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REAL ESTATE UPDATE

This update is the first in a series that will focus on unique aspects of real estate law in jurisdictions around the globe.

Real Estate Investment in China

Since the year 2000, the average annual growth rate of real estate investment in China has been over 20 percent. The annual double-digit growth is expected to continue despite the increasing number of regulations that China is placing on foreign investment. Conscious of the need to keep pace with the demand, China adopted the PRC Property Right Law (“2007 Property Law”) in an attempt to provide greater structure to real property law and to create a more stable environment for continued foreign investment.

This briefing discusses the Chinese system of holding and transacting in real property and the rules for foreign investment in the Chinese property market.

CHINA’S REAL PROPERTY FRAMEWORK

Historically, Chinese real property law has been marked with uncertainty as to the protection of private real property rights. As foreign investment continues to flow into the Chinese real estate market, the Chinese government has made significant strides toward embracing the concept of private ownership rights. The movement toward greater private ownership rights culminated on October 1, 2007, when the 2007 Property Law became effective. This new law provides more expansive property rights to private owners and demonstrates China’s commitment to boosting economic and social development by creating a climate of greater certainty.

The Chinese real property regime is based upon a system of collective ownership of land and the granting of land use rights by the state for the use thereof. For the most part, the state owns all urban land and local collectives own all rural land. In order for a private developer to improve land, the developer must enter into a land use rights agreement with the state. A land use rights agreement establishes the duration of the developer’s land use rights and the purposes for which the developer may use the land. The term of a land use rights agreement is 70 years for residential property, 40 years for commercial property and 50 years for all other uses. Once a land use right is granted, the land may not be put to any other use without the state’s consent. Consideration for a use grant must be paid in a lump sum upon execution of the land use rights agreement. Generally, uses granted under land use rights agreements are limited to surface rights and do not include any sub-surface rights.

In the event that the land in which a developer has an interest is designated as rural land, it is necessary for the land to be transferred from the local cooperative to the state. Prior to a developer entering into a land use rights agreement in connection with rural land, the local cooperative and the state are required to follow certain requirements to effect such transfer, including the payment of compensation for moving expenses to those individuals occupying the land at the time of the transfer and having the transfer occur in connection with an open sale of the land use rights associated with the land. If the local cooperative and the state do not precisely



follow the procedures required for the transfer, the national government can intervene and unwind the transaction, even several years after a developer has constructed a building on the property. Upon the expiration of the land use rights agreement, the land use rights granted to the developer revert to the state, unless the land use rights are renewed. Following adoption of the 2007 Property Law, the land use rights for residential real estate automatically renew, but Chinese law does not provide the terms and conditions of renewal.

Although a private developer is not permitted to own land, a private developer is permitted to own, in the Chinese equivalent of fee simple, the buildings that the developer constructs on the land. In order for a developer's ownership of a building to become effective, the developer must register the building with the state. If a number of entities own units in a building, each entity enjoys exclusive ownership of its unit and joint ownership of common areas and facilities with owners of other units in the building, together with the right of management thereof.

Buildings (1) are freely transferable between private developers, (2) can be leased to third parties and (3) can be used as security for loan proceeds. Unlike American law, leases under Chinese law do not create real property rights, but instead merely create contractual rights to the use of the facility. The right to mortgage a building to secure a debt, however, more directly parallels American law. A developer has the right to mortgage its property to secure debt both in connection with the acquisition of a building and the construction of an improvement.

An additional reform included in the 2007 Property Law is a limitation on the expropriation rights of the Chinese government. The 2007 Property Law limits the state's private real property expropriation rights to expropriations for the "public interest" and, in the event that the state expropriates private real property, the state must provide the private owner compensation. Although this reform creates greater certainty in private ownership, the 2007 Property Law provides no definition of public interest or formula by which compensation should be determined. In addition, the state's having to pay greater compensation for the expropriation of land will likely translate to higher purchase prices for land use rights. Fortunately, land owned by foreigners rarely has been expropriated; land owned by local cooperatives is most likely to be targeted for expropriation by the state in connection with the process of reclassifying the property from agricultural to urban.

Easement rights also are recognized under the Chinese system as registerable rights to use the property of another. Parties create an easement by written contract, but the easement is only enforceable against third parties if it has been registered. Once the easement has been registered, the easement usually runs with the land, binding the transferee in the event of the transfer of land use rights, unless specifically terminated by the owner/user of the benefitted land. If parties have entered into a written easement, but neither party registered the easement, the easement generally will not run with the land and is likely unenforceable by a transferee. Additionally, adjacent property owners and users have certain "access rights" over the property of their neighbors. If an owner or user of real property requires access to adjacent property or structures for construction or repair of buildings or utility facilities, such as electrical lines, gas pipes, etc., then the adjacent owner is required to grant access to its property, and, in the event of damage to the building as a result of such access, the owner will be entitled to compensation. The full scope of access rights, although clarified by the 2007 real property reforms, has been a matter of great contention because of delays in projects caused by claims of access rights to items such as sunlight in the shadow of a large skyscraper.

Generally, foreign investors are afforded the same basic real property rights described above as their Chinese counterparts. However, as discussed more fully below, the Chinese government has established a



number of regulations relating to the type, amount and mechanics of real estate investments that can be made by foreign investors.

FOREIGN INVESTMENT IN REAL PROPERTY

As noted above, the Chinese real estate market has experienced exponential growth in recent years. In 2006 and 2007 the Chinese government adopted numerous regulations to create greater stability in an overheated real estate market that has been driven, in part, by speculation, and to focus foreign investment on those types of developments and locations that, in the government's determination, would most benefit the Chinese people and economy.

Any passive foreign investment in real estate requires the approval of the Chinese government. Foreign investors are subject to greater scrutiny than are domestic investors. In fact, foreign investors with "bad records" are prohibited from acquiring interests in a domestic real estate company. Once a project receives approval from local authorities, the approval must be registered with the Ministry of Commerce. If the project is considered a restricted project (as described below), and the estimated cost of the project is over \$50 million, the project requires the approval of the national authorities. In addition to projects that are restricted, the state restricts certain types of projects, including villas and high-end hotels. If foreign investors desire to expand a project, an additional approval by the applicable authorities will be required.

Separate and apart from the required approval of their investment, foreign investors are required to establish a foreign-invested real estate enterprise (FIREE) as their vehicle for investment. In order to establish a FIREE, a foreign investor is required to enter into an agreement with the current holder of land use rights or local land administration authority, as applicable, securing the land use rights for the property the foreign investor intends to develop. A FIREE can be established as a joint venture with a domestic party, but it is not permissible for the FIREE to fix a return for the domestic party or foreign party. The formal certificate of approval for a FIREE will not be issued until the foreign investor has paid the land grant premium for acquisition of the land in full.

If a foreign company seeks to develop land for its own use, the general rule is that the company is not required to establish a FIREE, but would be required to have an approved branch or representative office in China. As a condition to the purchase of land use rights by the foreign company for its own use, the foreign company is required to submit evidence of approval for establishment of its local entity. Depending upon the type of use, such as for hotels or warehousing services, local authorities may interpret the investment to be passive and require the establishment of a FIREE. The standards establishing the types of investments that would be considered passive investments vary by jurisdiction.

China also strictly regulates the debt-to-equity ratio of projects by FIREEs. The foreign investment rules require that a FIREE consist of at least 50 percent registered capital, meaning that the funding of a development consist of at least 50 percent equity contributed by the investors, regardless of the size of the investment. Consequently, the maximum debt-to-equity ratio for a project by a FIREE is 50/50. This requirement is, on average, greater than other foreign-invested enterprises, which, depending on the size of the project, require between 33.3 percent and 70 percent registered capital. In addition to the strict equity requirements imposed on proposed foreign investments, a FIREE is prohibited from obtaining loans if (a) it has not obtained a land use certificate, (b) the amount of registered capital paid into the FIREE is less than 35 percent of the total development investment and (c) the registered capital of the FIREE has not been completely paid in. When buying into a domestically-funded real estate project, a foreign investor is required



to pay the acquisition price in a lump sum payment of its own capital, rather than in installments as is otherwise permitted in cross-border mergers and acquisitions.

THE SHAPE OF THINGS TO COME

A sizeable portion of the capital that has financed the rapid expansion of the Chinese economy and spurred the large scale of development that has occurred during this decade has come from foreign investment. China continues to adjust not just to rapid urbanization, but to the expectations of returns driving foreign investment. As expectations of returns slow, foreign investors begin to seek other places for investment. As a result, China has instituted numerous reforms, the basics of which are described above, in an attempt to create greater certainty in the Chinese real estate market. One caveat of the general trend toward providing greater certainty to foreign investors is the impending expiration of the first land use rights certificates granted by the state. If the state becomes too aggressive in its land use rights renewal requirements, the state's position will become a cause of insecurity for both investors and companies contemplating building plants in China.

In addition to reforms in basic real property law, the Chinese government has instituted numerous guidelines to foreign investment in order to contain real estate prices inflated by speculative investment and to direct foreign investment into projects that can greater benefit the state.

The Chinese government seems to understand that certainty is an important element to continued foreign investment and that foreign investment is a very important component to the country's continued growth and success. As a result, the current trend appears to be that China will continue reforming its real property laws to create more stability in the real estate marketplace and to maintain its status as a sound investment for real estate investors considering overseas expansion.

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- Brazil
- Cuba
- India
- Italy
- Mexico
- Montenegro
- Offshore Tax Havens
- Russia
- United Arab Emirates
- United Kingdom
- Uruguay

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