

CHAPTER 1 — INTRODUCTION TO CHINESE CONSTRUCTION LAW

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¶1-001 Construction in China

China is in a construction boom. Construction is taking place in all sectors of the economy and in all provinces in China. Projects range from domestic residential housing and commercial office towers to sophisticated petrochemical plants, nuclear power stations, dams, pipelines, ports, road and rail projects, etc. This construction boom is likely to continue in the foreseeable future as China builds and improves its infrastructure. The successful hosting of the Beijing 2008 Olympics is an example of the sophistication and improvements that are being made to China's infrastructure. The Shanghai 2010 World Expo, the Western Development Strategy and National Housing Reform all provide enormous opportunities for foreign companies interested in China's construction market. In addition, the recently announced RMB 4 trillion economic stimulus plan is aimed squarely at infrastructure investment, with 45 per cent of the headline package to be plowed into railways, roads, airports and the power grid¹. The expected growth of urban infrastructure projects, environmental and energy production projects will play a huge and growing role in driving construction activity in China. Therefore, many foreign construction, engineering and design companies, international property investors, and equipment and material suppliers have come to China in order to take part in this development or to provide technical and managerial support to Chinese construction enterprises.

China's construction industry is a mainstay of the Chinese economy and on 26 February 2008, at a State Council press conference, the Vice Minister of Housing and Urban-Rural Development (formerly the Ministry of Construction, now known as the Ministry of Housing and Urban-Rural Development of the People's Republic of China) ("MOHURD"), stated that China is the largest construction market in the

1 China Economic Review, January 2009

world now, which has the value of RMB 1.5 trillion². China's construction output in 2008 accounted for more than 5.7 per cent of its Gross Domestic Product³. In 2008 urban fixed asset investment in construction grew by 30.4 per cent over the previous year⁴. The output value in the construction sector was up 24.4 per cent in the first half of 2008⁵. In railway construction alone, China invested RMB 330 billion to build railways in 2008, including 80 new projects⁶. China is proposing to invest RMB 600 billion in railway construction each year from 2009 to 2012⁷. Road construction also continues unabated with an 85,000 km expressway network to be constructed over the next 30 years⁸. By the end of 2007, a total of 53,600 km of expressway ran through China⁹.

¶1-002 Construction Law in China

The diverse nature of the construction process in China brings together various laws and regulations which cover design and construction work in such respects as obtaining approvals, standards of workmanship and equipment, provisions for the operation of construction sites, matters of health and safety, and of environmental concern. Chinese construction laws also cover road and railway construction, water and waste projects, energy projects, as well as the traditional building and engineering trades.

This book is intended to provide an overview of construction law in China as it pertains to foreign investors. The various laws and regulations that impact on the construction process in China are discussed, together with some practical guidelines on some of the common pitfalls that foreign investors encounter with construction projects in China.

The Chinese Contract Law, its major characteristics and general principles as well as its focus on construction project contracts are analysed in Chapter 2 of this book. The Contract Law underpins all construction transactions and accordingly a good understanding of the Contract Law is an essential foundation if you are going to undertake construction projects in China.

Another important foundation is land ownership in China. No construction project can proceed without property on which, or over which, to build and therefore a brief introduction to China's unique land ownership regime will be provided in Chapter 3, together with a commentary of the new Property Law, which was enacted in 2008. Here, issues that confront foreign investors in the acquisition of land for construction projects are specifically studied.

Any Chinese construction law book will inevitably include reference to the Construction Law and its associated survey, design, quality and safety regulations. The Construction Law is the key piece of construction legislation in China and is

2 Chinanews, 26 February 2008

3 PRC National Bureau of Statistics

4 Ibid, 26 February 2009

5 Ibid, 31 July 2008

6 Sina Finance, 9 March 2009

7 Ibid

8 XHBY News, 25 November 2008

9 Ibid

currently undergoing an extensive review process by MOHURD. Therefore, key aspects of the Construction Law and the proposed revised and updated Construction Law are commented upon in Chapter 4, and quality and safety issues in Chapter 5 of this book.

In addition to the Construction Law and the Contract Law, which are the principle laws that govern construction in China, the Tender Law will be discussed in Chapter 6, and the Wholly Foreign Owned Enterprises Law and the Joint Venture Law in the context of foreign investment in China are also examined in Chapter 7. All of these laws have a bearing, to a greater or lesser extent, on the construction process for foreign companies in China. The concluding chapters (ie Chapters 8, 9 and 10) cover important topics like market access to China's construction industry and common issues for international owners, contractors, designers and project managers as well as arbitration and alternative dispute resolution for construction disputes in China.

Before looking at the construction industry in China, which is still relatively unsophisticated, it is instructive to consider the changing nature of the international construction industry because this is a good pointer for how the industry in China will likely develop and the opportunities that might present themselves in China over the coming years.

¶1-003 The changing nature of the international construction industry

The industry in the 1970s

Over the last three decades the construction industry worldwide has changed considerably. Technology now plays a major part in the design and construction process. Owners and contractors have become more sophisticated in their use of various delivery systems and we have seen innovative financing and procurement methods used for public works projects.

This is a far cry from the 1970s and early 1980s, when the construction process was relatively straightforward and less contentious. For instance:

- Owners contracted with architects and engineers, who prepared the plans and specifications. Subsequently, owners contracted with general contractors, who took responsibility for the entire project and hired subcontractors directly, ie a design, bid, build process.
- The concept of "master builder" still prevailed and architects, engineers and general contractors had a sense of professional responsibility and camaraderie, ie there was generally a teamwork type approach.
- Architects, engineers and general contractors were reasonably compensated for their work; this provided an incentive to invest their professional time and resources in projects.
- Disputes were commonly resolved by negotiation "over a cup of tea", ie lengthy and costly arbitration and/or litigation were relatively rare.

The industry in the 1980s and 1990s

Things changed in the late 1980s, when formal dispute resolution of construction disputes became common and construction litigation and arbitration grew. During the 1980s and 1990s contractual relationships moved towards:

- Design-build procurement with fast track design being the norm.
- Construction management with construction managers acting as the owner's agent to supervise a number of trade contractors, who contracted directly with the owner.
- Management contracting where the management contractor contracted directly with the owner and with trade contractors and accepted responsibility to guarantee maximum project cost and time of completion to the owner.
- Concession contracting where contractors joined with owners to build, operate and own facilities and infrastructure.
- Turnkey; Engineer, Procure and Construct ("EPC"); and Engineer, Procure and Construction Manage ("EPCM") type contracting.
- Owners and their consultants creating new contract documents to place significant (and often inequitable) risk on contractors.
- Owners undertaking projects with inadequate financing or no financing in place.
- Owners accepting the lowest tender without proper consideration of value engineering or other technical or practical considerations.

These adversarial relationships and the change from traditional forms of contracting are no better demonstrated than in the Hong Kong construction industry. In Hong Kong, the change can be largely traced to the rise of the construction claims consultants and the increased involvement of lawyers.

The industry became more "contractual" and parties were more inclined to take contractual positions to support non-payment or non-performance. This was driven largely by two factors (certainly in the case of Hong Kong):

- inequitable risk allocation in contracts, and
- acceptance of the lowest tender for the work.

This led to contractors accepting most of the risk and yet being unable to price that risk and still remain competitive enough to win sufficient work. The inevitable consequence of this was that contractors sought to make claims in order to recover their profit, and in some cases, simply to break even and cover their costs. The situation was exacerbated because it was always possible to find a contractor who was prepared to take on risk at a low price. Contractors began to employ claims departments and actively prosecute claims for additional compensation against owners. Owners responded by denying claims and employing their own claims consultants and lawyers to "fight" the contractors.

It is in effect a vicious circle and ultimately the owner pays because he/she is drawn into lengthy and expensive disputes that probably could have been avoided had he/she equitably shared the risk in the contract and chosen the contractor most able to perform the work for a fair price, rather than the lowest price.

The industry at the present time

By the time the Asian financial crisis of the late 1990s arrived, the construction industry in Asia was confronted with the harsh reality that adversarial relationships could not survive and therefore it moved to develop new relationships that could best be described as "team building" or "alliance contracting". These developments grew rather quickly in certain jurisdictions and helped to foster a more cooperative culture among contractors, designers and developers, who favoured working as part of a team made up of other industry members. Mediation and other forms of non-adversarial dispute resolution have also grown in prominence as the construction industry has slowly moved from an industry of confrontation to one of cooperation.

The coming years most certainly will bring more strategic alliances. Construction firms will combine and collaborate, moving on from partnering to relationship-based collaboration on complex projects. In other words, there will be more long-term relationships in which success is defined over time rather than by a single transaction.

¶1-004 The internationalisation of construction in China

Another factor we are seeing today is the increased globalisation of the world economy. Large construction companies from the United States, Europe, Japan and Korea dominate the industry. However, some 80 per cent of the world construction market is in developing countries (including China) and increasingly the longest bridges, the deepest tunnels, the tallest buildings, the largest shopping malls, the largest and deepest ports, the most advanced airports, the biggest dams and other examples of the extremes of design and construction are taking place in China.

According to the PRC National Bureau of Statistics, in 2006 there were 60,166 construction enterprises in China of which 59,317 were domestic funded, 479 were funded from Hong Kong, Macau and Taiwan, and 370 were foreign funded¹⁰. The total number of people employed by these 60,166 construction enterprises was 28,781,600 with 4,676,100 people being employed by state-owned construction enterprises alone¹¹. On any analysis, therefore, the construction industry in China is enormous.

As indicated by the statistics in the previous paragraph, many of the world's largest construction engineering and design companies have a presence in China and increasingly work with Chinese design institutes and Chinese contractors, material and labour suppliers on projects around the world. This in turn is leading to increased sophistication in construction procurement, performance and management in China.

To this end, we are starting to see a movement away from the traditional separation of design and construction, which has been the predominant model in China for the last 25 years, towards a more integrated project management, and even turnkey, approach. Ultimately, of course, there are many different procurement options available for construction projects, such as:

- Build-only Contracts
- Design-only Contracts

¹⁰ National Bureau of Statistics, PRC "Main Economic Indicators on Construction Enterprises by Registration Status (2006)"

¹¹ Ibid

- Design Development Contracts
- Design and Build Contracts
- Design and Manage Contracts
- Turnkey Contracts
- Cost Reimbursable Contracts
- Cost Plus Contracts
- Management Contracting Contracts, or
- Construction Management contracts.

And while many of these models are not yet widely in use in China, it is only a matter of time before we see more integrated turnkey-type arrangements, where once the owner's specification has been finalised his/her next task is essentially to turn the key in the completed project and start it up.

In this connection, it is seen that Chinese contractors are now more willing to take on design-build projects than they have been in the past, and much of this could be attributed to the role and influence of international architects, engineers and contractors, as well as the demands of international investors and developers of projects in China and globally.

Chinese contractors are increasingly venturing outside China and learning and assimilating international best practices and project management skills. It is interesting to note that 51 Chinese contractors were included in the "Engineering News Record" list of the largest 225 international contractors in 2008¹² (ie an increase of two as compared to the total units in year 2007, an increase of three as compared to the total units in year 2006, a decrease of three as compared to the total units in year 2005, an increase of two as compared to the total units in year 2003, and an increase of four as compared to the total units in 2002, which itself was an increase of five as compared to the total units in 2001). Only the United States has more internationally active contractors. It is also interesting to see that there were two construction companies amongst the twelve largest enterprises (ranked by foreign assets¹³) from China which again demonstrates the increasingly international outlook of Chinese contractors. Chinese designers and contractors are particularly active in Africa, the Middle East and South America, where the access to raw materials is available and politically acceptable.

¶1-005 The challenges for international construction, design and project management companies and owners in China

International construction, design and project management companies

We have seen, in the previous section, how foreign funded construction engineering and design companies (including those from Hong Kong, Macau and Taiwan) made up less than 1.5 per cent of the total construction enterprises in China in 2007. Nevertheless there were some 849 foreign funded construction engineering and

12 Engineering News Record 2008 Top 225 International Contractors

13 UNCTAD, World Investment Report 2002

design companies registered in China, which is a significant number and this emphasises how important China is for international construction engineering and design companies.

Project management services in China are very much in their infancy and on the whole tend to be undertaken by foreign enterprises rather than domestic Chinese enterprises. As discussed above, the Chinese construction industry remains organised in the traditional manner with the design institutes on one side and contractors on the other. As such, procurement systems such as design-build and turnkey EPC are not commonly seen or used. This however, is changing and MOHURD is encouraging Chinese construction enterprises to embrace the project management model. This can be seen from the issue of a notice by MOHURD on 18 December 2008 entitled "Guidance Opinion on the Establishment of Project Management Enterprises by Large-Scale Engineering Supervision Enterprises" (*Jian Shi* 2008 No 226). This notice encourages local construction authorities to identify some large-scale engineering enterprises, especially those with supervision qualification (at comprehensive and Grade A level), as well as tendering agency (at Grade A level) and cost control (at Grade A level) qualifications, and encourage these enterprises to establish project management enterprises. It is likely that this process will continue and we will see a maturing of the China construction market.

It is fair to say that the Chinese construction market is becoming increasingly difficult for international construction companies to penetrate and recent regulations issued by MOHURD have had a detrimental impact on many international construction engineering and design companies. Issues that affect international construction, design and project management companies operating or seeking to operate in China will be further discussed in chapters 8 and 9.

Owners and developers

Massive foreign direct investment ("FDI") has been largely responsible for China's dynamic export expansion over the past two decades. From 1979 to 2008, the total flow of utilised FDI amounted to US \$855 billion¹⁴. The huge inflow of investment has helped to generate huge construction demand for factories, refineries, transportation facilities and other infrastructure in China.

In addition, China's growing middle class is leading a large demand for consumer products, which itself leads to the need for expanded infrastructure as well as factories and industrial facilities. China has 166 cities with populations over one million (as compared with nine in the United States), and China's urban population is growing at 2.5 per cent a year¹⁵ and increasing population demands more buildings and all types of construction development.

Traditionally, international construction companies have undertaken most of their China projects for international owners and developers. Japanese companies tended to appoint Japanese contractors, Korean companies tended to appoint Korean companies, and so forth. However, the recent regulations which affect international construction, design and project management companies (refer Chapter 8 for more details) have altered the traditional picture considerably and we are finding that more and more international owners and developers are turning to Chinese designers and contractors

14 PRC Ministry of Commerce

15 New York Times, 28 July 2004

CHAPTER 4 — THE CONSTRUCTION LAW

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¶4-001 Introduction

The *Construction Law of the People's Republic of China* (the "Construction Law"), which became effective on 1 March 1998, was the first Chinese law regulating construction-related activities. Accordingly, the Construction Law is the first port of call for any foreign investor considering construction or real estate projects in China. In essence, the Construction Law is the prime legislative mechanism for controlling and supervising the administration of construction activities in China, for ensuring the quality and safety of construction projects, and promoting the healthy development of the construction industry in China.

The Construction Law consists of 85 Articles divided into eight Chapters, covering: general provisions, construction licensing, contract awarding and contracting of construction projects, supervision of construction projects, management of construction safety and operation, management of construction project quality, legal responsibilities, as well as various appendices.

¶4-002 Scope of the Construction Law

Construction activities

Article 2 of the Construction Law defines “construction activities” as “all sorts of activities related to the construction of buildings and their affiliated facilities as well as the installation of circuits, pipelines and equipment” and specifies that all construction activities and the supervision of all construction activities in China must abide by the Construction Law.

Accordingly, the scope of the Construction Law can be described as follows:

- The law covers construction within the territory of China.
- The law regulates owners, survey and design institutions, construction enterprises (contracting units), supervision units, administration authorities and natural persons participating in construction activities.
- The law covers the construction activities of building, rebuilding, expanding, repairing, dismantling, etc of buildings (Art 2 of the *Urban Real Estate Administration Law of the People's Republic of China* specifies that buildings are houses and other structures on land) and affiliated facilities, as well as the installation of circuits, pipelines and equipment (including, for example, elevators).

Activities not covered by the Construction Law

Article 83(1) of the Construction Law provides that the construction of small-sized buildings designated by the people's governments of provinces, autonomous regions and municipalities must be carried out in accordance with the Construction Law. On the other hand, Art 83(2) and (3) as well as Art 84 of the Construction Law specify the types of building construction activities to which the Construction Law is inapplicable:

- renovation of memorials and ancient buildings certified by law as cultural relics for protection
- buildings erected for risk and disaster relief, other buildings for temporary use and low-storied residential buildings constructed by farmers for their own use, or
- buildings for military use.

Unrealistically narrow scope

This scope is, however, rather narrow, insofar as it only covers building works. It does not apply to civil engineering, such as rail or road projects, or power projects or other process plant or infrastructure projects. One possible explanation for this unusual situation is that other government departments did not want the Ministry of Construction (as it then was) to encroach on their areas of responsibility. Accordingly, the Ministry of Transportation is responsible mainly for highways, bridges, etc; the Ministry of Electric Power remains responsible for power projects, and so forth. This is because these industrial ministries under the State Council had traditionally exercised regulatory control of all production and construction activities within their respective industries. However, having said this, Art 81 of the Construction Law allows the State Council to specify special projects that will be subject to the Construction Law. However, this rather unsatisfactory situation may change as the

revised Construction Law being considered by the Ministry of Housing and Urban-Rural Development (“MOHURD”) has an enlarged scope of application (see discussion below).

¶4-003 General principles

The general principles of the Construction Law are expressed in Art 1 of the Construction Law as:

- *Equality and Safety* — Construction activities have to guarantee the quality and safety of construction projects and comply with the State's safety standards for construction projects.
- *Healthy Development* — The State assists the development of the construction industry, supports research on construction science and technology in order to raise the level of housing and construction design, encourages energy-saving and environmental protection and advocates the adoption of advanced technology, advanced equipment, advanced processes, new building materials and modern managerial methods.
- *Legality* — The conduct of all construction activities must observe the Chinese laws and regulations and should in no way undermine social and public interest as well as the legitimate interests of others.

¶4-004 Construction licensing

Application for construction permits

According to Art 7 of the Construction Law, before the start of a construction project, the owner must apply to the competent construction administrative department for a construction permit. However, owners of construction projects who have obtained approval of work-start permits do not need to apply for construction permits.

Construction permits and approval of work-start permits co-exist, but operate under different systems. In fact, approval of work-start permits is only applicable to a small portion of projects, ie those stipulated by the State Council (see *Circular concerning Strict Control on the Development Projects of Real Estate of Top Grade*, issued by the State Council on 26 May 2005). In order to avoid repeated approvals, the Construction Law provides that construction projects that have obtained approval of work-start permits in accordance with the procedure stipulated by the State Council are no longer required to apply for construction permits. It should be noted however, that work-start permits must be obtained in strict compliance with the State Council's stipulations.

The *Measures for the Administration of Construction Permits for Construction Projects* (the “Construction Permit Regulations”), effective on 1 December 1999 and revised on 4 July 2001, provide that if no permit has been obtained for a construction project (when permit is required), the construction of the project may not be commenced. In addition, a construction project cannot be divided into a number of smaller construction projects in order to avoid the need to apply for a construction permit.

Article 8 of the Construction Law specifies eight conditions that must be fulfilled in order to apply for a construction permit, as follows:

- the approval formalities for construction project land use have been complied with
- construction projects within urban planned districts have obtained planning permits
- where demolition and relocation are necessary, the progress of demolition and relocation have complied with the requirements of construction
- contractor(s) for the project have been chosen
- working drawings and technical data are available to meet the needs of construction
- specific measures are available to ensure the quality and security of construction.
- funds for construction are available (for example, the Construction Permit Regulations specify that if the construction duration is less than one year, the funds raised shall not be less than 50 per cent of the total contracted value, whereas if the duration is longer than a year, the funds raised must not be less than 30 per cent of the total contracted value), and
- other conditions as stipulated by laws and administrative regulations.

Assuming these conditions are fulfilled, the competent construction administrative departments shall issue the construction permit within 15 days from the receipt of the application.

The Construction Permit Regulations also specify the abovementioned eight conditions, and add one further condition, namely that a supervision agency has been appointed where necessary.

Validity of construction permits

Article 9 of the Construction Law requires that the owner should start to build the project to which the permit relates within three months after obtaining the construction permit. If the work cannot commence on schedule, the owner must then file an application specifying that there has been a delay and the validity period will be extended by a period of three months. Only two such applications will be permitted and therefore a maximum delay period of six months could be obtained. However, once the validity period expires, the construction permit will automatically expire.

Suspension and resumption of construction

Both the Construction Law and Construction Permit Regulations refer to suspension of construction and the effect this has on the validity of the construction permit. In essence, if a project under construction is suspended due to special reasons, the owner must, within one month after the date of suspension, report the suspension to the permit issuing authority. The owner must inform the authority about the cause of the suspension, the estimated duration of the suspension, and the measures being taken for the maintenance and management of the project. Upon resumption of construction, the owner must also report to the permit issuing authority. If the

suspension is over one year, the owner must, prior to the resumption of construction, apply to the permit issuing authority for inspection and verification of the construction permit (Art 10, the Construction Law).

¶4-005 Qualifications of contractors

Qualification conditions

In accordance with Art 12 of the Construction Law, construction engineering enterprises, prospecting units, design units and project supervisory units which engage in construction activities must meet the following conditions:

- (a) possession of registered capital that complies with the State provisions (ie *Circular of the Ministry of Construction on Printing and Distributing the Standards for Special-grade Qualification of General Contracting Enterprises for Construction* (effective on 13 March 2007))
- (b) possession of specialised technical personnel with statutory professional qualifications consistent with the construction activities they engage in
- (c) possession of technology and equipment necessary for related construction activities, and
- (d) other conditions as stipulated by laws and administrative regulations (for example besides satisfying the conditions of (a), (b) and (c) above, construction enterprises must also satisfy the conditions specified in the *General Principles of Civil Law of the People's Republic of China* and the *Company Law of the People's Republic of China* regarding the legal person or company).

Accordingly, contractors and designers in the construction industry must apply for their qualifications on the basis of conditions, such as registered capital, net assets, specialised technicians, technology, equipment and track record, and may only engage in construction activities within the scope of their qualification grade after passing the qualification examination and obtaining the appropriate qualification grade certificate (Art 13, the Construction Law; the *Provisions on the Administration of Qualifications of Enterprises in Construction Industry*).

The regulatory basis for the qualification regime

The current qualification system for survey and design, construction and supervision enterprises is governed by the following regulations:

- *Regulation on the Management of the Survey and Design Qualification of Construction Engineering* (Decree 160) promulgated on 1 September 2007
- *Provisions on the Administration of Qualifications of Enterprises in Construction Industry* (Decree 159) promulgated on 1 September 2007, and
- *Administrative Provisions on the Qualification of Project-Supervising Enterprises* (Decree 158) promulgated on 1 August 2007.

The revision of the qualification regime

The qualification system for survey, design, construction and supervision enterprises was established by three separate regulations in 2001, which were subsequently revised in 2007 as noted above.

The following chart outlines the qualification categories under the current regulations as compared with the previous ones.

	<i>Previous Regulations</i>	<i>Current Regulations</i>
Survey	General	General
	Specialty	Specialty
	Labour Services	Labour Services
Design	General	General
	Industrial	Industrial
	—	Specialty
Construction	General Contracting	General Contracting
	Specialty Contracting	Specialty Contracting
	Labour Service Subcontracting	Labour Service Subcontracting
Supervision	Specialty categories	General
	—	Specialty
	—	Firm

Approval authorities

There are two levels of approval authority under the existing regulations:

- Central (or national), namely the State Council Construction Administrative Management Authority, and
- Local (provincial level and municipal level), namely the competent construction administrative departments in each province, autonomous region and municipality.

The current regulations keep this two-level approval system. However, the approval powers over certain construction specialty Grade 1 contracting categories have been transferred from the central level to the local level, namely the specialty Grade 1 contracting, other than construction of railway, transportation, water resources, information industry and civil aviation. In addition, the approval powers over the qualification of certain construction categories were transferred to the municipal construction administrative departments, which are a new addition to the qualification regime. While operational efficiency may be enhanced by the workload being transferred to local authorities, whether the quality of the approval services will be improved is open to question, given that local interest considerations could be taken into account.

The following table shows the approval levels required for each grade of qualification.

		<i>Previous Regulations</i>	<i>Current Regulations</i>
State Council Construction Administrative Authority	Survey	Grade A	Grade A
	Design	Construction engineering design, Grade A; Other engineering design, Grade A and Grade B	Grade A and certain Grade B
	Construction	General contracting, Special Grade and Grade 1; Specialty contracting, Grade 1	General contracting, Special Grade and Grade 1; Certain specialty contracting, Grade 1
	Supervision	Grade A	General Qualification and Grade A of Specialty Qualification
Province-level construction administrative departments	Survey	Grade B and Grade C; Labour Services	Grade B and Grade C; Labour Services
	Design	Construction engineering design, Grade B, Grade C and below; Other engineering design, Grade C and below	Certain Grade B and Grade C
	Construction	General contracting, Grade 2 and below; Specialty contracting, Grade 2 and below; Labour services	Certain general contracting, Grade 2; certain specialty contracting, Grade 1 and Grade 2
Municipal level construction administrative departments	Supervision	Grade B and Grade C	Grade B and Grade C of Specialty Qualification and Firm Qualification
	Construction	—	Certain Grade 3 general contracting; Grade 3 specialty contracting; Labour services

construction company of their choice. This also has the effect of depriving Chinese designers and contractors of the much needed foreign expertise and experience to assist the Chinese construction industry to achieve international standards.

In this regard the American Chamber of Commerce in China, in its 2005 White Paper, concluded that:

“Restrictions within the Construction and Design Regulations and the Project Management Regulations deprive Chinese contractors, designers and project managers of the expertise and exposure to talent they need to develop into world-class competitors. As mentioned, the continued separation of construction from engineering and design runs contrary to international practice, and the multi-disciplinary integrated EPC approach. The Ministry of Construction, specifically with the promulgation of the Construction and Design Regulations and the Project Management Regulations, undermines its efforts to promote various EPC contracting models in China.

Overall, market opportunities for foreign companies are extremely limited and thus a major concern for the American Chamber of Commerce. While some positive steps have been taken over the past year, new regulatory hurdles have been placed in the path of foreign companies attempting to undertake construction, engineering and design roles in China.”

These concerns have been repeated by the American Chamber of Commerce in subsequent White Papers, as well as by the European Chamber of Commerce in China in its Position Papers since 2006.

Clearly, the restrictions imposed on foreign construction entities are counter-productive and in some cases unfair; nevertheless several foreign construction entities and engineering design firms have established enterprises in China under the new regime and are providing design, construction and project management services to (predominantly) multinational corporations in China. We will continue to see several more enter the market over the next several years, once they come to accept that MOHURD is not going to turn the clock back to the old days of Decree 32. While some of the restrictions may be softened over time, the author does not believe that MOHURD will change its stance on the skills qualification requirements substantially. The old saying “when in Rome, do as the Romans” has a very real resonance to the construction market in China.

CHAPTER 9 — LEGAL ISSUES FOR FOREIGN OWNERS, CONTRACTORS AND DESIGNERS IN CHINA

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9-001 Introduction

In this chapter we highlight some of the specific issues that the author has come across that affect foreign owners, contractors and designers operating in China. These issues arise from the application of the various laws and regulations relating to construction operations in China, and have to some degree been discussed in the previous chapters dealing with the Contract Law, the Construction Law and the Quality Regulations. This chapter aims to provide a practical legal guide to some of the issues that foreign owners, contractors and designers are likely to encounter in China, together with some recommendations as to how to respond.

The areas to be discussed include the following:

- the use of standard form contracts
- the prohibition against the “dividing up” of a construction project
- the restrictions on subcontracting
- name borrowing
- project management and supervision
- liquidated damages
- bonds and guarantees
- contractor’s liens
- limitation of liability
- consequential loss
- *force majeure*
- quality issues

- choice of law
- payment
- variations
- pricing methods
- design
- defects liability
- joint and several liability
- good faith
- termination, and
- retention.

¶9-002 Common issues

Standard forms of construction contract

Standard form contracts have been in use for some time in China. In 1991, the former Ministry of Construction and State Administration of Industry and Commerce ("SAIC") jointly produced a standard form construction contract (the "PRC Construction Contract"). Following the enactment of the Construction Law and the Contract Law, the PRC Construction Contract was revised on 24 December 1999 (the "revised PRC Construction Contract"). The revised PRC Construction Contract consists of three parts:

- (i) Articles of Agreement
- (ii) General Conditions, and
- (iii) Special Conditions.

It contains provisions which are common in many international standard form contracts, in particular the old Federation Internationale des Ingenieurs Conseils ("FIDIC") Red Book (4th Edition), for instance:

- General description of the works
- Definition of the contract documents
- Applicable language and law
- Appointment and role of an engineer
- Obligations of the owner and the contractor
- Commencement of the works
- Extension of time
- Suspension and termination of the contract
- Quality and inspection
- Safety

- Payment
- Variations to the works
- Completion of the works
- Defects period
- Subcontracting
- Insurance and performance bonds, and
- Dispute resolution.

The PRC Construction Contract was primarily designed for domestic projects, ie projects without foreign elements. The revised PRC Construction Contract is also intended to be used for projects with foreign elements. The revised PRC Construction Contract is a well balanced contract, which can reasonably be accepted by foreign owners and contractors. It has the advantage of being tailored to fit the legislative and regulatory framework in China and although likely to be amended by owners, it is nevertheless a fair contract.

The main disadvantage of the revised PRC Construction Contract is that it is based on the traditional form of contracting and does not cater for design-build procurement. To address this issue, MOHURD and SAIC jointly issued a standard form project general contracting contract (the "PRC Design-Build Contract") in January 2009 for public comments, which could fit the design-build model. The PRC Design-Build Contract consists of three parts:

- (i) Articles of Agreement
- (ii) General Conditions, and
- (iii) Special Conditions.

It also contains provisions which are common in many international standard form contracts, in particular the FIDIC Yellow Book, for instance:

- General definitions
- Rights and obligations of the owner and the contractor
- Applicable language and law
- Appointment and role of an engineer (supervisor)
- General design obligations
- Applicable design technical standards
- Commencement of the construction
- Extension of time
- Suspension and termination of the contract
- Quality and inspection
- Safety

- Payment
- Variations to the works
- Completion of the works
- Defects period
- Subcontracting
- Insurance and performance bonds, and
- Dispute resolution.

The FIDIC suite of contracts has also been translated into Chinese by the China National Association of Engineering Consultants in conjunction with FIDIC. Derivatives of these contracts have been used on projects in China and are acceptable to MOHURD and the other regulatory authorities.

In the author's experience, FIDIC contracts are generally acceptable to Chinese contractors as well as the regulatory authorities. The FIDIC White Book is also widely used for consulting services. The American Institute of Architects ("AIA") forms are occasionally used, but this is not common and the author does not recommend the use of the AIA forms in China due to the legislative and regulatory differences between China and the United States. Finally, many Hong Kong developers use Hong Kong standard contracts in China, with mixed success, particularly where such contracts have not been appropriately modified with regard to the Chinese legislative and regulatory framework, which can lead to legal and operational difficulties. Given the increasing numbers of Chinese contractors working internationally, it is likely that we will see FIDIC contracts used more often in China.

Prohibition against "dividing up" the construction project

As discussed in chapters 2 and 4, Art 272 of the Contract Law and Art 24 of the Construction Law prohibit the owner from contracting construction projects in parts. Accordingly, Art 24 of the Construction Law and Art 272 of the Contract Law prohibit the practice of dividing one piece of construction work into unreasonable sections and awarding each section to different contractors when read together. As such, an owner cannot "divide up" a construction project which should be undertaken by a general contractor. As mentioned earlier, general contracting is encouraged in China and Art 24 of the Construction Law clarifies that an owner can award the survey, design and construction works, and the procurement of equipment to a general contractor.

It is common for large scale construction projects, especially infrastructure projects, to be divided into several packages. An advantage of the package approach is that the owner is able to spread his risks among a number of contractors. On the other hand, if a large infrastructure project is awarded as a single package, it is likely to be very difficult for an owner to find a general contractor who has the necessary funding and resources to undertake the work. It is the author's view that in most cases it is not feasible to treat large infrastructure projects as projects that should be completed by only one contractor.

Nevertheless, the effect of Art 24 of the Construction Law and Art 272 of the Contract Law is that the owner is, in most cases, obliged to award a construction project as a single package to one contractor. The difficulty that arises in interpreting these two articles is that they do not say when a project should be let to a general

contractor and when it can be divided into packages and let separately to different contractors. For example, can an owner award three separate contracts for the construction of the building structure, the building cladding and the interior fit-out works? Or can an owner undertake a project in phases if the owner does not have sufficient funds or resources to complete the project in one phase? As with many situations in China, the provisions are deliberately vague and therefore extensive administrative discretion is vested in MOHURD and its local branches.

It should be noted that the Beijing Municipal Government has split the Beijing Subway Line No 5 into several small packages (in fact 21 separate civil engineering packages). This definitely has the benefit of being more attractive to Chinese contractors, who perhaps do not have the resources or experience to construct complex underground structures. However, it has the opposite effect for foreign contractors, who do not want to commit large amounts of resources for a relatively small part of the project overall. It also makes the project more expensive because there are so many unnecessary interfaces, which lead to increased supervision requirements. Hence, despite the need for foreign tunnelling technology and expertise, only one Sino-Foreign Joint Venture ("SFJV") has been involved in the construction of Beijing Subway Line No 5. Perhaps not surprisingly, this SFJV has had the best performance safety and quality record of all the contractors involved, and its package is held up as the showcase example of tunnelling construction in Beijing. In the author's view, it is entirely possible that savings of more than 20 per cent could have been achieved if one turnkey contract had been awarded for Beijing Subway Line No 5.

In terms of Art 24 of the Construction Law and Article 272 of the Contract Law, it could be argued that the Beijing government's position is contrary to the Construction Law and the Contract Law. However, because the Construction Law in principle applies to construction activities connected with building and auxiliary facilities, and Art 19 of the Tender Law provides that the procuring entity can divide the project into various reasonable segments, it is arguable that the government's position does not contravene the Construction Law and the Contract Law.

Furthermore, there are often legitimate technical engineering, scheduling and financial reasons to undertake a construction project in phases. The phases can be based on individual buildings (each considered as a "unit") or on groups of buildings. In many cases, if a project is complicated, and the investment scale is very large, then it can be undertaken in several phases on the basis of technical engineering, scheduling and financial reasons. The purpose of allowing such a phased approach is to improve the quality and efficiency of the project, when specialist contractors are engaged for specialised types of work to improve the quality of the project, and multiple contractors can do the construction works at the same time to improve the efficiency of the project.

Finally, the Construction Law also permits the use of consortia and therefore the prohibition against dividing up a large construction project may be overcome by a group of contractors tendering as a consortium. Art 27 of the Construction Law allows construction projects which are large in scale or involve a complex structure to be jointly contracted by a consortium of two or more contractors. This is a common feature in large scale infrastructure projects around the world. For example, the

construction of both the Taiwan High Speed Rail and the Hong Kong International Airport, two of the largest infrastructure projects in Asia, were divided into several packages and almost all of them were awarded to consortia.

Restrictions on subcontracting

It is usual for a main contractor to subcontract work to subcontractors who are qualified to do the work. The subcontractors are normally divided into domestic subcontractors, who are selected by the main contractor, and nominated or designated subcontractors, who are "nominated" by the owner. The Construction Law and the Contract Law impose certain restrictions on a main contractor's right to select his subcontractors and this will be discussed below.

Owner's consent

Ordinarily, unless the main contract states otherwise, the main contractor is free to appoint whoever he/she thinks is appropriate to carry out any subcontracted work. Generally for cost reasons, the main contractor will select its domestic subcontractors by reference to the lowest conforming bid, rather than the subcontractor most suitable for the job.

Article 29 of the Construction Law provides that the main contractor may subcontract part of its work to a suitably qualified subcontractor. However, save for subcontracts which are pre-agreed under the main contract, the main contractor must obtain the consent of the owner before it subcontracts. It is unclear under the Construction Law whether the consent of the owner is required for the work that is subcontracted or for the actual appointment of the subcontractor. The wording is probably wide enough to extend to both interpretations.

In any event, if the owner does not agree with the main contractor's choice of subcontractors and withholds his/her consent, the main contractor cannot proceed to award subcontracts and this will inevitably lead to delay which may or may not be compensated. A way around this might be to pre-agree in the main contract the works that can be subcontracted and the subcontractors who the main contractor can appoint. Another solution would be to expressly provide in the main contract that the owner's consent to a subcontract cannot be unreasonably withheld.

Finally, Art 29 of the Construction Law does not affect the appointment of nominated subcontractors as they are in any event selected by the owner. It should be noted, however, that Art 66 of the Bidding Measures (as discussed in Chapter 6) specifies that the procuring entity cannot directly specify particular subcontractors. In addition, Art 6 of the *Administration Measures on Subcontracting of Building Construction and Municipal Infrastructure Works Construction*, which came into effect on 1 April 2004, specifically provides that the owner is not permitted to directly designate subcontractors. This appears to make the process of nomination effectively illegal in China.

Completion of principal structure of construction project

A further restriction on subcontracting is the requirement that the main contractor complete the principal structure of the construction project. This triggers the issue of what is the "principal structure" of a building? One answer is contained in a national standard named *Unified Standards for Acceptance of Construction Quality for Building Project* (GB50300-2001), which was issued by the former Ministry of Construction and General Administration of Quality Supervision, Inspection and

Quarantine Authority in 2001. Within this standard, it defines the scope of the "principal structure" for different types of buildings (including wooden, steel, concrete and other structure buildings). According to this standard, "principal structure" basically means the skeleton of a building. For instance, the "principal structure" of a concrete structure building includes the molding board, steel bars, concrete, pre-stressing force, the poured structure, and the assembled structure; the "principal structure" of a steel structure building includes the steel structure welding, the fastening and connecting parts, single-layer steel structure installation, multi-layer and high steel structure installation, steel structure coating, steel structure assembling, steel structure pre-assembling, steel grid structure installation, and pressed metal board. In both the case of the concrete and steel structures, the construction works for the foundation, decoration, façade, water supply and drainage, heating and air conditioning, electrical and mechanical systems, intelligence systems, ventilation and elevator works are excluded from the "principal structure".

The requirement that the main contractor complete the principal structure of the work arguably makes management contracting an illegal form of construction contracting in China. Management contracting involves the management contractor being responsible to the owner to procure the works and as such entering into subcontracts with works contractors to undertake the whole of the works, with the management contractor undertaking overall management and coordination of the works. Management contractors do not typically maintain a large workforce and certainly do not carry out the principal structure of the work themselves. Management contracting has many advantages from a procurement point of view and it is a popular way of contracting in the UK and the US. Unfortunately, given the requirements of the Construction Law and the Contract Law, it is unlikely to prosper in China. Again, this is another example of how the rigidity of the traditional split between design, construction and management that underpins the Construction Law prevents innovative forms of procurement being adopted in China. One possible way around this restriction is for a properly qualified foreign contractor to form a consortium with one or more domestic contractors to contract for a project whereby the foreign contractor undertakes project management and the Chinese contractors will carry out the work within the scope of their qualifications.

Restriction on sub-subcontracting

Article 29 of the Construction Law prohibits a subcontractor from further subcontracting the subcontracted work. This prohibition is intended to avoid the situation where the work is carried out by either contractors who are not qualified to carry out the work or because of multiple subcontracting there is no profit margin left in the price, which leads to the sub-subcontractor cutting corners and neglecting quality and safety during construction. This has also been an issue in Hong Kong, where extensive sub-subcontracting has resulted in quality and safety compromises that have led to lengthy court proceedings and demolition of defective buildings at great cost to the public.

The prohibition on sub-subcontracting, if properly enforced, is clearly positive for the Chinese construction industry. However, it does create operational and legal difficulties for those contractors who undertake specialist works. Such specialist contractors usually only provide specialist technical expertise and supply of materials and equipment to a project. The actual construction work is sub-subcontracted to other contractors. If strictly enforced, the prohibition on sub-subcontracting will stifle the