

PRC Construction Law

– A Guide For Foreign
Companies



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FOREWORD

This book is a welcome addition to the Chinese construction law literature. It is the first English language book on PRC construction law and therefore should be accessible and relevant to foreigners who intend to participate in China's growing construction market. As such, it offers an excellent introduction to the laws and regulations relating to the Chinese construction industry.

The construction industry in China provides a vital service for the government, private companies, real estate developers as well as individual homeowners. It underpins everyday life in China and employs many millions of people. With Beijing hosting the Olympic Games in 2008 the world will see Chinese construction first hand.

The author is an experienced international construction lawyer who is able to write using his international experience. The author not only sets out the substantive law (with his own comments as appropriate), but also gives practical guidance based on his experience of construction law in China.

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ABOUT THE AUTHOR

Ashley Howlett is a partner with the International Law Firm Jones Day and leads the Jones Day Greater China construction practice. Based in the Beijing office, his practice primarily deals with construction and engineering issues connected with real estate, infrastructure and major projects. He is involved in all aspects of the design and construction process, including drafting and negotiating contract documentation, project consultancy, dispute avoidance and dispute resolution by way of mediation, structured negotiation, arbitration, and litigation.

Ashley Howlett have lived and worked in several countries in Asia, he is recognised as a leading practitioner of construction law and is one of only two lawyers in China chosen by the prestigious “International Who’s Who of Construction Lawyers”.

The objective of this book is to provide a source book of material, which is accessible and relevant, to help foreign construction professionals and foreign enterprises better understand the laws and regulations that affect construction in China. Whether there has been success in the goal is for others to judge.

I have received a great deal of help in the production of this book. Quite frankly, this book would not have been possible without the contributions of several people, who have provided advice, criticism and support over the past year. I am particularly grateful for the support and patience of my assistant Liu Qing. In addition, I would like to express my sincere thanks to Yang Ning, Li Hong, Lisa So, Jeanne Kang, Beth Bunnell, Zheng Yanli and Jessica Fei, who have provided valuable insight and guidance on the various laws, regulations and construction practice in China and, in many ways, this book is the product of their hard work and dedication.

It is almost impossible to write a book about Chinese construction law because the industry is developing and growing so quickly that the laws and regulations, of necessity, change rapidly. Also, due to the speed of change, the multiple regulatory authorities involved and the occasional lapse of transparency, all laws and regulations are not always published or made available publicly in a timely way. Accordingly, the law is stated on the basis of materials available to me up to May 2006. The errors contained within this book may be many, but they are all mine.

Finally, to all who have helped me on this journey — they know who they are — my heartfelt thanks!

Ashley M. Howlett
Beijing
People's Republic of China

[The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated]

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CHAPTER 1

INTRODUCTION TO CHINESE CONSTRUCTION LAW

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¶1-001 Construction in China

China is in a construction boom. Construction is taking place in all sectors of the economy and in all provinces in China. Projects range from domestic residential housing and commercial office towers to sophisticated petrochemical plants, nuclear power stations, dams, pipelines, ports, road and rail projects etc. This construction boom is likely to continue in the foreseeable future as China builds and improves its infrastructure. The Beijing 2008 Olympics, the Shanghai 2010 World Expo, the Western Development Strategy and National Housing Reform all provide enormous opportunities for foreign companies interested in China's construction market. In addition, the expected growth of urban infrastructure projects and energy production projects will play a huge and growing role in driving construction activity in China. Therefore, many foreign construction, engineering and design companies ("construction companies"), international property investors, and equipment and material suppliers have come to China in order to take part in this development or to provide technical and managerial support to Chinese construction enterprises.

China's construction industry is a mainstay of the Chinese economy and is projected to become the largest construction market in the world by 2010¹. China's construction output in 2003 accounted for 6.9% of its Gross Domestic Product². In 2004 fixed asset investment grew by 27.7% over the previous year³. The output value in the construction sector was up 18.4% in the first half of 2005⁴. In railway construction alone, China is proposing to invest US\$12.05 billion to build railways in 2005⁵. This is almost double the amount from 2004 and includes 58 new projects and 48 extended projects⁶. Road construction also continues unabated with an 85,000 km expressway network to be

1 Standard & Poor.

2 PRC National Bureau of Statistics.

3 Ibid.

4 Ibid, 2 August 2005.

5 China Daily, 13 January 2005.

6 Ibid, 26 January 2005.

constructed over the next 30 years⁷. By the end of 2004, a total of 34,000 km of expressway ran through China⁸.

¶1-002 Construction Law in China

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

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

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

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

Any Chinese construction law book will inevitably include reference to the Construction Law and its associated survey, design, quality and safety regulations. The Construction Law is the key piece of construction legislation in China and is currently undergoing an extensive review process by the Ministry of Construction. Therefore, key aspects of the Construction Law and the proposed revised and updated Construction Law are commented upon in Chapter 4, and quality and safety issues in Chapter 5 of this book.

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

⁷ Xinhua, 13 January 2005.

⁸ Ibid.

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

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

The industry in the 1970's

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

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

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

The industry in the 1980's and 1990's

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

- Design-build procurement with fast track design being the norm.
- Construction management with construction managers acting as the owner's agent to supervise a number of trade contractors, who contract directly with the owner.
- Management contracting where the management contractor contracts directly with the owner and with trade contractors and accepts responsibility to guarantee maximum project cost and time of completion to the owner.
- Concession contracting where contractors joined with owners to build, operate and own facilities and infrastructure.

- Turnkey; Engineer, Procure and Construct (“EPC”); and Engineer, Procure and Construction Manage (“EPCM”) type contracting.
- Owner’s and their consultants creating new contract documents to place significant (and often inequitable) risk on contractors.
- Owners undertaking projects with inadequate financing or no financing in place.
- Owners accepting the lowest tender without proper consideration of value engineering or other technical or practical considerations.

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

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

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

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

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

The industry at the present time

By the time the Asian financial crisis of late 1990’s arrived, the construction industry in Asia was confronted with the harsh reality that adversarial relationships could not survive and therefore it moved to develop new relationships that could best be described as “team building” or “alliance contracting”. These developments grew rather quickly in certain jurisdictions and helped to foster a more cooperative culture among contractors, designers, and developers, who favoured working as part of a team made up of other industry members.

In addition, the rise of partnering contracts, as pioneered by the oil industry, has been embraced by the construction industry. Mediation and other forms of non-adversarial dispute resolution have also grown in prominence as the construction industry has slowly moved from an industry of confrontation to one of cooperation.

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

¶1-004 The internationalisation of construction in China

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

According to the PRC National Bureau of Statistics, in 2003 there were 48,688 construction enterprises in China of which 47,866 were domestic funded, 535 were funded from Hong Kong, Macau and Taiwan, and 287 were foreign funded⁹. The total number of people employed by these 48,688 construction enterprises was 24,142,700 with 5,243,200 people being employed by state owned construction enterprises alone¹⁰. On any analysis, therefore, the construction industry in China is enormous.

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

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

- Build-only Contracts;
- Design-only Contracts;
- Design Development Contracts;
- Design and Build Contracts;
- Design and Manage Contracts;
- Turnkey Contracts;
- Cost Reimbursable Contracts;
- Cost Plus Contracts;

⁹ National Bureau of Statistics, PRC "Main Economic Indicators on Construction Enterprises by Registration Status (2003)".

¹⁰ Ibid.

- Management Contracting Contracts; or
- Construction Management contracts.

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

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

Chinese contractors are increasingly venturing outside China and learning and assimilating international best practices and project management skills. It is interesting to note that 45 Chinese contractors were included in the "Engineering News Record" list of the largest 225 international contractors in 2004¹¹ (ie an increase of two as compared to the total units in year 2003; and an increase of four as compared to the total units in 2002, which itself was an increase of five as compared to the total units in 2001). Only the United States has more internationally active contractors. It is also interesting to see that there were two construction companies amongst the twelve largest enterprises (ranked by foreign assets¹²) from China, which again demonstrates the increasingly international outlook of Chinese contractors.

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

International construction, design and project management companies

We have seen, in the previous section, how foreign funded construction engineering and design companies (including those from Hong Kong, Macau and Taiwan) made up less than 2% of the total construction enterprises in China in 2003. Nevertheless there were some 822 foreign funded construction engineering and design companies registered in China, which is a significant number and this emphasises how important China is for international construction engineering and design companies.

Project management services in China are very much in their infancy and on the whole tend to be undertaken by foreign enterprises rather than domestic Chinese enterprises. As discussed above, the Chinese construction industry remains organised in the traditional manner with the design institutes on one side and contractors on the other. As such, procurement systems such as design-build and turnkey EPC are not commonly seen or used.

It is fair to say that the Chinese construction market is becoming increasingly difficult for international construction companies to penetrate and recent regulations issued by the Ministry of Construction ("MOC") have had a detrimental impact on many international construction engineering and design companies. Issues that affect

¹¹ Engineering News Record 2004 Global Construction Sourcebook.

¹² UNCTAD, World Investment Report 2002.

international construction, design and project management companies operating or seeking to operate in China will be further discussed in Chapter 8 and Chapter 9.

Owners and developers

Massive foreign direct investment (“FDI”) has been largely responsible for China’s dynamic export expansion over the past two decades. From 1979 to 2001, the total flow of utilised FDI amounted to US\$568 billion¹³. The huge inflow of investment has helped to generate huge construction demand for factories, refineries, transportation facilities and other infrastructure in China.

In addition, China’s growing middle class is leading a large demand for consumer products, which itself leads to the need for expanded infrastructure as well as factories and industrial facilities. China has 166 cities with populations over one million (as compared with nine in the United States), and that China’s urban population is growing at 2.5% a year¹⁴ and increasing population demands more buildings and all types of construction development.

Traditionally, international construction companies have undertaken most of their China projects for international owners and developers. Japanese companies tended to appoint Japanese contractors, Korean companies tended to appoint Korean companies, and so forth. However, the recent MOC regulations which affect international construction, design and project management companies (refer Chapter 8 for more details) have altered the traditional picture considerably and we are finding that more and more international owners and developers are turning to Chinese designers and contractors for their FDI construction projects. This inevitably presents enormous challenges and opportunities for misunderstanding and disputes. Common issues that are of concern for international owners, designers, contractor and project managers will be discussed further in Chapter 9.

¶1-006 Construction disputes

Why are there so many construction disputes

One of the reasons why disputes arise on construction contracts is because of the complexity of the contracts. But in reality most disputes arise over three fundamental issues:

- quality;
- time; and/or
- cost.

It is in these areas where most construction disputes occur: the owner might have concerns about the quality of the constructed facility, the contractor might be delayed and this could have financial implications for the owner, the owner might interfere with or

¹³ National Bureau of Statistics, PRC.

¹⁴ New York Times, 28 July 2004.

disrupt the contractor causing financial loss for the contractor. All of these are potential areas of dispute.

Most construction disputes start from an event on the construction site. Either the event itself causes an additional cost or a delay to an item of work, or it exposes an earlier problem, or it is the cause of a problem that arises later. Following this event, a claim is submitted by the party who has suffered additional costs. This claim is followed by further claims and counterclaims and a “dispute or difference” is born. This sequence will occur frequently on virtually every construction site.

However, while every site has its claims and disputes, the vast majority, perhaps as many as 90% of claims are settled either during construction or during the negotiations which follow the completion of the construction. It is the remaining 10% of claims which persist that become the subject of arbitration or litigation.

The disputes which cause the most serious problems generally consist of a large number of separate items, as claims and counter claims. This may be an accumulation of separate, distinct, irreconcilable problems or, more frequently, results from the human tendency to decline to reach agreement on new claims whilst some previous claims are still unresolved. One difficult problem claim tends to result in a whole series of disputes on items which should have already been agreed.

Why are construction disputes often so complex

There are various characteristics of a construction dispute that are generally considered to make the issues more difficult to resolve. These include the following:

- the number and type of contractual relationships;
- the number and nature of documents;
- the number and location of witnesses;
- time-related claims, eg delay and acceleration;
- technical questions for experts to resolve; and
- the amount in dispute.

The number of participants in construction projects also leads to increased complexity. For instance, not only do you have the traditional owner and contractor relationship, you often also have a project manager, a designer, and a host of specialist advisers and consultants appointed to look after the interests of the sponsors, owners, operators or suppliers. Funding institutions are also increasingly becoming more involved.

Arbitration of construction disputes

Traditionally, standard form construction contracts include a clause requiring that any disputes or differences arising under the contract should be referred to arbitration. Therefore it is usual for most construction disputes to be resolved by arbitration rather than litigation in the courts. It is also becoming more common to adopt various forms of alternative dispute resolution for construction disputes, and techniques and processes which have been successfully adopted in many jurisdictions include: