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INDUSTRIAL SECTORAL CONTROL

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[¶1-005] Governing legislation

- (1) *Regulations on Foreign Investment Guidelines*, enacted by the State Planning Commission and effective as of 1 April 2002 (“*Investment Direction Procedures*”);
- (2) *Catalogue on Industry Guidelines for Foreign Investment*, enacted by the State Development and Reform Commission and the Ministry of Commerce and effective as of 1 December 2007 (“*Industrial Catalogue*”);
- (3) *Law of the People’s Republic of China on Sino-Foreign Equity Joint Ventures*, effective as of 1 July 1979 and revised on 15 March 2001 (“*EJV Law*”);
- (4) *Regulations for the Implementation of Law of the People’s Republic of China on Sino-Foreign Equity Joint Ventures*, enacted by the State Council and effective as of 20 September 1983 and revised on 22 July 2001 (“*EJV Regulations*”);
- (5) *Law of the People’s Republic of China on Sino-Foreign Co-operative Enterprises*, effective as of 13 April 1988 and revised on 31 October 2000 (“*CJV Law*”);
- (6) *Detailed Rules for the Implementation of the Law of the People’s Republic of China on Sino-foreign Cooperative Enterprises*, issued by the Ministry of Foreign Trade and Economic Cooperation and effective as of 4 September 1995 (“*CJV Regulations*”);
- (7) *Law of the People’s Republic of China on Wholly Foreign-owned Enterprises*, effective as of 12 April 1986 and revised on 31 October 2000 (“*WFOE Law*”);
- (8) *Detailed Rules for the Implementation of Law of the People’s Republic of China on Wholly Foreign-owned Enterprises*, issued by Ministry of Foreign Trade and Economic Cooperation, effective as of 12 December 1990 and revised on 12 April 2001 (“*WFOE Regulations*”); and
- (9) *Catalogue of Priority Industries for Foreign Investment in Central and Western Region*, jointly issued by National Development and Reform Commission and Ministry of Commerce, effective as of 1 January 2009 (“*Regional Catalogue*”).

[¶1-010] History of control

For the first 30 years following the founding of the People’s Republic of China (“PRC” or “China”), China prohibited any participation by foreign capitalists in its economic development. The first cracks in this wall were planted in the Second Session of the Fifth National People’s Congress in 1979. This meeting marked the start of China’s opening up to the world.

The magnitude of the changes wrought by this plenary meeting can be seen by the figures. In 1978 China exported USD97.5 billion — 30 years later in 2008 China exported USD14285.5 billion. China's foreign reserves have gone from a paltry USD1.67 billion in 1978 to a unrivalled USD1.95 trillion. Imports have increased from USD108.9 billion to USD 11330.9 billion in 2008. However, perhaps most pertinent to the book at hand, foreign investment increased from USD17.7 billion for the four years from 1979–1982 to USD923.95 billion in 2008. In the span of 30 years China has gone from a no man's land for investment into the world's number one foreign direct investment (“FDI”) destination.

Although these figures defy an outsider's expectations the differences within the country are more pronounced still. In the span of half a generation China has developed a sophisticated legal system and moved from wariness towards foreign investment to active encouragement.

Despite these changes China's open-door policy has always retained a door and sometimes this door is slammed shut on certain industries or activities. Although, it has opened up in a way that not even the most ardent Sinophile would have anticipated in 1979 China still maintains specific restrictions on the inflow of foreign capital into the country.

Foreign investors should also bear in mind that almost every step in the establishment process for a foreign investment enterprise (“FIEs”) and its resulting operation in China requires approvals from a wide range of Government authorities. In the main this is not onerous control, indeed in many cases the authorities play more the role of a cheerleader than an umpire.

¶1-030 Pre-2001 industrial sector control

For many years, China did not have a specific piece of legislation which set out the restrictions or encouragement to be granted to specific types of foreign investment. The approval authorities would generally base their decisions on vaguely worded legislation contained in laws or regulations regulating joint ventures (“JVs”, including equity joint ventures or EJV and contractual joint ventures or CJVs) and wholly foreign-owned enterprises (“WFOEs”) or upon “internal policies”, which were not published, not available to the general public and indeed often thought to be non-existent.

EJV and WFOE legislation

The *EJV Regulations* (prior to the 22 July 2001 amendment) and *WFOE Regulations* (prior to the 12 April 2001 amendment) provided only the very broadest of brushstrokes as to what was allowed.

The *EJV Regulations* proposed a vague list of permitted JV projects (ie energy development, building materials, chemicals, metallurgical industries, machine manufacturing, instrument and meter assembly industries and offshore oil exploitation equipment, manufacturing, electronics & computer industries and communication equipment manufacturing, light industry, textile, foodstuffs, medicine, medical apparatus and packaging industries, agriculture, animal husbandry and aquaculture; and tourism and service industries).

This vague list was largely ignored and EJVs were established in a wide range of industries.

The lack of specific regulations was probably due to a mix of the authorities not sure as to what they were doing and fear of the consequences of allowing the door to be too wide open. Foreign investors also were unsure of how to invest in China and had an opposite fear from that of the Chinese authorities who feared their entry into China. The foreign investor's major concern was whether they would be allowed out again.

However, as both sides gained in experience the regulations outlining the means by which investments may be made were being improved. The provisions of the *WFOE Regulations* represented a better approach than the *EJV Regulations* in that they sought to list prohibited and restricted sectors and not all permitted sectors.

The *WFOE Regulations* were in many ways a forerunner of the *Industrial Catalogue* (discussed below) which sets out whether a particular type of business is open to foreign investment and whether certain encouragements or restrictions exist.

¶1-060 Investment Direction Procedures and Industrial Catalogue

China began to issue the *Investment Direction Procedures* and its accompanying *Industrial Catalogue* in 1995. This gave foreign investors a far clearer picture regarding the Chinese Government policies and “internal guidelines” in respect of their planned foreign investment.

This first ever *Industrial Catalogue* clarified that some industrial sectors, many of which were regarded as being lucrative, were barred from having foreign investment.

In essence, the *Investment Direction Procedures* divides foreign investment into four categories:

- (1) Encouraged;
- (2) Permitted;
- (3) Restricted; and
- (4) Prohibited.

The “encouraged”, “restricted” and “prohibited” categories are listed in the accompanying *Industrial Catalogue* (the latest version came into effect on 1 December 2007 and will be discussed below in more detail). Any sector not listed in the *Industrial Catalogue* is deemed to fall within the “permitted” category.

The *Investment Direction Procedures* also provide a general description and different treatment for a project depending upon its category. As part of China's efforts to implement its WTO obligations, the *Investment Direction Procedures* were also revised to take into account China's undertakings under such treaty.

The importance of the Industrial Catalogue

As the primary legislation determining whether a specific foreign invested project will be allowed, restricted or encouraged, the *Investment Direction Procedures* and the *Industrial Catalogue* are the initial regulations to be considered by any potential foreign investor.

In some cases a proposed project will be “prohibited” (eg news agencies, TV, satellite uplinking stations, microwave stations etc).

In other cases the proposed project may be restricted (eg animal husbandry, cotton (raw cotton) processing, certain types of mining, gold exploration etc) whereas other projects may be encouraged (eg storage and processing of vegetables, production of new anti-cancer medication, manufacturing of mine trolleys for mining, etc) and such classification will be a major criteria in determining whether the project will benefit from Customs duty and related VAT exemption (further details to be discussed in **Taxation and Customs duties** from ¶28-005 to ¶28-070).

Since its inception the *Industrial Catalogue* has undergone a number of revisions, including 1995, 1997, 2002, 2004 and 2007.

2007 Industrial Catalogue

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¶1-110] General introduction

At the end of 2007, the National Development and Reform Commission (“NDRC”) and Ministry of Commerce (“MOFCOM”) jointly issued the latest version of the *Industrial Catalogue*. This revised version replaced the *2004 Industrial Catalogue* and became effective as of 1 December 2007. As always the changes in the *2007 Industrial Catalogue* reflected shifts in China’s economic and industrial policies.

In 2007 China’s foreign direct investment policy changed from export led growth to quality investment supporting domestic led growth. As Ma Kai, Minister of NDRC stated, “the focus is on strength, not scale”. The general economic policy was set by the 11th Five-Year Plan which set a course away from projects that:

- (1) Rely upon cheap Chinese raw materials or energy;
- (2) Are wasteful or lead to high level of pollution;
- (3) Manufacture export-orientated products; or
- (4) Manufacture low-tech products with little value added.

On the other hand “green is the new black” when it comes to the projects that are being encouraged. Encouraged projects include:

- (1) Energy-saving;
- (2) Environmental protection;
- (3) Transportation infrastructure development;
- (4) Hi-tech manufacturing;
- (5) Logistics;
- (6) Business outsourcing; and
- (7) Improvements in agricultural technology.

A quick glance at the *2007 Industrial Catalogue* shows the affect that the 11th Five-Year Plan had. For example “real estate” and “products directly exported” were deleted from the encouraged category. This made sense for China’s economic situation in 2007 before the global economic crisis began to bite. In 2007 China was facing enormous international pressure in respect of its currency. China’s encouragement to its export-

orientated industries and the massive current account surplus was adding further pressure on the authorities for a RMB appreciation. In addition China was facing bottlenecks in respect of resources and energy. There were concerns that China was in effect importing pollution by being the world’s factory.

Another strategic concern of the PRC authorities was to stem the inflow of international “hot” money into China. Due to expectations of an appreciation in RMB there had been a rush by foreign investors to bring money into China, particularly into the overheating real estate sector. The PRC authorities had major concerns that this would further contribute to building further asset bubbles within China.

Just as the move away from export and real estate industries signalled deeper policy concerns, such concerns could also be seen in the areas that were upgraded to encouraged status. The list of encouraged sectors included services and higher value added services such as “leasing and commercial services”, “bank and telecommunications back office service, software development and related contracting business”; “culture, sports and entertainment”, “management and operation of public show facilities, sport centres, and training facilities, as well as related intermediary services” have been added to the encouraged category.

These changes showed China’s intended move in 2007 from a “quantity economy” to a “quality economy” and concern for the environment with reference to a “green GDP”.

¶1-130] Encouraged category

The *2007 Industrial Catalogue* has substantially followed the categorisation methodology used in the *2002* and *2004 Industrial Catalogues*. Although the industrial sectors under this category remain very much the same (reduced from 13 to 12), the total number of items under the “encouraged” category and the contents have significantly changed. The total number of encouraged sectors has been significantly increased from 246 to 351, with the following allocation:

- agriculture, forestry, animal husbandry and fishery (12 items);
- mining (9 items);
- manufacturing (282 items);
- generation and supply of electricity, gas and water (7 items);
- transportation, storage, and post (14 items);
- wholesale and retail (2 items);
- leasing and commercial services (3 items);
- scientific research, technological services and geological survey (14 items);
- water resources, environmental and public facility management (4 items);
- education (1 item);
- health, social security and social welfare (1 item); and
- culture, sports and entertainment (2 items).

STRATEGIC CONSIDERATIONS BEFORE INVESTMENT

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LOCATION OF FOREIGN INVESTMENT VEHICLE

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Location is a crucial, if often overlooked and underrated, factor for foreign investors to consider when preparing to make an investment in China.

¶10-005] The Chinese investment smorgasbord

China is geographically varied. From bustling coastal cities to tropical rainforests in Yunnan province, from the mountains of Tibet to the deserts of Xinjiang, it is a country of great contrasts in landscape.

The smorgasbord of available investment opportunities is equally varied. China has five special economic zones, 14 coastal open cities, 260 coastal special economic zones (not entitled to full central preferential treatment), six open cities along the Yangtze River, 19 inland provincial capital open cities, 13 open cities along the border areas, 25 economic and technological development zones, 15 free trade zones, 13 frontier economic cooperative zones, 43 new and high technology zones and even 11 national holiday zones. A brief commentary on some of the most important types of zones follows:

(1) Special Economic Zones ("SEZs")

SEZs have been one of the most spectacular of China's very many successes since its opening up to the world. SEZs offer preferential tax treatment, superior infrastructure and efficient bureaucracy.

The Shenzhen SEZ in Guangdong province was the first SEZ and was approved by the 15th Standing Committee of the 5th National People's Congress in August 1980. Shenzhen has been transformed from a sleepy fishing village to a bustling metropolis. Prior to the establishment of Shenzhen, the location was part of the Bao An territory. In 1984, the GDP of Bao An was RMB100m. In 2004, Shenzhen's GDP increased to RMB400 billion, which was 4,000 times that of 1984.

Interestingly, a first-time visitor to Shenzhen will often be struck by two things. First, there are very few southern Chinese in Shenzhen. In many ways, Shenzhen is China's version of New York where people from all over the country have come to seek their fortune. As a result, you are more likely to be confronted with a Northeast Chinese accent than a Cantonese one. Secondly, in a country which has an over-supply of males, Shenzhen's females outnumber the men by seven to one — a fact which your local business partners will not normally tire of telling you.

(2) Free Trade Zones ("FTZs")

Many Western companies, especially those involved in trade, assembly and after-sales service, have established companies in FTZs. The advantages of a FTZ are efficient bureaucracy, liberal business scope and preferential tax treatment. The most famous FTZ in China is Waigaoqiao in Shanghai.

(3) Economic and Technological Development Zones ("ETDZs")

ETDZs are similar in nature but more widespread than SEZs. FIEs established in ETDZs enjoy preferential treatment in relation to Customs, tax and approval procedures.

[¶10-010] Where is foreign investment going?

Foreign investment has not been equally distributed to date throughout the country. 80% of the total foreign investment finds its way to the coastal areas in China. According to the *China Statistical Yearbook* of 2005, realised foreign investment varies from a breathtaking USD260.96 billion in Guangdong province to a paltry USD0.04 billion in Shaanxi province. Generally, foreign investment has been concentrated in the Pearl River Delta, the coastal areas, the Yangtze River corridor and, to a lesser degree, the Beijing-Tianjin corridor.

[¶10-030] What are the investment locations of medium-sized foreign companies?

Investment by medium-sized foreign companies is predominantly located in the Shanghai-Yangtze Delta and the Beijing-Tianjin corridor, based on the PRC investment statistics, discounting the amount of investment from Hong Kong (much of which is actually mainland money being channelled into China in order to be eligible for foreign-invested enterprise preferential treatment and foreign trading rights) which is predominantly invested in the south.

This section will focus on basic manufacturing entities only. Many manufacturing entities select location based upon factors such as raw material supply, location of major customers, etc.

[¶10-060] Is the concentration of investment in coastal areas wise?

The answer to this question will depend, to a large degree, upon the intention of a foreign investor. For foreign investors wishing to establish greenfield manufacturing facilities, the answer will very much turn upon objective economic factors, such as the availability of skilled workers, land price and infrastructure. However, for foreign investors wishing to acquire targets in China, they may find that the best companies in the popular areas have already been acquired, and most of those remaining are not willing to be sold.

The following pros and cons should be weighed by investors when considering location:

Coastal Areas*Pros*

- rule of law ("Fazhi", in Chinese: 法治)
- efficient bureaucracy
- better infrastructure
- pool of skilled employees
- economic mentality

Cons

- higher land prices
- higher labour prices
- increasingly selective
- increasingly high HR cost

Neutral Factors

- Where is the market?
- Is the market saturated?
- Are there any preferential treatments available?
- Are there any energy resources?

Interior Areas

- lower land prices
- lower production prices
- more support from local authorities
- rule of man ("Renzi" (in Chinese: 人治)) rather than rule of law
- lack of infrastructure
- lack of skilled employees
- transport
- "iron bowl" mentality

The advantages enjoyed by FIEs in coastal areas are not only numerically superior but also qualitatively so. Even the three advantages of the interior regions listed above seem theoretical when seen in the light of practice.

The issue of land price is at best debatable. Negotiating land prices in areas where the only companies are State-owned enterprises is challenging. Even within the coastal area, there can be huge differences in prices. It appears that there has been a trend in recent years to move away from manufacturing sites in Shanghai due to higher costs, perceived higher regulatory pressure and perceived manpower difficulties.

This initial drift from Shanghai was to neighbouring cities such as Suzhou and Kunshan. In recent years, these cities also seem to be becoming increasingly expensive (and selective) as well. More and more foreign investment seems to be trickling down to cities like Changshu, Ningbo, Changzhou, Wuxi, etc.

The cost factors can be difficult for the visiting foreign investors to judge. It seems that all development zones in Eastern China are stuck in a time warp. According to information provided by the development zones in respect of wages in Shanghai, Suzhou and Kunshan, the blue-collar workers in all these development zones earn around RMB800 per month. It is difficult for locals to believe that a factory worker in Shanghai earns the same as one in, say, Changzhou.

However, the advantage of lower labour costs is questionable when important factors such as productivity and availability of skilled workers are addressed. There are countless stories of state-of-the-art equipment lying idle or broken in interior regions because no skilled workers can be found to operate the machines.

However, more and more clients are pleasantly surprised by the quality of human resources available in second, third or even no tier cities. Added advantages are the loyalty of such employees and the lower costs of social insurance in these cities. Below is a comparison of the labour costs in Shanghai, Kunshan and Chongqing.

Shanghai: Social Insurances and Payment

Description	Paid by the Enterprise	Paid by the Individual
Pension	22.5%	8%
Unemployment	2%	1%
Injury	0.5%	—
Maternity	0.5%	—
Medicare	12%	2%

Kunshan: Social Insurances and Payment

Description	Paid by the Enterprise	Paid by the Individual
Pension	18%	7%
Unemployment	2%	1%
Injury	0.5–0.9%	—
Maternity	1%	—
Medicare	8%	2%

Chongqing: Social Insurances and Payment

Description	Paid by the Enterprise	Paid by the Individual
Pension	20%	8%
Unemployment	2%	1%
Injury	0.5%–2.0%	—
Maternity	0.7%	—
Medicare	8%	2%

When weighing up the pros and cons, the question that should be asked is not “why are foreign investors concentrating on coastal areas?” but rather “why are some foreign investors taking the risk of establishing a company in the interior regions?” especially considering the fact that foreign companies are much more dependent than domestic competitors on “fairness” based on the rule of law.

¶10-090 Why do foreign companies invest in interior regions?

Most foreign companies investing in the interior regions do so because:

- (1) The Chinese partner is located there;
- (2) They (mainly JVs) believe the myths regarding the interior areas; or
- (3) In some isolated cases, they actually have good reasons for locating inland.

Reason 1: The Chinese partner is located there

Generally, foreign investors will only view location as an issue if it is considering a WFOE. For those who wish, or are forced to realise their China project in the form of a JV, the issue is of secondary importance when considering a partner.

Foreign investors establishing a JV normally locate, logically enough, their projects in the same area as their Chinese partner¹. Questions concerning the market, infrastructure, distribution and pool of available labour often go unasked.

Reason 2: JV Myths

Myth #1: “I can deliver to all of China from my Joint Venture.”

China is the world’s largest country from a population view and is 4th largest geographically. However, foreign investors, European investors for example (who often have ten or more subsidiaries in the far smaller 320-million European Union), will often have unrealistic expectations about the capacity of a single JV to cover the whole of the Chinese market.

Myth #2: “My Chinese partner will look after distribution.”

Many first-time investors in China are full of optimism in relation to their prospective partner’s distribution network. Some medium-sized investors believe that they have found Chinese partners in one province who are able to distribute the products throughout China. Due to the gap between expectations and the unsatisfactory reality, the distribution network will often be the first source of problems for the JV.

Myth #3: “I know the Mayor. We have GREAT guanxi with the authorities.”

Often, the less developed an area is, the more hearty the initial relationship with the Chinese authorities will be. Although “guanxi” can be useful in the establishment stage, it may be negative in a later stage. However, this is an extremely complicated issue. Many foreign-invested projects in less developed areas do enjoy positive assistance and “guanxi” with the local authorities. Often, these foreign-invested entities are the largest taxpayer and also a source of local pride. Whether or not a FIE benefits from such relationship will depend very much on the involvement of its management and board of directors.

Reason 3: Isolated cases of good reasons

Good Reason #1: Proximity to location of raw materials

Although the focus of foreign investors is mostly on China as a manufacturing hub, it should be noted that China is also a big country geographically which has large deposits of raw minerals and materials. China is rich in supplies of rare earth, magnesite, chromium, ferrous metals, coal and bentonite, to name a few.

Most foreign investors entering into a JV Contract with a Chinese entity will normally select arbitration. An award handed down by a formal arbitration organisation against a Chinese party may be enforced in a court in the PRC pursuant to the *New York Convention* and in accordance with the *PRC Civil Procedure Law*. Accordingly when choosing a forum for arbitration, it is important for the parties to ensure the forum country is a signatory party to the *New York Convention*. Otherwise, enforcement of the arbitration award may become an issue. Legally a PRC court is only entitled to refuse to enforce an international arbitral award pursuant to the grounds outlined in Art V of the *New York Convention* (namely public order or serious procedural bias). In practice PRC courts will not refuse to enforce the arbitral award.

Popular arbitration choices are Stockholm, Hong Kong or CIETAC.

[¶17-490] Language

The issue regarding the governing language of the JV Contract was not addressed in the *EJV Law* of 1979. As a result, many thought it was possible to include (and actually has been included) in the JV Contract a provision stating that an English language (or other foreign language) version of the contract would prevail over its Chinese language counterpart in case of a dispute between the two languages used in the contract. However, it was doubtful whether such a provision could be strictly enforced in China. As discussed above, the JV Contract only becomes effective upon its approval by the relevant Government authorities in China. In practice, the approval authorities base their approval on the Chinese language version of the contract and thus it is unlikely that the approval authority would be willing to approve a contract which states the English version will prevail. Accordingly the best the foreign party can hope for is for both language versions to be equally binding. Naturally, this illustrates the importance of having both versions conform to one another. Such translation normally could only be done by a person with a legal background.

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[¶20-005] Overview

In the previous sections, we have discussed important legal issues relating to the establishment of FIEs.

However, the actual work only really starts after the FIE has been set up. As is so often the case in life, as the work commences many of those who were involved sink off-stage. Often a limited number of managers are left to worry about the operation of the FIE. The foreign investor's senior management, lawyers and accountants often depart for new tasks (of strategic importance no doubt). However, there are many important issues relating to the operation of a FIE that deserve detailed discussion and consideration by the management. This section hopes to provide an overview of major issues of concern including taxation of FIEs, management, board, fraud, compliance, land use, construction, foreign currency financing, and the granting of security by FIEs, etc.

ORGANISATIONAL STRUCTURE

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¶20-020] Governing legislation

- (1) *Law of the People's Republic of China on Sino-foreign Equity Joint Ventures*, revised on 15 March 2001 ("EJV Law");
- (2) *Regulations for the Implementation of Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures*, enacted by the State Council and revised on 22 July 2001 ("EJV Regulations");
- (3) *Law of the People's Republic of China on Sino-Foreign Co-operative Enterprises*, revised on 31 October 2000 ("CJV Law");
- (4) *Regulations for the Implementation of Law of the People's Republic of China on Sino-Foreign Cooperative Enterprises*, issued by MOFTEC and effective as of 4 September 1995 ("CJV Regulations");
- (5) *Law of the People's Republic of China on Wholly Foreign-Owned Enterprises*, effective as of 20 October ("WFOE Law");
- (6) *Detailed Rules for the Implementation of Law of the People's Republic of China on Wholly Foreign-Owned Enterprises*, issued by MOFTEC and revised on 21 April 2001 ("WFOE Regulations"); and
- (7) *Company Law of the People's Republic of China*, effective as of 1 January 2006 ("Company Law").

BOARD

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¶20-050] Definition of the board

In the case of a limited liability FIE the board of directors ("board") is the highest body and decides the strategic issues of the company in compliance with the JV Contract (if any) and the articles of association. The board supervises the affairs of the company and arranges for the proper organisation of the company's activities. The board tends to be non-executive (ie not directly involved in daily management of the FIE).

¶20-070] Powers of the board

The Board has broad powers and basically needs to be involved in any major and strategic business decision. In most cases the articles of association will list decisions upon which board approval must be obtained. Typically the major decisions include at a minimum:

- (1) Appoint management;
- (2) Amend the articles of association;
- (3) Major investments or mergers;
- (4) Increase or decrease of the FIE's registered capital;
- (5) Approve a share transfer in the FIE registered capital; and
- (6) Approve the FIE's annual financial statements.

¶20-090] Composition of the board

The *EJV Law* requires that the composition of the EJV's board be negotiated by the parties by reference to the shareholding percentage of the parties thereto. The *CJV Law* also requires that the composition of the CJV's board be negotiated by the parties by reference to the investments or cooperation conditions offered by the parties thereto.

Generally, the board structure of a JV is largely determined by the share ratio of the parties. However it is not a mandatory requirement, thus the parties concerned have some negotiation room on this matter. In practice, other factors, such as the contributions, operational status, technology, and financing ability of each party, also come into play in determining the composition of the board.

¶20-110] Board decisions that require unanimous consent

Pursuant to the *EJV Law*, the following issues of an EJV require the unanimous consent of all directors present:

- (1) Amendments to the articles of association of the EJV;
- (2) Suspension of operations and termination of the EJV;
- (3) Increase and decrease in the registered capital of the EJV; and
- (4) Merger and division of the EJV.

Pursuant to the *CJV Law*, the following issues of a CJV require the unanimous consent of all its directors present:

- (1) Amendments to the articles of association of the CJV;
- (2) Termination of the CJV;
- (3) Increase and decrease in the registered capital of the CJV;
- (4) Merger, division and change of incorporation form of the CJV; and
- (5) Mortgaging of assets of the CJV.

In addition, PRC law allows the shareholders of an EJV or CJV to make other issues subject to unanimous consent in the JV Contract and articles of association.

Upon registration, land certificates will be issued to people who hold the rights or interests in land. State-Owned Land Use Certificates, Collective Land Ownership Certificates and Collectively-Owned Land Use certificates are issued by the people's governments at or above the county level; other land rights or interests certificates are issued by the land administration departments of the local people's government at or above the county level.

¶30-110 Registration of all lands and related rights

Based on the *Land Registration Rules*, all lands are required to go through the registration process. The registration consists of an initial land registration and land change registration. The initial land registration refers to the general registration of all lands within each administrative jurisdiction in China in accordance with the procedures set out in the *Land Registration Rules*. The land change registration refers to all registrations subsequent to the initial land registration.

According to Art 8, the process for the initial land registration commences with the publication of announcements by the local governments concerning the division of the land registration districts and the time limit for registration of lands within each district. Pursuant to the announcements, all land interests holders must apply to the relevant Land Administration Bureau for an initial registration of their rights and interests in land. If the Land Administration Bureau, after examination, determines that an application has met the registration requirements, it will make a public announcement which, among other things, will set out the time limit for other interested parties to challenge the said application. Within the time limit, interested parties may apply to the Land Administration Bureau for a re-examination of the said application. Where an application is not challenged or has been challenged unsuccessfully, it will be registered in accordance with the *Land Registration Rules* and the relevant certificates (if applicable) will be issued to the applicant.

Subsequent to the initial land registration, all registrations are referred to as land change registrations, which essentially record changes and termination of interests in land or other changes in respect of interest holders. Land change registrations include:

- (1) The registration for the establishment of land use rights, land ownership and other land related rights;
- (2) The registration of changes to land use rights, land ownership and other land related rights;
- (3) The registration of a change of names, addresses and land use; and
- (4) The cancellation of land registration.

It is important to note that *Land Registration Rules*, in addition to calling for a registration of all lands, provide for a registration of all the rights or interests in the land. By virtue of Art 2, such rights and interests include State-owned land use rights, collective land ownership, collectively-owned land use rights, mortgage/charge interests, leasehold interests and other rights or interests. The legal status of some of these rights had never been clarified previously.

¶30-130 Impact of the *Land Registration Rules*

Article 69 provides that a land user or owner who fails to apply for a land registration in accordance with the *Land Registration Rules* will be deemed to illegally occupy land. Therefore, all interested parties should comply with the *Land Registration Rules*, including ensuring that the transactions are registered in accordance with the *Land Registration Rules*.

One clear positive impact of the *Land Registration Rules* is that it provides a uniform basis for a registration of rights of land charge throughout China. Prior to the *Land Registration Rules*, apart from a very general statement in Art 42 of the *Security Law*, land charge registrations were mainly governed by regional rules such as the Beijing and Shanghai *Charge Rules*. Furthermore, according to the *Land Registration Rules*, chargees will be issued "other land related rights certificates" upon registration and such certificates provide the necessary legal proof for charge interests in the PRC. Therefore, in cases of financial institutions that conduct lending facilities in localities without any relevant rules, the promulgation of *Land Registration Rules* gave them an added layer of legal certainty and protection. Such impact of the *Land Registration Rules* has nevertheless become less obvious with the issuance of *Real Property Charge Measures* in 1997.

¶30-150 Effect of registration

According to Art 62, the registration records and documents are conclusive proof of transfer, charge and lease of land use rights. In addition, Art 65 states that the land registration cards are primary documentation and legal proof of land ownership, land use rights and other rights or interests in land including a charge or lease thereof, while the land certificates are duplicate documents of a portion of land registration cards.

According to the *Land Registration Rules*, the land registration records may be available for public search. Article 62 provides that a transferee, chargee or lessee may apply for a search in writing and the authorities must issue written search results. However, it is unclear whether a potential transferee, chargee or lessee can also make such application under the *Land Registration Rules*. The more recent *Land Search Rules*, which became effective on 1 March 2003, make it very clear that any person can make a public search of land registration records with the consent of the land rights holders. This clearly represents progress in China's land administration. The *Land Search Rules* provide a legal avenue for any potential transferee, chargee or lessee who would be interested in doing a search as part of the due diligence process.

The PRC land registration system does not guarantee indefeasibility of title and there is no insurance provided for title defects. Article 71 provides that if an error or omission is found in relation to registration, the land administration department must make the corrections and the interested parties may also apply for such corrections. The *Land Registration Rules*, however, do not provide any means for dealing with the effects of such correction on an innocent third party such as a bona fide purchaser for value without notice. This is probably the major defect of the system. It is doubtful that the land registration department will compensate a person who suffers loss due to errors or omissions made by the registration personnel in the process of land registration, although the victim may undertake an administrative action against the relevant land registration department.

Notwithstanding the foregoing discussion pertaining to defects, the *Land Registration Rules*, by setting up a comprehensive land registration system and making records available for public search, have indeed represented a significant step forward and thus provided the necessary transparency and predictability in the evolution of the land system in China.

Real property ownership and registration

Real property ownership.....¶30-200 Local nature of real property ownership registration.....¶30-230

¶30-200 Real property ownership

“Real property” refers to the land use rights together with buildings and structures on the land. Subject to the restriction of land ownership and duration of land use, private ownership (by individuals and corporate entities) of real property is allowed in China. The foreign direct ownership of real property has now been restricted by *Opinion (2006) No 171*, which was issued as part of China’s recent efforts to control the flow of foreign hot money into its real property sector and curb the overheating of real property market. Building ownership is generally evidenced by a building ownership certificate.

“Real property” can be transferred, leased or charged. The leasing of real property will be further discussed in ¶30-370 and the charge of real property will be discussed in ¶27-200.

¶30-230 Local nature of real property ownership registration

The *Real Property Law* only contains general provisions regarding real property ownership registration. Article 60 states that where a building is completed, registration with the local real property administration department shall be carried out and a building ownership certificate obtained. Article 16 of the *Administrative Rules on the Registration of Building Titles in the Urban Areas* (“*Building Title Registration Rules*”) specifically provides that the registration procedures shall be carried out within three months after the building is completed. The following documents must be submitted for such registration:

- (1) Land use certificates or other evidence of land use;
- (2) Construction Land Planning Permit;
- (3) Construction project planning permit;
- (4) Construction commencement permit; and
- (5) Construction completion, acceptance and delivery documents.

The real property rights, such as the chargees’ rights over the property, are required to be registered as well. It is interesting to note here that the *Building Title Registration Rules* do not deal with the registration of leasehold interests over buildings. It is not clear why this is the case. Given the fact that the *Building Title Registration Rules* came into effect more than two years later than the *Leasing Measures*, it is probably the legal draftsmen’s view that the registration provisions contained in the *Leasing Measures* are sufficiently detailed and should not be duplicated.

Since the issuance of the *Real Property Title Certificate Circular* by the Ministry of Construction, local governments have been requested to gradually implement a system of issuing one single combined certificate for both land use rights and building ownership thereon, ie a real property ownership certificate, instead of two separate certificates (ie land use certificate and building ownership certificate).

A sample Real Property Title Certificate is set out in ¶30-502.

FIEs’ land and property use

Bare land use rights as registered capital contribution¶30-300 Leases.....¶30-370
Direct acquisition of bare land use rights.....¶30-330 Construction¶30-390

With the above brief introduction of China’s land and real property ownership and registration system as the backdrop, we now turn to the discussion of FIEs’ land and property use as an operational issue. FIEs’ land and property use can be obtained by the following methods.

¶30-300 Bare land use rights as registered capital contribution

For many JVs, especially those engaging in the manufacturing sector, it is often the case that they obtain land use rights from the Chinese party as a part or all of such Chinese party’s registered capital contribution to the JV.

Foreign investors should pay close attention to several critical issues. First of all, they should find out whether the land use rights in question are granted or allocated. This can be verified by consulting the land registration records. Notwithstanding the issuance of the *Land Registration Rules*, a public search is, however, not available. Instead, the practical approach is to ask for a copy of the land use certificate for the land use rights concerned. As discussed above, the appropriate land use certificates should be issued for all properly acquired Granted Land Use Rights, while land use certificates may in some cases not be issued for Allocated Land Use Rights. It is important for the foreign investor to examine closely the contents of such land use certificate. Not all land use certificates issued in the past do not state clearly whether the land use rights concerned are “granted” or “allocated”. A Land use certificate specifies the term of the land use therein, eg for a term of 50 years, then the land use rights in question are likely to be “granted” in nature. On the other hand, if the land use certificate does not specify the term of the land use, the relevant land use rights are “allocated” in nature. For land use certificates that were issued more recently, the nature of the land use (ie granted or allocated) is clearly spelt out in such certificates.

As discussed above, Allocated Land Use Rights cannot be legally disposed of without being converted into Granted Land Use Rights. In the past allocated land use rights could not be contributions to the registered capital by the Chinese party in the form of Allocated Land Use Rights.

Nevertheless, there are cases of local legislation which allows contribution in limited circumstances.

However, in the early years of China's open door policy, partly due to a lack of clear regulations in this area, many JVs had been set up with the Chinese party contributing Allocated Land Use Rights as part or all of its registered capital contribution.

After having determined that the land use rights in question are indeed granted in nature or after having converted Allocated Land Use Rights into Granted Land Use Rights (with the issuance of the relevant certificate), foreign investors should also examine closely the terms of the land grant contract. As mentioned above, the land grant contract, which contains all the important terms concerning the land use, not only binds on the original grantee of the land use rights but also binds on all subsequent transferees thereof. In other words, the land grant contract flows with the land use rights.

In addition, the foreign investor should make sure that all land grant fees have been fully paid. According to the *Land Grant Regulations*, the land grant fees are paid before the issuance of the land use certificate. In practice, however, many Chinese companies have struck deals with the local land administration department whereby the payment of the land grant fees are postponed or sometimes even exempted. The foreign investor concerned should make sure that such postponement and exemption would not become problematic for the JV in the future because the land use rights will be issued in the name of the JV after the contribution. As a result, the JV may be liable for any fees payable if the postponement expires or exemption is cancelled, not recognised, or held invalid, illegal or unenforceable.

¶30-330] Direct acquisition of bare land use rights

Land use rights are acquired by entering into a land use rights grant contract with the relevant land administration authority. It is crucial to ensure that you are contracting with the proper administration. More details can be found in **Land** at ¶2-530.

¶30-370] Leases

Bare land use rights

As mentioned above, although Granted Land Use Rights can be legally dealt with by transferred and charged, the current PRC legislation does not seem to lay down a clear legal basis for the leasing of bare land use rights. The *Real Property Law* does not contain any provisions concerning the leasing of bare land use rights. Almost all land granting contracts have provisions that prohibit leasing undeveloped land. Therefore in practice wherever the term "leasing" appears, it will refer to the leasing of buildings or land use rights together with buildings thereon.

Buildings

While the status of a lease of bare land use rights is not legally certain in China, a lease of buildings in urban areas by a FIE for its production, business operation and residential purposes, falls squarely within the jurisdiction of the *Leasing Measures*.

In leasing buildings, a FIE shall pay close attention to several provisions of the *Leasing Measures* that may have a significant impact on the leasing transaction. First of all, Art 5 of the *Leasing Measures* provides that buildings involving one of the following situations cannot be legally leased:

- (1) Buildings for which no ownership certificate has been issued;

- (2) The relevant building ownership or other rights are restricted by judicial or administrative bodies;
- (3) Buildings under common ownership where the consent of other owners in common has not been obtained;
- (4) The relevant building ownership is in dispute;
- (5) Buildings that were constructed illegally;
- (6) Buildings that fail to meet the relevant safety standards;
- (7) Buildings that have been charged and where the consent of the chargee has not been obtained;
- (8) Buildings that fail to meet the provisions of the relevant public security, environmental or health departments; and
- (9) Buildings that are prohibited from being leased by the relevant laws and regulations.

Article 9 requires that a written lease agreement be entered into between the parties, which shall include the following terms:

- (1) The names and domiciles of the parties;
- (2) Details of the location, area, decoration and facilities of the building;
- (3) The purpose of the lease;
- (4) The lease term;
- (5) Rental and the method of payment;
- (6) Repair responsibilities;
- (7) Provisions regarding subleasing;
- (8) Conditions for amendment and termination of the agreement;
- (9) Liabilities for breach; and
- (10) Other provisions.

Article 14 provides that a lease agreement shall be registered with the local real property administration authorities within 30 days after it is signed and the following documents should be submitted for such registration:

- (1) The written lease agreement;
- (2) The building ownership certificate;
- (3) The parties' identification documents; and
- (4) Other documents required by the local government.

Upon registration, a building lease certificate will be issued to the parties. A building lease certificate is the proof of legal occupation of the leased building. Failing to carry out the requisite registration may result in penalty by the local government on the part of the parties.

[¶30-390] Construction

Except for the issues discussed in **Land** at ¶2-530 which include contracts, qualification of contractor, licences and permits and specifications in respect of construction, foreign investors should make strategic consideration of the following issues.

Construction Land Planning Permit and Construction Design Planning Permit

Article 31 of the *Urban Planning Law* provides that a "Construction Land Planning Permit" must be applied for before acquiring lands for construction purpose. Article 32 of the same law further provides that for all construction works carried out in urban areas, the relevant entity must apply to the relevant urban planning department, which will (based on the relevant urban planning and designing requirements) issue a Construction Design Planning Permit. Without this latter permit, the FIE cannot proceed to obtain the requisite construction permits and have the construction work commenced.

A sample "Construction Land Planning Permit" is set out for reference in ¶30-503.

Construction work permit

In order to start construction work, the FIE will have to apply to the relevant construction administration department for a "Construction Work Permit" for the proposed construction (with the exception of some minor projects or those projects approved by the State Council). Article 8 of the *Construction Law* provides that the following conditions must be met before a Construction Work Permit can be issued:

- (1) The land use approval procedures for the construction project have been properly carried out;
- (2) The Construction Design Planning Permit has been obtained for the project;
- (3) Where any demolition and removal works are required, the schedule thereof meets the needs of the construction;
- (4) A contractor has been hired for the project;
- (5) There are sufficient construction drawing and technical data required for the construction project;
- (6) Safety measures are in place that will ensure the quality and safety of the construction project;
- (7) The required funds have been set aside for the construction; and
- (8) The project meets other conditions prescribed by law.

The relevant construction administration department will issue the Construction Work Permit within 15 days should all the requirements be satisfied.

The FIE must commence construction work within three months after obtaining the Construction Work Permit. The Construction Work Permit can be extended twice, each with a term of three months. A Construction Work Permit is void if its term expires. Accordingly, no construction work can be commenced on such basis.

Quality supervision

According to the *Construction Quality Regulations*, the quality of new construction projects has to be supervised and monitored by quality supervision organisations designated by the relevant construction commission. Furthermore, the municipal construction commission can also conduct such quality inspection of construction works on a random basis. The *Construction Quality Regulations* also prescribe the liabilities for a construction project sponsor (such as a FIE) for poor construction quality.

Completion and acceptance

Once construction works are completed, the quality of the works shall be inspected and then accepted in accordance with the *Construction Project Inspection and Acceptance Rules*. The inspection and acceptance committee shall consist of representatives from departments in charge of banking, material supply, environment, labour, fire and so on. The FIE (as the project sponsor), construction contractor, survey and designing institutes shall participate in the inspection and acceptance.

Only after successful inspection and acceptance can the FIE proceed to apply for and obtain a building ownership certificate or real property certificate for the new building or structure.

If the FIE does not have these documents, it is not legal to proceed with construction and it will not be possible to subsequently obtain a building title certificate.

The exact approval procedures do vary from place to place (and also seemingly from project to project) but in the main should look similar to the following chart: