

## Advice for Contractors Undertaking Work in China

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**This article, focuses on some of the most important practical and legal aspects for would-be contractors in the Peoples Republic of China ("PRC"). Many might consider these points to be obvious, but it is remarkable how many have overlooked them, only to be heavily prejudiced or to lose out altogether in what should be one of the most fruitful markets of the 1990s and future decades.**

### Selecting and forming the entity

To undertake construction work in the Peoples Republic of China, one has to be a PRC "legal person". It is not sufficient simply to open up a representative office. PRC law specifically forbids such offices from engaging in direct business operations. Representative offices opened are useful to demonstrate to PRC authorities the parent company's full and genuine intention to take the PRC seriously. They develop the company's profile, nurture the relationship with local individuals and entities and obviously assist in the servicing of clients.

There is the choice of establishing one of two legal entities: a Wholly Owned Foreign Enterprise ("WOFE") or a Sino Foreign Joint Venture ("SFJV"). Originally, only the latter was permissible, but the PRC has now relaxed its construction requirements such that WOFEs are now frequently used. From a practical point of view, the basis for determining which entity to form depends upon three main factors:

- (i) the required degree of local construction assistance and risk-sharing for the project: a high degree would favour the SFJV;
- (ii) the presence of any specific requirements of the particular developer, employer and/or financier: they may sometimes prescribe the type of "legal person" who must tender for and carry out the works;
- (iii) whether or not the contractor meets the legal criteria for establishing a WOFE: a foreign investor who wishes to establish a WOFE has to satisfy the criteria laid down by the Ministry of Foreign Economic Relations and Trade ("MOFERT"), and there is a published set of detailed rules for Sole Foreign Investment Enterprises. Applicants have to present MOFERT with a feasibility study report demonstrating, for

example, that their capital and investment, proposed land use, tax structure, foreign exchange proposals, accounting and overall liability meets, and will continue to meet, the prescribed requirements.

### Permits, permits and permits

Whichever entity is selected, there exists a barrage of permits, licences and other papers that a would-be contractor must obtain before it can carry out any PRC works. Practical advice is that it is not only necessary definitively to identify the necessary documentation needed, but also to apply in good time. All too often I am approached by clients very late into their tender, when they have suddenly realised that they lack much of the paperwork needed to mobilise and start works on site. Day one of their mobilisation is looming, but there is no longer any chance that all necessary permits will be obtained in time. Complicated legal arrangements have to be contemplated as a stop-gap measure while their papers are being processed. This is inadvisable and easily avoided.

### National and local

It is surprising how many contractors become bogged down in the requirements of relevant local authorities without spending a moment to consider the overall legal requirements of the PRC, a wholly separate body of law. Conversely, on occasions, contractors have done their homework regarding the PRC's legal requirements without pausing to consider the mass of local authority regulations, requirements and restrictions that almost inevitably exist.

### Risk evaluation - financing

This article is really about risk, and minimising it. Nonetheless, one of the most important areas of risk arises from the entity which is going to finance the project, and

how it will be done. In recent times, the PRC authorities have announced that the amount of financing by state bodies is to be cut back, to reduce inflation that has beset the country. The best practical legal advice for would-be contractors is to obtain firm and legally binding agreements from the relevant authorities if financing is to be provided on their part. If the contractor is to provide finance, it is important for the contractor to check that the credentials of those purporting to lend cover their legal ability to lend in the PRC. That may be unnecessary in the case of worldwide lending institutions who have already established lending vehicles within the PRC.

### **Political risk**

The Tiananmen Square events prompted much legal debate and claims over whether awarded contracts had been "frustrated" or affected by *force majeure*. The best practical advice that can be given nowadays is to consider whether insurance should be taken out to cover not only the common types of construction risk, but also political risk. Premium payments will be high, but of course if the developer is offering to take out insurance, that becomes less of a concern!

### **Evaluating bargaining power**

Such evaluation should stand as the foundation of all tender negotiations, but nowhere more so than in the "emerging" markets. State employers, in particular, are often so keen to obtain technology transfers and tangible benefits that they are prepared to provide incentives and concessions, which might not be available to contractors in more developed countries. Concessions might extend to factors such as: assisting the contractor to arrive at tax ceilings; paying or contributing towards the contractor's tax liability; assisting with customs negotiations and duties; minimising or doing away with liquidated damages for non-completion; generous loss and expense clauses; pro-contractor disputes resolution; and choice of law clauses. There is a practical message however: the key is "evaluation". All too often would-be contractors proceed with negotiations heavy-handedly, giving the impression of being brash and insensitive to the manners and ways of their PRC hosts. I have seen this go wrong when representing developers. The converse is also true. If the contractor's legal and other advisers adhere too rigidly to the risk allocations and practices of standard forms of construction contract, the contractor may very well lose out through insufficient exploration of potential concessions by the employer/developer. Often, PRC employers are quite happy for their would-be contractor to draft the Conditions of Contract and the other legal documentation for the project. That should be seized upon, and legal advisers should move away from standard conditions to tip the legal balance in favour of the contractor, while at the same time preserving a reasonable working situation for the employer.

### **Tax, glorious tax?**

One could write a book on this subject, or at least a

separate article. The best practical summation is that after establishing what assistance the employer will give, for example in the persuading of local authorities to allow tax ceilings and other tax incentives, it is important to appreciate that relevant PRC taxation laws have recently changed. Therefore, detailed legal and accounting advice is recommended.

### **Getting your money out**

There have been, encouragingly, few problems experienced by PRC contractors in this area. Nevertheless, practical consideration needs to be given to issues such as the choice of currencies to be used for project payments, where these payments are to be made, export credit arrangements, the risk in currency (and indeed other) fluctuations and any restrictions imposed upon the employer if monies are to be paid or transferred to other than the immediate location of the works.

### **Dispute resolution and choice of law**

While the laws of the PRC are ever blossoming, and the PRC's courts and arbitral vehicles have been used to resolve disputes, my own practical advice to would-be contractors endowed with sufficient bargaining power, is to provide in the contract for Hong Kong arbitration subject to Hong Kong law. My second choice would be Hong Kong arbitration subject to PRC law. Those who do not include arbitration clauses at all will run the exclusive gauntlet of the PRC's courts.

### **Early selection of a 'facilitator'**

I am referring to a local person whom the contractor trusts to carry out the absolutely essential day-to-day liaison, not only with the employer/developer, but also (often even more importantly) with the local authorities. The key to doing business in the PRC is *guanxi*, that indefinable mix of personal contact, personal relationship, personal trust, and "face". PRC negotiators will warm to foreigners who involve locals in this way, and the foreign contractor should derive great benefit. What might take foreigners weeks or even months to obtain can often be achieved in days or hours by the correct "facilitator".

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