KING & WOOD

PRC LAWYERS

China's Big Bang in Construction:
Adapt or Perish

By Mark Schaub, Qingjian Chen and Emilia Shi
King & Wood Shanghai

"*Adapt or perish, now as ever, is nature's inexorable imperative.*
H. G. Wells (1866 - 1946)

Foreign enterprises participating in China's construction field have also often been active in complaining about their treatment. Foreign invested enterprises have often taken umbrage about restrictions on their market access, the absence of a level playing field and the lack of transparency.

Unfortunately for the foreign companies it appears someone in the Chinese government has been listening. New regulations are now being rolled out that do bring greater market access and make the playing field more level. However, for many foreign companies the new regulations will, at least in the interim term, cause much greater more discomfort and difficulty than the previously familiar albeit imperfect system.

Crossing the River by Feeling the Stones vs. Big Bang

Articles on law giving in China often refer to "crossing the river by feeling the stones". The saying sums up the Chinese practice of carefully and incrementally adapting their legal system. However, the new regulations in respect of construction are more of a big bang rather than incremental.

On 1st October 2003 the foreign invested construction sector will be revolutionized by Decree 113 and Decree 114. These new regulations herald a new whole new way in which foreign enterprises will need to approach the construction field in China. Before examining the likely effect of these regulations it may be worthwhile to examine how the industry is normally conducted today.

The Good Old Days: Construction

Construction has to date been an extremely restricted area for foreign investment and contractors.

Before the issuance of Decree 113, the Provisions on Establishment of Foreign-invested Construction Enterprises (File No. 533, 1995) jointly issued by the Ministry of Construction and the Ministry of Foreign Trade and Economic Cooperation specifically mainly regulated foreign invested construction enterprises. Pursuant to Article 2 thereof, construction wholly foreign owned enterprises (WFOE) were prohibited from being established.

Currently foreign construction companies have the following alternatives to operate in China:

- via an existing construction Sino-foreign joint venture
- by establishing a specific project based Sino-foreign joint venture
- obtaining a qualification certificate to act as a foreign contractor

The last two alternatives (especially the foreign contractor license) has been favored by foreign companies that either 1) specialized in particular aspects of a project (i.e. a nominated sub-contractor for a certain aspect e.g. curtain walls for some office buildings); or 2) wish to maintain a high degree of independence (i.e. did not feel comfortable in relation to establishing a long term joint venture with a Chinese partner).

In addition to the above options a number of foreign engineering consultancy have established WFOE consulting enterprises which carry out project management service or other types of construction related services.

Good Old Days - Design

Foreign companies have also been active in providing design related services in China. Design services include companies engaging in the following types of activities:

- Concept Design;
- Project zoning and landscape design;
- Preliminary design;
- Instruction or advise to Local Design Institutes
- Acting as an general design consultant

Currently most foreign designers, engineers and architects carry out PRC projects by:

- Off-shore Co-operation via a China local partner.
- Establishment of a Representative Office in China
- Establishment of a design FIE in China (rarely)

In practice foreign architects, engineers and designers have normally been registered as a Foreign Designer in China and then co-operate with a local Chinese design institute. Some foreign designers never even bothered to register but just acted as a design consultant for the employer of some projects. Such co-operation can be a close working relationship or in some cases to a co-operation in name only where the Chinese design institute merely “chops” the foreign companies drawings. In most cases the Chinese design institute will give at least some assistance in relation to the local construction standards and specifications.

It should be noted that many foreign architects and designers fail to register in the PRC on the basis that they are “famous” in Europe or the United States or elsewhere. However, such an attitude can lead to major problems in relation to the validity of design contract except for concept design according to the Construction Law, fulfillment of contracts as well as in receiving offshore payment.

The Big Bang's New Regulations

Pursuant to the WTO Accession Treaty namely Annex 9 China agreed to open up its economy to foreign investment in respect of architectural services, engineering services, integrated engineering services, urban planning services (except general urban planning), however only in the form of joint ventures but with a foreign majority permitted. Within five years after China's accession to the WTO, the Chinese government had agreed to allow WFOE will be permitted in construction and joint ventures in related engineering services. The WTO documents state that the projects to be undertaken by WFOEs are subject to restriction.

China has by issuing Decree 113 and 114 actually opened up the construction industry to foreign investment two years earlier than it was legally required to under the WTO Accession Treaty.

Decrees 113 and 114 loosen the restrictions in relation to foreign investment in construction and design enterprises in China. However, this apparent loosening has been accompanied by a number of additional requirements which are likely, at least initially, to result in problems and uncertainty for foreign construction companies in China.

Impact of Decree 113 on Construction

Main Contents of Decree 113 - Decree 113 allows foreign investors to establish a foreign invested enterprise (FIE) construction company in the form of a WFOE (for the first time), or as a contractual joint venture ("CJV") or as an equity joint venture ("EJV"). In addition the Decree defines the documentation and procedural requirements to establish such entity.

Importantly the regulations specify that a construction-related FIE must be approved and licensed by the competent construction authorities. The level (i.e. central or provincial) will depend on the qualification ranking sought. Accordingly it will not only be the Ministry of Commerce who will approve such companies but also the Construction Ministry.

Unlike most joint ventures there is also a requirement that the Chinese partner(s) to such entity hold no less then 25% of the registered capital of the FIE. Many people confuse this with the 25% shareholding requirement for foreign investors in Sino-foreign enterprises. However, it is clearly required that the Chinese shareholder hold at least 25% of the shares in the joint venture.

No More Direct Contracting by Foreign Companies - Article 26 of Decree 113 annuls the Provisional Measures on the Qualification Administration of Foreign Investment Enterprise Contracting Projects in China as of 1st October 2003. Accordingly foreign contractors have only a limited grace period in which to reorganize their Chinese operations.

According to an official from the Ministry of Construction, foreign companies are still allowed to apply for the Qualification Certificate to Contract Projects in China and such certificates will still be issued in the normal manner.

Pursuant to the Provisional Measures on the Qualification Administration of Foreign Investment Enterprise Contracting Projects in China, the Qualification Certificates are required to be renewed every five years. **After 1st October 2003, such renewal will no longer be available**

and the foreign contractor shall automatically lose its qualification to engage in direct contracting upon expiry of its certificate.

However, according to an official from the Ministry of Construction, construction contracts entered into by qualified foreign companies before 1st October 2003 are likely to be allowed to continue to be performed even if not completed by such date.

The effect of these changes in regulations is that in the future foreign contractors wishing to engage in construction in China will be required to establish a FIE and will not be able to be registered on a project by project basis.

Allows for First Time for Establishment of WFOE Construction Enterprise – As mentioned above Decree 113 allows for the immediate establishment of WFOE construction enterprises two years ahead of China's commitment schedule under the WTO accession treaty.

Choosing Upon a Vehicle – JV or WFOE?

For most foreign contractors the crucial decision will be whether to establish a joint venture or a WFOE. In the writers' opinion there is no black and white answer. A decision should be made on a case by case basis after carefully analyzing each company's experience, types of projects and intentions for China. The following items should be considered prior to making a decision:

Will the Restricted Business Scope of a WFOE Severely Hamper my China Business? - WFOE construction companies will be limited to projects which are 1) wholly or primarily invested by foreign investors; or 2) funded by international aid agencies, or 3) wholly paid for by foreign companies; or 4) technically difficult projects. Joint ventures on the other hand will face no such restrictions (other than qualification certificates).

In practice the above restrictions mirror to a great extent the current restrictions in respect of foreign contractors. Smaller and/or specialist construction companies have tended to act within such a scope of project anyway. For this reason we assume such types of companies will tend to prefer a WFOE solution.

Larger and more ambitious contractors (i.e. those who wish to act as General Contractors for some local large housing or infrastructure projects) will probably seek out a joint venture solution. Indeed most large foreign contractors already have joint ventures in place.

In discussions at which the authors' have been present some contractors have suggested that it would be helpful and transparent for guidelines to be developed to elaborate what is meant by category 4 i.e. technically demanding projects. In our opinion such guidelines may make matters somewhat more transparent but are not likely to be helpful. In our experience this category was always a useful catch all to allow a foreign contractor into a project in cases where the owner strongly wanted this but the project did not fall within the other categories. Defining this category is likely to remove a degree of flexibility in such cases and would result in an adverse impact upon the WFOE's ability to enter into such projects.

Will I be Able to Work Together with a Joint Venture Partner? - A construction joint venture is unlikely to have a silent Chinese partner, given that 25% is a sizeable enough a shareholding to mean the Chinese shareholder is likely to have some role in the entity – in any event he will

be able to enjoy a veto right in respect of certain key decisions by law i.e. sale of shares, change of articles of association and may seek to add additional points by contract. Fortunately the authorities did not make this provision as onerous as they could have.

In some restricted industries the joint venture partner must have as good as or a better qualification certificate than the joint venture – such a regulation would have meant that foreign contractors could only enter into joint ventures with Chinese construction companies. This would block joint ventures with potentially attractive partners (e.g. investment companies, development areas) that may be willing to allow the foreign contractor to take the lead in management whereas they would contribute in other ways e.g. capital or bringing in projects.

It should be noted that the regulations could have been much more restrictive. Foreign companies are able to enter into joint venture arrangements whereby they are able to carve out a greater participation in management or profit sharing than their share of the registered capital alone would suggest. In addition foreign contractors may enter into technology transfers or technical assistance agreements whereby it can also its share of the income from a project.

Qualifications – Another major headache for foreign contractors will be the requirements in respect of qualifications. On April 8, 2003, the Ministry of Construction has promulgated the Implementing Rules of the Ministry of Construction on Qualification Administration under the Administrative Regulations of Foreign Investment Construction Enterprises ("the Implementing Rules") to facilitate the execution of Decree 113. Generally speaking, construction FIEs will be granted national treatment in most respects as local domestic construction enterprises.

However, such national treatment shall involve requirements such as minimum registered capital levels and obtaining qualification levels. The construction FIEs shall also be governed by Grade Classification Standards of Construction/Installation Enterprises as well as Decree 87 and Decree 113.

Article 22 of Decree 113 provides that foreign companies that has obtained a Qualification Certificate to Contract Projects in China before implementation of the said Decree and intends to set up construction FIEs shall apply for construction enterprise qualification with corresponding grade as per their performance record of the projects undertaken within the territory of China.

Article 12 of Decree 87 provides that newly established construction enterprises shall be rated at the lowest grade and with one (1) year for tentative period.

Accordingly any foreign contractor which wishes to obtain a higher qualification certificate i.e. Special Grade, Grade A or Grade B for its FIE will need to show corresponding qualifications and expertise of projects previously contracted in China.

The Implementing Rules confirms that construction FIEs whose foreign investors have legally contracted projects in China and those restructured from domestic construction enterprises may apply for qualification of higher grades based on the track records of their foreign investors and/or the previous domestic enterprises.

In the authorities' opinion it is unlikely that the PRC authorities will retreat from the position that a PRC qualification must be based on a PRC track record. This would appear at least to the authors of having a certain logic.

One area where we assume greater flexibility will be shown is in regards to which entity has such track record. Many foreign enterprises for tax or liability or strategic reasons establish FIEs in China via a specifically established holding company (e.g. Hong Kong). Naturally such company will not have a track record in China. We are confident (but this has not been confirmed) that the PRC authorities will also take PRC projects of the parent company and also possibly affiliates into account.

Can I Justify the High Registered Capital Requirements? – One area which concerns a number of foreign companies is the relatively high registered capital requirements. The requirements can be very complicated and will depend on which types qualifications you wishes to obtain.

This is in our opinion a justified concern and will pose a major problem for foreign construction companies. However, with careful planning requirement may not be as insuperable as first appears. Possible (or at least partial) solutions may include:

Investing working capital

Contributing technology (normally up to 20%) into the FIE

CJV arrangement whereby Chinese partner has most of the registered capital but the foreign party enjoys high degree of management control and/or revenue

Which Approval Authorities Are Responsible? – Pursuant to Under Decree 113 authorization for granting approval for establishment and Qualification Certificates for construction FIEs are split between 1) the competent foreign trade and economic co-operation administration (Ministry of Commerce – the revamped MOFTEC and its relevant local departments) and 2) the competent construction administration.

The Ministry of Commerce approves the establishment of construction FIEs in respect of the foreign investment element whereas the Ministry of Construction is responsible for issuing the Qualification Certificate. The level of the authority (i.e. Beijing or local) will depend on the classification of the enterprise (Special Grade and A Grade will be approved at the Beijing level).

The fact that two authorities are involved will naturally complicate the approval procedure. The two authorities in question may also have varying policy goals in applying the new regulations. Also it should be noted that it is generally more difficult and time consuming to have a project approved at the central level rather than the lower levels.

One interesting dilemma is that given the approval of establishment and issuance of the qualification certificate are essentially de-coupled it means that a risk arises that a FIE may be established and capitalized but then fails to get the desired or hoped for qualification certificate.

One possible way to minimize this risk is to make contribution to the registered capital dependent upon an appropriate qualification certificate being issued.

Impact of Decree 114 on Design

Main Contents of Decree 114 - In many regards Decree 114 mirrors Decree 113. Indeed it even contains provisions that require domestic companies to contribute at least 25 percent of the registered capital in joint ventures, allows for the establishment of wholly foreign-owned enterprises and includes the same two-step approval process. However, whereas certain aspects of 113 appear to make life more difficult for foreign contractors it seems that certain aspects of 114 are not possible to fulfill.

Crucial Issues Regarding Establishment of Design FIEs

Timing - According to Decree 114, foreign companies may apply for establishment of joint venture design companies as of 1st December 2002. However, no official details have been provided as to when the authorities shall commence accepting applications for establishing wholly foreign-owned enterprises.

Number of Foreign Qualified Professionals - Decree 114 provides that wholly foreign-owned design companies applying for buildings, engineering, and design qualification certificates require that a percentage of the foreign service suppliers be qualified as certified engineers and architects in China. Such foreigners must comprise no less than one-fourth of the total number of registered engineers and architects (such total number is set according to the standards of each enterprise qualification level) of the relevant company. Therefore at least one-quarter of the technical team must be expatriates with professional design experience. For joint ventures, the ratio is set lower (i.e. at one-eighth).

The aggregated period for such foreign professionals' stay in China is required to be at least six months *per annum*.

We assume that the Chinese motivation is at least in part to ensure that wholly foreign owned enterprises are 1) uncompetitive due to the high number of expatriates; and 2) have placed a great practical advantage to establish a joint venture instead. The residency requirements effectively stops a foreign company from "stacking" its office with expatriates based in its Hong Kong, Taiwan and Singapore offices.

A further difficulty is how foreign professionals will obtain the Chinese qualifications. As far as we understand the situation only the United States and China have a mutual recognition project in place (see below).

Provisions of Regulations of PRC Certified Architects - Article 36 of the Provisions of Regulations of PRC Certified Architects states that foreigners' applying for national examination and registration as a PRC certified architect must be dealt with in accordance with the principle of reciprocity. Another daunting aspect is that the foreign professionals are also required to take such examination in Chinese. We understand that to date **no expatriate** has received the Chinese certified architect qualification by means of national examination.

However, before the expatriates reading this article start complaining about these new regulations it should be borne in mind that they are based on “reciprocity”. Most Western countries have far more restricted regimes in place in respect of Chinese architects working in their countries. For example Germany requires would be applicants to have lived in Germany for at least ten years, be fluent in German and to pass a German architect examination. By this measure the Chinese regulations pose a far lower barrier.

Reciprocal Acknowledgement of Professionals between China and Other Countries – It should be noted that some reciprocal arrangements do exist. An agreement exists between China and the USA for recognition of architects (although we understand only 10 have been recognized). Further, structural engineers of Commonwealth Nations (i.e. United Kingdom, Australia, Canada, Singapore) are acknowledged in China. In practice more than twenty structural engineers have been acknowledged through agreements reached by relevant associations in China and other countries.

Qualification - Except for the restriction set forth to qualified expatriates, design FIEs are granted national treatment for their qualification and activities conducted in China. Thus provisions regarding domestic design companies also apply to such FIEs e.g. a newly established design FIE shall start applying for the qualification no higher than Grade B and be subject to a tentative period of two years.

Summary

> *"As a general rule the most successful man in life is the man who has the best information."*
> ***Benjamin Disraeli***

Decrees 113 and 114 will have a clear impact on the way foreign construction companies have been involved in China's construction industry. To a large extent the present business models will no longer be possible as of 1st October 2003.

The new regulations do place foreign contractors and designers under time pressure – even more so if they have not taken any action to date. However, the new regulations do also provide advantages and may prove to have lasting benefits for those who get their planning right at the current stage.

It is unlikely that the Chinese authorities will give way on requirements based on reciprocity or on the level playing field. It is not clear why they should be expected to do so if their nationals are not granted the same rights overseas.

Indeed international companies in China may find that their most intractable opponents will not be the Chinese authorities but rather their colleagues back home who are unwilling to open up their own construction industry. In the authors' opinion the best approach in dealing with the new regulations will be to exploit the flexibility contained therein and lobby for clarifications and changes which are 1) helpful and 2) practically possible and reasonable for the authorities to agree to.

The major question facing foreign contractors is how they should best comply with the regulations. Hoping or waiting for a last minute reprieve will not be a successful strategy. Legally it appears there is no framework for an additional period of grace – if in practice it is granted then it will only be that – an additional period of grace. At some stage foreign construction related companies will need to come to terms with the new realities of doing their business in China.

Although there are undoubtedly difficulties and problems ahead the companies who inform themselves well and have a well thought out strategy may find the new regulations to be a

greatly welcome loosening of restrictions on their ability to do business in the long run.

Please contact us if you would like a full translation of the new Regulations or for further advice:

King & Wood Shanghai Mark Schaub (schaub@kingandwood.com) Emilia Shi (shijinjuan@kingandwood.com) Tel: +86 21 6385 2299 Fax: +86 21 6386 5660/6386 5770 21/F Shui On Plaza 333 Huai Hai Road (M) Shanghai 200021, CHINA	**King & Wood Beijing** Xu Ping (xuping@kingandwood.com) Qingjian Chen (qingjianchen@kingandwood.com) Tel: +86 10 65612299 Fax: +86 10 65610840 30 Floor, North Tower Beijing Kerry Centre 1 Guanghua Road Beijing 100020, CHINA
King & Wood Guangzhou Tel: +86 20 38911757 Fax:+86 20 38912082, 38912083 30/F, Room 03, 45/F CITIC Plaza, 233 Tianhe North Road, Guangzhou, P.R. China	**King & Wood Chengdu** Tel: (+86-28) 627-7898 Fax: (+86-28) 652-7070 / 652-8080 11/F, First City Plaza 308 Shuncheng Avenue Chengdu 610017, CHINA
King & Wood Shenzhen Tel: (+86-755) 212-5533 Fax: (+86-755) 212-5580 47/F, Shun Hing Square Di Wang Commercial Center Shennan Road East Shenzhen 518008, CHINA	