From Retail to Real Estate—A New Trend in China and Its Upcoming Challenge for Legal Department

Michael Qu

Recent years have seen a rapid expansion of investment in China of foreign retail giant. Contrary to the worldwide economic crisis, the Chinese market has become a hot destination for foreign capital, especially capital from retail giant. Facing fierce competition in the market, traditional supermarket seems outdated. For some retail investors, looking for diversity or unique will be a way out. Among others, a combination of the whole chain of retail, entertainment, logistics and service by developing city commercial centers nowadays are becoming a new trend for retail giant. Is this only a trial to invest in the Chinese real estate market due to huge appreciation of assets and increasing rental for real estate, or a must-do strategy? The answer could be different.

Engaging more in the real estate market, retail giants seem to be less experienced in the industry compare to what they have in the retail market. Since the legislation system on real estate in China is not quite mature, there is still uncertainty or risk for some investors. Prior to discussing some challenges they are facing, let's first of all have a general picture on Chinese legal system on real estate.

Chinese land system and the basic principle and practice for foreign investors on real estate

A. Overview of the Chinese land tenure system

The most distinctive feature of the Chinese land tenure system is that land ownership is independent of the land use right. Land ownership is divided into two categories: state-owned land and collectively-owned land. Natural persons or other organizations can only acquire land use right and as a result it is impossible for any of them to acquire the ownership of land in China.

In China, when land is to be used for construction, the criteria must be followed as below:
First of all, as a general rule, only state-owned land may be directly used for construction of commercial or profit seeking projects such as real estate development;
Second, only after collective land is requisitioned, i.e., it is converted to state-owned land, may it be used for commercial project construction and development;
Thirdly, if agricultural land is to be used for construct commercial projects, users must go through the approval and examination procedure with government authorities for the conversion of agriculture use to construction use.

B. Measures available for foreign invested enterprises ("FIEs") to acquire land use right

As a matter of practice, the FIEs, just like domestic Chinese enterprises, may acquire land use right by grant, allocation, leasing and so on. Specially, the FIE can acquire land use right as follows:

(1) Land use right grant. In a land use right grant, the land user enters into the contract for grant of land use right with the government and pays the land grant premium in exchange for land use right for a fixed period of time. The land subject to grant is always state-owned land. Upon receiving the state-owned land use certificate, the FIE may sell, lease or mortgage land use right to other land users. In China, most land use right were once granted by agreement arrangement. Since 2002, it is required that land for commercial and industrial purpose shall be granted by bidding, auction or listing, subject to limited exceptions. If there are two or more land users intending to use the same plot of land for other purposes, land use right must also be granted by bidding, auction or listing.

(2) Land use right allocation. By allocation, the land user can acquire land use right at no cost or, under certain circumstances, by only paying the fee for resettlement and infrastructure. The terms of allocated land use right are not fixed, i.e., the termination date is not certain. However, the government retains the right to terminate it at any time. Since acquisition of land use right by allocation applies only within the scope of military, public, infrastructure purpose, etc., it is recently seldom a measure for most FIEs.

(3) Using land use right as a capital contribution. In incorporating a joint venture, the Chinese party may use state-owned land use right or collectively-owned land use right as a capital contribution or cooperative conditions. However, the Chinese Party entitled to use collectively-owned land as capital contribution must be the collectively-owned land owner or a member of the collective economic organization.

(4) Building purchase or leasing. When acquiring the building of state-owned enterprises or other owners by purchase or leasing, land use rights are acquired as well.

(5) Leasing of land. A FIE may acquire land use right by leasing land or sites from the government. However, currently the Chinese government does not encourage a FIE to acquire land use right by leasing.

(6) Transfer of land use right. A FIE can acquire land use right from other land users, i.e., land use right can be transferred from one land user to another. Both the granted land use right and allocated land use right can be transferred between land users though they are subject to different requirement and procedures.

C. Channels of investment available to foreign investors

China has experienced the excessive investment in real estate for several years and consequently the Chinese government issued several regulations to control the overheated market of real estate. Under the Catalogue for Guidance of Foreign Invested Industries, foreign investors are restricted from investment in the development of large tract land, high standard hotels, villas, high standard office buildings, international exhibit centers as well as the transaction on the 2nd tier market of real estate and the companies engaging in agency or brokerage of real estate, and are permitted to Invest in all other types of projects.

In addition to the above Catalogue, business existence is a prerequisite for foreign entity or individual to purchase real estate in China for non-personal use. In other words, the entity or individual must first establish a foreign invested enterprise and then conduct business as designated in the business scope. In practice, the investors are told by the government authority not to establish a real estate company unless it has a specific project, meaning that a foreign investor first acquire land use right, building ownership or sign the contracts for grant of land use right with the government authority or for purchase of real estate ownership with developers or owners of buildings.

Apart from the easiest way of land acquisition from the state, acquisition of equity interest or assets are also preferred in practice. The most straightforward way for a foreign investor to invest in the real estate industry is to acquire the equity interest of shareholders of an offshore company, which is the parent company of a FIE engaging in development of real estate in China. Since the transaction takes place outside China, the parties do not need to receive the approval of acquisition from the Chinese government authorities and can avoid some taxes in China. If a foreign investor acquires shareholder's equity interest in a domestic company or its increased registered capital, or purchases and operates the assets from a domestic company, the transaction shall be governed by special procedure required for foreign investors in acquisition of domestic companies. In practice, most investors invested in real estate industry by purchasing the equity interest of a company. This is because the investor can avoid red tape and save cost and time by purchasing the equity interest as compared to purchase the project itself.

By understanding the general system of real estate investment in China, now we are back to the topic most retail investors are interested in. Usually, as has practiced by retail investors for years, the main purpose for acquiring land use right or real property is to operate a supermarket. If there are some extra places to utilize, they will lease to other tenants for profit. Contrary to the narrowing profit in retail market, the profit from managing the portfolio of property is increasing stably in recent years. This could be the initiative for some retail investors. Why not developer a commercial center to operate? As a matter of fact, for some investors, successful cases have already been seen in other countries.

However, developing a commercial center in China requires traditional retail giants experience in real estate practice, especially what different from domestic ones. The restriction on foreign investment is generally loosened recent year, but in real estate industry, it is quite to the contrary. As a principle, a foreign investor must acquire a specific plot or project before it enter into the Chinese market, and then establish a local real estate company, which is subject to government's approval. By doing so, it could be easier for central government to control "hot money" from abroad, but more complex for foreign investors.

Lucky for foreign investors, compare to local and domestic developers, they are more welcomed due to the fact introduction of foreign investment still credits a performance for local government and a commercial center with a world-wild brand will contribute a lot to local economy, it is more easier to acquire a plot from local government with a rather low price.

Let's take TESCO as an example, with its first shopping center opened in early 2010 in Qingdao, China, it targets to copy this model in the next two years for 18 shopping centers in 14 cities. This is a new strategy escaping form the old pattern of leasing from landlord, could come up with an initiative of cost controlling but definitely is not only a pilot. IKEA, another kind of furniture retail, will also expand its shopping center in different cities in the coming years.

Some challenges facing by retail giant in practicing real estate investment

One big challenge faced by retail giant is the scarcity of land recourse in downtown. Since the expansion target for most retail giants are huge, there comes the question “where are the new projects”. In finding more expansion opportunities, more legal risks will be exposed at the meantime.

(1) Cooperative relationship with local developer could be a problem generator. Let’s take a look at the development of retail market in China. Since 2004, with abandon of restriction policy of foreign retail investment, it is allowed for solely foreign-invested companies enter the Chinese market, then comes a wave of worldly famed investors rushed into the market and a series of M&A cases took place, such as TESCO and B&Q did. Till the year of 2009, we’ve seem a relatively saturation in some big cities, which means it is more difficult to have ideal location for development. Then we’ve seen more and more retail brands are combined with large developers, i.e. Wal-mart has strategic relationship with Dalian Wand, a country-wide developer with more than 40 shopping centers. Cases like this will be more easy to find tailor-made location, and best thing is legal risk will be controllable while it will not be necessary to do credit check every time when it comes up with a new cooperate partner.

However, most cases we’ve seen are for leasing project, the retail investors play a role as tenants. Talking about cooperative relationship for project development, there are successful examples, but is early to say it a good solution. Especially from a legal perspective, compare to what retail investors are used to do, more experience is required from property management and legal practice. Among others, some difficulties are very challenge. First issue is how to raise investment. Money is always life for developers, even though financial crisis pull down the investment, the Chinese market are considered as a “refuge harbor”, but talking about commercial centers which requires investment of millions of billions of dollars, no one could treat it a piece of cake, not mention copy the model a dozen of time within one year. How to finance and market the project? Raising money from domestic partners is a good choice. Then it comes the second issue of Sino-foreign joint venture. Tracing back to what happened in 2004 since release of restriction on foreign investors, most foreign investors are eager to escape from these Chinese partners. Now the old way comes along again, is it now more experienced and less-conflicted for foreign investors to negotiate with their Chinese partners? At lease a win-win solution shall be available. There are other issues that retail giants will never face before is how to deal with grey areas which they used trying to avoid, like finding out a workable way to pay less taxation, how to negotiate with government for low price, etc. These are questions for most developers and now for the retail investors as well.

(2) While some locations are moving towards suburban areas, the land use right or ownership may not totally legitimate, but still seems acceptable, is it worth take a shot? More cases are with related to the land of industrial use and collectively-owned construction land use right (“CCLUR”). There are some successful cases establish retail stores on industrial land, but

with the restriction of Commercial Bureau, only land with commercial use can be used for retail market, cases like this still violate such restriction. It could be much confused through legal perspective. For the latter scenario, in some localities, collectively-owned construction land use right are allowed to be used for a supermarket, the only problem is what the process is compare to the land transaction of a state-owned land used right. Both cases are challenge for legal counsel to provide advice and solutions.

Let's take CCLUR for example. The Land Administration Law of PRC stipulates that the transaction of CCLUR only applied when:
(a) Starting up enterprises or joint ventures together with other units or individuals by way of using land use right as shares; or (b) legally transferring of CCLUR by enterprises due to bankruptcy or acquisition, etc. Both circumstances shall subject to general planning for the utilization of land.
Meanwhile, some local regulations set up a more wide and detailed condition for transaction of CCLUR. Regulations from Guangdong Province outline the following points for transactions of CCLUR:
(a) Any transaction regarding collectively-owned non-construction land is prohibited before it is legally converted to construction land;
(b) The title of land use right shall be clear and excluding peasants' residential land use right;
(c) The use of CCLUR shall be complied with general zoning plan for the utilization of land;
(d) The usage of the CCLUR shall be approved by local government. No CCLUR can be used for the development of commercial resident houses.
There are also procedure requirements for transaction of CCLUR for foreign investors to proceed:
(a) A majority consent letter shall be obtained from villagers of collective economic entity, who is the owner of land use right;
(b) Transaction of CCLUR for the purpose of commerce, tourism or entertainment shall be conducted through public auction, bidding or listing refers to relevant procedures applied to granting of state-owned land use right;
(c) The transaction of CCLUR shall be registered in local government.
But the problem is in most places, such policy is still under pilot implementation, the required procedure is hard to proceed with everything black and white. It is a challenge to manage legal risks if the investor wants to proceed project like this.

(3) Trying to acquire existing projects from third party is always a better solution, especially acquire from local company by just changing the brand of the store. We've seen the same trend years before, which makes the retail giants rapidly expand their business, but also left quite a lot of problems to solve for coming years, like HR settlement, layout alteration and legal dispute. The most complicated and unpredictable problem for acquiring assets or shareholders from domestic companies by a foreign company is it shall go through special procedure and approval from Chinese authority. In addition to the new implemented Anti-trust Law of PRC, which empowers Chinese government more right to monitor M&A projects, acquisition of real estate projects isn't as easy as it seems to be.

A normal procedure for acquisition assets or shareholders from domestic companies by a foreign

company is summarized as follows:
(a) Investors deliver documents to the competent government authority (MOFCOM and provincial MOFCOM) for approval;
(b) If foreign investors acquire the domestic enterprise to establish a FIE, unless it is otherwise provided by relevant regulations, the competent government authority must decide whether approval is granted within 30 days upon receipt of all documents. If approved, the Certificate of Approval will be issued.
(c) If foreign investors conduct asset acquisition, the investors are required, within 30 days after receipt of the Certificate of Approval, to apply for registration of establishment to the competent government authority (SAIC and its local counterparts), and acquire the Business License. However, if foreign investors conduct equity acquisition, the acquired domestic company is required to apply for the registration of change to the original government authority and acquires the Business License.
(d) Investors must, within 30 days upon receipt of the Business License, register with government authorities in charge of tax, custom, land and foreign exchange.
However, through the above procedure, only a one-year term of the Certificate of Approval and Business License will be issued. After paying off land grant premiums, the land use right certificate will be issued and further, the formal Approval and Business License will be issued. Besides that, many different documents are needed to be present through every step.

The truth is expanding more stores doesn't always mean taking more legal risks. By establishing a more professional and effective legal procedure, work can be more productive.

Some suggestion on internal function for legal affairs—to be more professional and effective

(1) Integrate risk assessment into decision making process. One solution is to put legal department into a superior level in management, not only a supporting role. Most commercial decisions are easy to make, but when combined with legal ones, they are mostly complicated. The higher level of management needs to not only hear the voice of legal, but also involve legal department into the management decision. Sometimes a veto from legal department may keep one company from big losses. The more power is given to the legal department, the more rational and practicable decision could be made.

(2) Optimize structure of legal department by specialized area of different issues, balance cost by head count and outsource legal service. With so many projects in plan, legal people are always short of hand, increase head count is of course a simple way out, but never neglect optimizing the current structure and function. One suggestion is let legal manager concentrate more on the projects by specific definition of his job description, have the professional people do what they are familiar with and good at is always an effective way, especially in the process of risk assessment and controlling. Another suggestion is wisely use out-source legal service. Different companies have different attitude towards out-source legal service, one thing in common is when a full-fledged legal department is formed, the cost of out-source legal service will decrease, meaning a lot of works used to be done by outside lawyers are now done by in-house counselors. But outside legal service is still needed while doing big project as development of commercial

center, local or experienced lawyers can provide constructive advice which play an important role on management decision.

(3) Utilize tools, platform or software to have more efficient and transparent communication and follow-ups with different functional department. Nowadays every step in company is reflected in SOP, legal department is no exception. We are more concerned on the process of contract finalization, but neglect the enforcement of contract, which is also important. Because a project of real estate development can last long and a lot of disputes are rising from process of contract enforcement. A platform or tool used to align with different departments can effectively control legal risks in implementation of project contract, triggering necessary alarm when non-compliance is met. For the companies who are confused with corporate licensing, this could be a best solution.

Nowadays, more and more MNC in China has placed in-house counsel in a very important position in corporation structure, for those retail giants who are eager to expand in Chinese market, a re-define and establish of in-house role will be a must do.