

# CHINA

## Legal Bulletin

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### Executive Summary



#### Navigating China's Land Law System

China's land law system may take some investors more familiar with Western practices, by surprise. In China, the state maintains ownership over the land, and grants its people a "land use right". We explore the basics of China's land law and the different kinds of land use rights, how they can be purchased, and the details of the granted land use contract. We also take an in-depth look at the current legal environment for investors interested in real estate, and provide insights as to what investors in those areas should be aware of.

#### Security Review for Mergers & Acquisitions

The Notice of the General Office of the State Council on the Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the "Notice") was issued by the State Council last February. It details the new mandatory security review for foreign companies pursuing mergers/acquisitions with domestic enterprise. China aims for this new procedure to act as a way to ensure national security is not compromised by foreign companies gaining access to state secrets through M&A. In our article, we discuss when the review takes place and how businesses can prepare for it.



#### China's Land Law System

Foreign Investors new to China may be surprised to find that they cannot actually buy land for development. Almost all land in China remains in the hand of the state, and the rest is held by local collectives and subject to restrictions.

So how do investors go about investing and building high rises, office buildings, or factories? Although people in China do not own land directly, they can own a "land use right" which mirrors some aspects of private land ownership in the West. Land use rights of state-owned property are acquired in the following three ways:

- State allocated land use rights for specific purposes. Only in rare cases is approval granted for transfer, and the government can retake the right without compensation.
- Granted land use rights, which normally are transferrable and can only be retaken through use of eminent domain.
- Transferred land use rights from another party, subject to the contract conditions of the original granted land use right.

Rural collectives, land which remains in the hands of villages, falls into three categories: agricultural, housing, and construction. Normally the first two categories of this land are out of reach for foreign investors. However,

construction land, may be obtained by leasing the land from the village, or by investing money into village enterprises.

In most cases, investors will either acquire a granted land use right directly from the government, or through transfer from another party already possessing a granted land use right. The pro-forma contract for a granted land use right has a number of limitations investors should be aware of.

#### Granted Land Use Right

The contract granting the land use right to an investor may differ depending on a number of factors. The most important is the kind of development being undertaken by the investor. The right is transferred to the investor for a set period of years:

- 40 for commercial use
- 50 for industrial use
- 70 for residential use

Investors can apply to renew the contract one year before expiry if the land is still in use. These contracts usually provide that, should the government choose not to allow renewal, the investor will be compensated for the fair value of any buildings or fixtures on the land. But the pro-forma contract also has an option for the government to take such fixtures without compensation, and investors should take care to make sure their investments are

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well protected. More importantly, investors should always be sure to apply for renewal timely and with due care. The government maintains the right to take the land and anything on it at expiry of the contract if the holding party does not apply for renewal. Also, investors should be aware that, since the government maintains ownership of the land, it may take back the land use right for public works projects or other reasons. Here too, land use contracts usually include a provision for investors to be compensated as to the fair value of the remaining land use right, expected profits from future development, and the value of buildings and fixtures on the property.

Investors can usually transfer, lease, or mortgage the land use right to another party, subject to the same conditions. However, contracts usually provide restrictions, including requiring a certain portion of the investment be made, or ensuring the land is suitable for construction. On the flip side, investors buying the land use right from another party should be aware of the conditions of the original contract during negotiations.

When acquiring the granted land use right directly from the government, investors can purchase the land through a number of different methods:

**Listing:** Investors make offers during a listing period, with the highest offer winning the land use right. The local land bureau issues a listing notice for the land at the Land Exchange, stating the transaction conditions, the price, the listing period, etc. During the listing period, the price is renewed according to the potential buyers' offers, until the deadline of the listing is reached.

**Auction:** Investors compete with each other for potential locations in an auction process. In order to obtain the materials to enter the auction, check the website of the local Land Resource Administration Bureau. The required documents vary depending on the nature of the applicant: a company will have to provide different information from an individual investor. Information about the investor's plans for the area, and a deposit, are commonly required.

**Bidding:** Investors place bids for the land use right, and the highest priced offer wins. The Local Land Bureau publishes a bid notice, directing potential bidders to get the necessary documents such as the bidding instructions, land-use plan, land-use contract, and bidding proposal.

Investors should pay a deposit and submit the bidding proposal, containing their offer, before the bidding deadline.

**Agreement:** Investors contract with the Local Land Bureau to transfer the land use right directly. This form of purchase, in China, is the most restricted. In order to prevent speculative purchasing and overcrowded development, the other forms of purchase are usually preferred.

The key difference between a granted land use right and actual private ownership of land is inherent in the title: granted land use rights allow investors land for a specific use -- not to use freely. The granted land use right contract contains detailed information about the investor's plans, and other usage is not allowed. These contracts focus on ensuring the investor completes the project promptly and to specification. Penalties are built in for delays in beginning and/or finishing construction, and for over/under investment. Speculative holding is prohibited, and the government can retake idle land within one or two years.

## Real Estate and Commercial



Real Estate in China is an attractive investment. With China's economy on the rise and the country's massive population in desperate need of housing, Chinese real estate may seem like a safe bet when compared to the recently tumultuous markets in the West. Property tax in China is low, and some cities even have no property tax at all.

However, China is wary of hot money and trying to cool down its increasingly unaffordable housing market. New property taxes were introduced this year in Shanghai and Chongqing to curb speculation. The recently revised Foreign Investment Catalogue almost moved construction and operation of villas into the "prohibited" category, and only after much debate left it as "restricted."

At the same time, corresponding efforts to stem domestic investment have made credit for such projects difficult to acquire locally. This has made foreign

investment all the more valuable, and after several years of decline, foreign investment more than doubled to 7% of property investment last year -- with returns to foreign investors also rising.

Investors should be sure to know the market when choosing where to build real estate or commercial buildings. Not every building in need of fixing up is easily found in a listing. Sometimes the easiest way to get information about a property is to inquire directly, and doing so may open up opportunities for private agreement.

## Industrial Land

When looking to build a factory or other industrial project, companies will need to buy land zoned for industry.

Investors choosing an area for industrial development not only need to be aware of what areas would be beneficial to their investment, but what areas their investment would be beneficial to. Local governments looking to increase certain kinds of investments can often help investors get favorable plots of land through specific zoning or other methods.

Furthermore, restrictions apply to certain kinds of development. Locating land properly zoned for production involving environmentally dangerous or toxic materials is difficult. Local governments will often be reluctant to sell land use rights for such disfavored investments, and/or may only be interested in selling rights to large tracts of land. This can prove a problem for investors, as PRC law prohibits them from simply using leftover land for other investment not detailed in the land use right contract.

Acquiring a land use right is not the only way -- nor necessarily the most efficient way -- to establish a factory. Leasing factories is becoming an increasingly popular option, as is leasing land zoned for industry. In some circumstances, investors may even purchase the shares of a company to gain access to the industrial land it holds.

## Conclusion

China remains one of the most attractive destinations for foreign investment. Investors should be aware of how the land law differs from that of the West, and always keep an eye out for how changing laws will shape the market.

*Li Xiaohan and James Craven*



## Security Review for Mergers & Acquisitions



The State Council issued on February 3, 2011 the Notice of the General Office of the State Council on the Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the Notice). The Notice announced that the Chinese government will carry out a security review for mergers with, and acquisitions of, domestic enterprises by foreign investors. In establishing the security review system, the review of a foreign investors' merger and acquisition is now a matter of national security. Based on a public review and comments submitted, the Ministry of Commerce has revised the Interim Provisions of the Ministry of Commerce on Matters Relating to the Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the Security Review Regulations) and formulated and published the Provisions of the Ministry of Commerce on Implementing the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (Rule 53), which came into effect September 1, 2011.

### Focus of the Review

According to the Notice a security review of an M&A will be applied in the following cases:

- A foreign investor merges with, and/or acquires a domestic military industrial enterprises and supportive military industrial enterprises, enterprises near major and/or sensitive military facilities, and/or other entities which relate to China's national defense;

- A foreign investor merges with and/or acquires a domestic enterprise relating to important agricultural products, important resources, important infrastructure facilities, important transportation services, key technologies, major equipment manufacturing, etc., which affect national security, and whose controlling power may be obtained by foreign investors.

A foreign investor shall be deemed to have actual controlling power via an M & A under any of the following circumstances:

- The total shares held by a foreign investor, its holding company, or its associated, subsidiary companies after the M & A will amount to 50% or more
- The total shares held by all foreign investors after the M & A amount to 50% or more
- The total shares held by a foreign investor after the M & A account for less than 50%, but the voting power held by the foreign investor is enough to have a material impact on resolutions from a shareholders' meeting, the general assembly of shareholders, or the board of directors
- Any other circumstance which leads to the transfer of the actual controlling power of a domestic enterprise regarding business decisions, financial affairs, personnel, technologies, etc. to a foreign investor.

Some supplements to the types of M & A by foreign investors are provided in the Notice, updating those specified in the Regulations on Foreign Investors' Merging with and Acquiring of Domestic Enterprises (the M & A Regulations).

An "equity merger," as mentioned in the M & A Regulations, means the foreign investor only:

a) purchases equity shares by agreement of the shareholders of a domestic non-foreign-funded enterprise,

or b) subscribes the increased capital of a domestic company, thus changing the domestic company into a foreign funded enterprise.

The Notice clarifies that a foreign investor can also conduct a merger by purchasing the equity shares from Chinese shareholders of a domestic foreign-funded enterprise, or by subscribing to the increased capital of a domestic foreign-funded enterprise.

Furthermore, a foreign investor can also merge or acquire a domestic enterprise by establishing a foreign-funded enterprise through which it purchases the equity shares of a domestic enterprise. Before that, the domestic foreign-funded enterprises are not deemed as foreign investment in terms of M & A of a domestic enterprise except for those foreign-funded investment-oriented enterprises as provided in the M & A Regulation.

### Content of the Review

The contents of the M & A security review include:

- The influence the M & A may have on national security, including the ability to produce domestic products and to provide domestic services as required for national defense, and the relevant equipment and facilities for performing these tasks;
- The influence of the M & A on the stable operation of the national economy;
- The influence of the M & A on the order of basic social life;
- The influence of the M & A on the capacity of research and development of key technologies involving national security.

### Procedures of the Review

The Notice requires that for a M & A of a domestic enterprise within the scope of the new security review, a foreign investor must file an application with the Ministry of Commerce according to the provisions of the Notice. Moreover, any relevant department of the State Council, national industrial association, enterprise of the same profession, or upstream or downstream enterprise which deems that it is necessary to conduct a security review of the M & A, may put forward suggestions regarding the security review of the M & A via the Ministry of Commerce.



If a foreign investor files an application for security review on its own or as suggested by the relevant department of the State Council or another party, the Ministry of Commerce may request a joint meeting to conduct the security review. Members of the joint meeting may decide to conduct a security review if they deem it necessary. Usually, a general security review of the M & A is conducted first, with a special review following if the transaction fails to pass the general review. The general review will be conducted by soliciting opinions from the relevant departments. If any department holds that the M & A transaction may affect national security, members of the joint meeting will initiate the special review procedure within five working days of receiving all necessary written opinions. Members of the joint meeting will complete the special review within 60 working days from the date of initiating the special review procedure, or may request that the State Council make a decision. They will then notify the Ministry of Commerce of their opinions in writing. Generally speaking, a security review will last 95 working days.

## Results of the Review

The Ministry of Commerce will notify the applicant in writing of the opinions on the security review after the joint meeting. If it is deemed that the M/ A will have a material impact on national security, members of the joint meeting shall require the Ministry of Commerce, jointly with the relevant departments, to terminate the transaction between the parties concerned and transfer the relevant equities/assets. The Ministry of Commerce is free to take any other

measures necessary to eliminate the effect of such M & A on national security.

## Practical Issues



Foreign investors that intend to merge or acquire a domestic enterprise will be faced with two official reviews of the transaction by the Ministry of Commerce, apart from the security review:

- A review of the submission of the foreign investment, which must be in accordance with both the M & A Regulations and the Catalogue for the Guidance of Foreign Investment Industries
- An anti-trust review aimed at preventing concentrations of business operators pursuant to the Antitrust Law and the Provisions of the State Council on Thresholds for Prior Notification of Concentrations of Undertakings.

Special attention should also be given to the provisions of Article 9 of Rule 53, which provide that with regard to the merger and acquisition of domestic enterprises by foreign investors, the authorities should judge whether

such transactions are subject to the security review based on the essential content and actual impact of the transaction; and foreign investors shall not avoid an M & A security review by any means, including; commissioned shareholdings, trusts, multi-level investments, leases, loans, contractual control, and overseas transactions.

Finally, before filing a formal application with the Ministry of Commerce for an M & A security review, the Applicant may file a consultation request with the Ministry of Commerce regarding the procedural issues for its proposed M & A to communicate all relevant information. However, this pre-filing consultation is not necessary for submitting a formal application, nor it has any legal or binding effects. It should be considered to be a clear sign that the Ministry of Commerce is encouraging foreign enterprises to take the initiative when making an application for an M & A security review.

## Conclusion

The Regulations on the Security Review System for Merger with and Acquisition of Domestic Enterprises by Foreign Investors shows the attitude of the Chinese government regarding large scale investment in local companies. This new measure could signal more restrictions to come and will certainly mean more time will be needed for future M & A. Wang Jing & Co. will keep close attention to the progress and trends concerning relevant legislations.

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