijing municipal government issued a notice in June 2002 to stop most agreement-based transfers of land use rights for business use,³² with only a few exceptions, such as construction projects in towns and small cities and land use for high-technology industries, which were still open to transfer by agreement.³³ Then in January 2004, Beijing municipal government promulgated its No. 4 Decree and eliminated even these exceptions.³⁴ This resulted in great changes to the real estate industry. The No. 4 Decree allows only those agreement-based land use right transfers that had already been approved by the government before the issuance of the Decree.³⁵ Other provinces, such as Yun Nan, have followed Beijing’s lead by enacting the bidding, auction and listing practice.
- Mortgage and pre-sale restrictions are also being increased. In April, 2003 the Supreme People’s Court issued an interpretation of the law relating to

²⁹ *Id.*, at art. 4.

³⁰ Notice of the State Council on Promoting Sustainable Healthy Development of the Real Estate Market (Sept. 8, 2003).

³¹ *Id.*, at art. 5.

³² Regulations on Termination of Grant by Mutual Agreement of State-Owned Land Use Right for Business Purposes (June 26, 2002).

³³ *Id.*, at art. 2(5).

³⁴ Supplementary Regulations on Termination of Grant by Mutual Agreement of State-Owned Land Use Right for Business Purposes (Jan. 17, 2004).

³⁵ *Id.*, at art. 1.

commercial housing sales contracts.³⁶ The interpretation states that it is illegal to execute a pre-sale contract before the developer has obtained a pre-sale permit.³⁷ The developer must also, at the time the contract is signed, disclose whether the property is subject to a mortgage.³⁸ Another judicial interpretation, issued in 2002, related to the priority of the contractor's payment claims.³⁹ The ruling reaffirmed that the contractor's right to receive payment takes priority over mortgagees' and other creditors' rights.⁴⁰

- As noted above, banks are applying more stringent loan requirements. In 2003, the central bank issued a notice regarding loan management in real estate.⁴¹ The so-called "No. 121 Decree" imposed numerous restrictions on real estate development loans. For example:
 - before a loan could be obtained the developer's equity had to equal least 30% of the project's total investment.⁴²
 - Loans can only be used for constructing projects in the municipality where the issuing bank is located.⁴³
- In April 2005, the central bank raised the Deposit Reserve Ratio to 7.5% from 7%. This resulted in decrease of RMB110 billion (about USD13 billion) in the funds available from banks.
- Recently, the State Council increased the capital which must be provided by the developer to over 35% for projects (excluding economic housing

³⁶ Supreme Court's Interpretations of Several Issues on Application of Law While Hearing Disputes Related to Commercial House Sales Contract (Apr. 28, 2003).

³⁷ *Id.*, at art. 2.

³⁸ *Id.*, at art. 8(1).

³⁹ Reply of the Supreme Court in Respect of the Issue of Priority of Construction Fee in Remuneration (June 20, 2002), Article 1.

⁴⁰ Article 286 of the Contract Law.

⁴¹ Notice by People's Bank of China on Further Strengthening the Administration of Loan Business to Real Estate (June 5, 2003).

⁴² *Id.*, at art. 1, ¶ 3.

⁴³ *Id.*, at ¶ 4.

projects) funded by bank loans. Given the fact that in a public auction for land, a developer must pay up the full amount of land grant fee upon winning the auction, smaller developers will have a hard time surviving.

- New regulations also cover property management. In 2003, the State Council issued a new regulation promoting the separation of development and subsequent operation of real property. Although the regulations do not appear to be fully binding, they outline “recommended” practices. For example, to select a qualified management entity, the bidding and auction methods are recommended by the government.⁴⁴ The management entity must have legal person status under Chinese law and its personnel are required to have certificates of qualification.⁴⁵

With the proliferation of new regulations, conflict among them is inevitable. Thus, although the Basic Law of Contract proclaims that the parties are free to contract as they please and that their bargains will be upheld, it remains to be seen whether bargains will be upheld that create interests that are inconsistent with the many regulations of the Bureau of Land Administration or the Ministry of Construction. For instance, one Chinese rule requires that all leases continue to exist following a foreclosure of the landlord’s interest.⁴⁶ Another rule gives lessees a “right of first refusal” to renew at the end of the lease term or to buy if the landlord should sell the underlying ownership of the land.⁴⁷ It is unclear whether this right can be “bought out” in advance.

⁴⁴ *Id.*, at art. 3.

⁴⁵ *Id.*, at art. 32.

⁴⁶ Contract Law (1999), art. 229.

⁴⁷ Contract Law (1999), art. 230.