Staggered start

China has taken promising steps with its new property law but recent regulations provide another obstacle for foreign investors. By Warren Hua and Marianne Ramel of Gide Loyrette Nouel

On March 16 2007, after more than a decade filled with legislative drafts and debates, the National People's Congress (NPC) passed the Property Law, which regulates public and private property rights. The Property Law will come into force on October 1 2007.

Until now, China's legal regime has been unable to fully regulate property rights or accommodate property-related projects in China. Before the passing of the Property Law, many of the relevant rights and issues were addressed in a piecemeal manner by miscellaneous national laws and administrative regulations.

The Property Law represents a big step forward and evidences the Chinese authorities' commitment to creating a more comprehensive and conducive legal regime for property rights in China.

General principles

The Property Law now provides that state, collective and private property rights are protected and must not be infringed. This means that the protection given to private property is equal to that afforded to property of the state.

Although an amendment to the PRC Constitution in 2004 confirmed the protection of a citizen's lawfully owned private property, the Property Law has extended this protection. It now applies to all natural and legal persons, regardless of whether the person is Chinese or a foreigner, or a domestic or foreign invested enterprise (FIE).

The Property Law covers both movable and immovable property and, to a certain extent, some intangible property rights.

Land ownership and land use rights

The Property Law reinforces that all land in China is publicly owned. Depending on location, land remains owned either by the state or by rural collective organizations or villages. As such, private investors do not have access to land ownership in China.

Having said this, private investment in Chinese real estate has been possible since 1988 when the PRC Constitution was amended to allow investors to acquire land use rights (LURs) over real properties owned by the state or rural collective organizations or villages. LURs are a form of property tenure where a party obtains or buys the right to occupy land for a given length of time from the state. The concept is close to leasehold in the UK or the perpetual lease in France (*bail emphytéotique*).

The Property Law refers to usufructuary rights being enjoyed by anyone who does not have full land ownership but who benefits from advantages derived from the use of publicly owned land. LURs are therefore a type of usufruct right.

In China LURs may be obtained from the state by investors by way of grant, allocation, or lease. Upon payment of a land grant fee, granted LURs may be obtained from the state through listing, bidding or auction procedures. However, grant of LURs through negotiation is still possible in a limited number of cases.

Allocated LURs are usually obtained by state entities and military units, non-profit organizations or for public infrastructure facilities. The use of allocated LURs for development is limited under the Property Law.

LURs may also be granted on rural collectively owned land, provided however, that the land has first been requisitioned by the state and then converted into state-owned land.

The Property Law reiterates that granted LURs are obtained for a maximum duration depending on the intended land use:

- 40 years for commercial, tourism and entertainment uses;
- 50 years for industrial, educational, scientific and technological, cultural, public health, sports or mixed purpose use; and
- 70 years for residential use.

Whatever the intended use, LURs over vacant land may be terminated or re-granted if construction has not started within two years of the date on which the rights were obtained.

One of the main changes the Property Law introduces is that LURs for residential purposes are renewed automatically upon expiry. Unfortunately, the law is silent on many issues and further implementing rules would be welcome to provide greater clarity, especially as to whether any fees will be charged, and, if no renewal is granted, what happens to buildings already constructed on the land. In fact, during the various drafts of the Property Law there were heated debates relating to the issue of fees. As such, the legislator deliberately left this issue out.

The Property Law does not elaborate on issues related to the renewal of LURs over non-residential land either, except to state that this must be dealt with in accordance with law.

Property owned by individuals, corporations and the collective may be expropriated in return for compensation, if it is in the public interest to do so. The law does not clarify the meaning of *public interest*. Further regulations or Supreme People's Court judicial interpretations might have to be issued in this respect.

The Property Law also introduces the concept of construction LURs. The user of the construction LURs will have the ownership of the buildings, or structures erected on the land. Moreover, if the relevant rights are recorded in writing and registered, the user may transfer, exchange, mortgage or donate, or provide as capital contribution, its rights together with the buildings, or structure, unless otherwise provided by law.

Creation, change, transfer and termination

China has no unified registration system for recording property rights. The Property Law introduces a unified registration system for immovable property to replace the current, rather cumbersome, registration system. This will protect each person's property and ownership rights. It is still unclear how this unified registration system will work in practice (for example, the scope of registration, and registration methods) so further regulations concerning this would be welcome.

Transfer and registration of immoveable property

The Property Law requires that the creation, change, transfer or termination of immovable property rights will become effective upon registration in accordance with the law. Otherwise, such creation, change, transfer or termination will be void. The registration of immovable property must be carried out with the local registration authority where the immovable property is located. A registration fee is payable and will be charged based on the number of applications provided to the registration authority and must not be charged on the basis of the area, or price of the immovable property. A specific standard fee will be jointly determined by the relevant department of the State Council together with the authority in charge of pricing.

When applying for registration, evidence must be provided showing ownership and title as well as other necessary information.

The functions of the registration authority are to examine the documents provided by the applicant, make enquiries of the applicant, register the relevant item in a truthful and timely manner and to perform duties stipulated by other laws and administrative regulations. If necessary, the registration authority may conduct on-site visits to enable it to conclude its investigation. The registration authority may not request any evaluation of the immovable property, carry out repeated registrations on the basis of annual inspections or conduct any activities exceeding its scope of authority.

The creation, change, transfer or termination of immovable property rights, where registration is required, becomes effective upon entry on the registry with the registration authority, which will serve as the basis for proof of title. The certificate for immovable property provided by the registry evidences ownership. The contents recorded on the title certificate for the immovable property must be consistent with that recorded with the registry; in case of any inconsistency, the information recorded with the registry will prevail unless evidence proves otherwise.

However, whether the rights are registered or not will not affect the validity of the contract, unless otherwise required by the law or agreed in the contract.

The rights holders or an interested party may make inquiries and examine the registration documents, which will form an important part in any due diligence exercise in China. If a rights holder or an interested party believes that any information entered on the register with the registration authority is incorrect, it may apply to the registration authority to correct the mistake. The correction may be opposed, and any party opposing the amendment has 15 days to bring a suit. If the suit is vexatious or without merit the claimant could then be liable to pay damages. On the other hand, the registry will compensate for any loss arising from erroneous information entered by the registry. This might provide some comfort to those involved in real estate projects in China.

The Property Law further provides that, in the case of the purchase of a not yet completed building or other immovable property, a pre-notification registration may be made. Once the pre-notification is registered, the purchaser's right is fully protected, including against any third party purchaser without notice.

Transfer and registration of moveable property

The creation or transfer of ownership rights over moveable property becomes effective upon the delivery of the property to the buyer. The creation, change, transfer or termination of any property rights over ships, aircraft and motor vehicles (including those under construction) do not have to be registered unless the rights shall be protected against a bona fide third party. The Property Law now recognizes the concept of, and sets out the conditions for, a bona fide third party purchaser for value.

Transfer of ownership property

The Property Law sets out the conditions when a purchaser will acquire good title in the case of both immovable and movable property. If: (i) the purchaser is in good faith when it acquires the property; (ii) reasonable consideration has been paid by the purchaser; and (iii) the property has been registered, if required by law, or delivered to the purchaser, the purchaser will acquire good title. As such, the original owner may only seek compensation against the person who was not entitled to sell the property in the first place.

Security interest

The Property Law extends the scope of security and expands the legal framework for secured lending set out in the 1995 PRC Security Law and its interpretation. The Property Law specifically provides that in case of any discrepancy between the Security Law and the Property Law, the Property Law will prevail.

Mortgage property

The following properties may be mortgaged:
i) buildings and other fixtures to land;
ii) construction/LURs;
iii) the right of operation over barren lands acquired through means of bidding, auction or public negotiation;
iv) manufacturing equipment, raw materials and semi-finished and finished products;
v) buildings, ships and aircraft under construction;
vi) transportation vehicles; and
vii) other properties that are not prohibited from being mortgaged by laws and administrative regulations.

The last item (vii) above might provide certain flexibility for both the lender and the borrower in secured lending transactions.

Author biographies

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Warren Hua is a partner at Gide Loyrette Nouel. He is qualified as a Chinese lawyer. He holds a bachelor's degree in law from the China Northwest Institute of Politics and Law and an LLM in international commercial law from the University of Kent, Canterbury. He has been practising law since 1994 and has developed considerable expertise in both litigation and commercial practice. He spent five years working for local law firms in Beijing and Jiangsu Province and another two years in an English law firm before joining GLN in 2002. His practice mainly covers banking and finance law, project and real estate finance.

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Marianne Ramel is a qualified English and Swedish lawyer. She holds an LLM in law from Lund University, Sweden, and qualified as an English solicitor by completing an English law degree at the London College of Law and two years of legal training at an English law firm. She continued to work for one of the leading English law firms on large cross-border and UK domestic banking and finance transactions. She has advised both lenders and borrowers on plain vanilla, project financing, property financing, acquisition financing and restructuring and refinancing agreements. She joined Gide Loyrette Nouel's Beijing office in 2005 and specializes in banking and finance law.

The Property Law also introduces the floating charge, a concept similar to that which exists in common law jurisdictions or the *fond de commerce* in civil law jurisdictions. Enterprises, individual industries, commercial units and agricultural production operators may create mortgages over their respective existing or future manufacturing equipment, raw materials and semi-finished and finished products upon written agreement between the parties. This creates a more credit-friendly environment allowing the debtor to maintain control over its property even after a loan has been provided.

The floating charge will crystallize at the time when: (i) the mortgagor has failed to perform its obligations; (ii) the mortgagor is declared bankrupt or is dissolved; (iii) other circumstances agreed by the parties in which the mortgage right becomes exercisable; or (iv) other circumstances that could have a serious impact on the fulfilment of an obligation.

Perfection of mortgage

The Property Law now clearly distinguishes between the validity of a mortgage agreement and the creation of a mortgage right.

In the case of items (i) to (iii) or buildings under construction provided under item (v) above, to have a claim as a secured creditor over such property, the property must be registered. The mortgage right is created on the date of registration. Having said this, the validity of the mortgage agreement is not subject to registration, and the lender will still be able to make a claim against the debtor; however, if another creditor has registered its mortgage rights over the same property before the first creditor, the first creditor will then have lost its priority over the said property.

In the case of items (iv) and (vi), ships and aircraft under construction under item (v) above and floating charges, the mortgage right is created once the mortgage agreement becomes effective. However, without any registration, the lender cannot make a claim against a bona fide third party. A floating charge must be registered with the administration for industry and commerce at the location where the mortgagor is located. Moreover, if the mortgagor has disposed of the floating charge at a reasonable price during the ordinary course of business, the mortgagee will not be able to make a claim against the purchaser.

Transfer and realization of mortgage

Contrary to the Security Law, the Property Law now states that, without the consent of the mortgagee, the mortgagor may not transfer the mortgaged property during the term of the mortgage, unless the transferee pays the mortgagor's debt to release the mortgage.

The measures of realization are the same as those existing now, namely by way of transfer, auction or sale, although they have been simplified.

Pledge

Any movables, except those whose transfer is forbidden by law and administrative regulations, may be pledged, including units of funds and account receivables.

The pledge right over account receivables will be created on the date the pledge is registered with a credit agency.

If units of fund or equity interests that are registered with a security registration and clearing institution are pledged, the pledge right will be created on the date of registration. Pledges over shares in non-listed companies must now be registered with the Administration for Industry and Commerce.

Foreign investment

Although the Property Law is hailed as a positive step forward for foreign property investors in China, recent legislative changes have made it difficult, if not impossible, for foreign investors to enter the booming Chinese property market.

On May 23 2007 the Circular on Further Strengthening and Regulating the Examination, Approvals and Supervision of Direct Foreign Investment in Real Estate Sector (Circular 50) was issued to expand last year's Circular 171 and further supervise foreign investment in the Chinese real estate market by tightening approval and filing requirements.

A foreign-invested real estate enterprise must have registered capital representing at least 50% of its total investment amount if the total investment is Rmb10 million ($1.3 million) or more.

Where Circular 171 prohibits foreign investors from purchasing real estate in China independent of an established local entity, Circular 50 imposes further restrictions. Circular 50 reiterates that foreign investors must establish FIEs and can only engage in real estate acquisition and development if approval has been granted by the Ministry of Commerce (Mofcom).

Circular 50 further states that to develop LURs or building rights, foreign invested real estate enterprises must be acquired according to Circular 50 and a land premium must be paid before the foreign investor attempts to establish its foreign invested real estate. It also states that parties to foreign-invested real estate enterprises must not enter into agreements for the arrangement of giving either party direct or indirect fixed returns.

In addition, Circular 50 strengthens the government's control over merger and acquisition activity, and investment in domestic real estate enterprises by offshore companies invested or controlled by Chinese enterprises or individuals (round-trip investment), including Chinese developers appearing as foreign enterprises.

On July 10 2007 the Circular of General Affairs Department of SAFE on Issuance of List of First Group of Foreign Invested Real Estate Projects Filed with the Ministry of Commerce No 130 (Circular 130) was issued to further cool down the overheated Chinese property market and curb the inflow of foreign currency and pressure on renminbi.

As a result, foreign invested real estate enterprises that have obtained approval from the local Mofcom since June 1 2007 and have filed with Mofcom, will not obtain a foreign debt registration certificate. Or if they have not filed with Mofcom, they will not obtain a foreign exchange registration certificate or foreign exchange settlement for capital account.

The consequences are, in the first case that the foreign-invested real estate enterprise might only be able to finance its real estate project by way of capital contribution because it cannot obtain any foreign debt and might not be able to meet the stringent CBRC criteria for onshore lending for real estate projects. In the second instance the foreign-invested real estate enterprise will not be able to function at all because it cannot open a foreign exchange account or make any capital contribution in foreign exchange.

First steps

The Property Law is most welcome as it provides a reasonable indication of the general direction in which property law in China is going. The new law has addressed some uncertainties previously existing in the legal framework, which is good both for property developers and owners. However, the recent regulatory developments have, at least in the short term, restricted foreign investors from investing in the Chinese property marketplace. As such they are deprived from taking full advantage of the Property Law.