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Briefing Paper

China's Evolving Construction, Engineering and Design Sectors

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Introduction

The Chinese construction industry has exploded in recent years, fueled by the four trillion RMB government stimulus package. There have been significant developments in the low-income housing sector, with resolutions to provide housing for 7.5 million urban residents, requiring significant new construction. Additionally, model contracts have improved efficiency in the general contracting area, and new recommendations for large scale supervision enterprises have established special incentives for A level firms and helped to control overall costs. Despite these positive steps, the government has several other regulatory areas that it must improve. Lehman, Lee & Xu recommends streamlining and improving the construction industry by opening the sector to more international companies who can provide specialized expertise and lower overall costs.

Regulation of Foreign-Invested Construction Enterprises

The Ministry of Construction's Decree 113 sets out a threshold qualification for foreign construction companies in China – this serves as a barrier to market entry, and decreases efficiency. Currently, companies must create a wholly foreign-owned enterprise (WFOE) or a joint venture with a Chinese firm in order to establish a local presence in China and comply with the regulations. Next, the venture must apply for a further qualification in order to become a Foreign-Invested Construction Enterprise (FICE); this process is difficult and demanding. The current law does not permit any bank guarantees or bonds to satisfy capital requirements, instead requiring more liquid assets. This barrier to entry surely restricts investment into the Chinese construction industry.

Additionally, foreign companies face staffing problems because all of their employees are subject to government regulations that limits who can work in China. Now, the law requires the foreign staff of foreign construction companies to reside in China for up to six months per year in order to work. This prevents firms from utilizing employees for a shorter period of time, and may prevent them from bringing their most qualified workers to China in the first place.

Foreign construction firms also face limitations as to the types of projects that they are allowed to undertake. Foreign firms are currently forbidden from taking on domestically-financed projects; they must only work on projects financed wholly from abroad, unless they can get an exception because the technical difficulty of the project would prevent a domestic

firm from completing the work. Even with this exception, over 90% of the Chinese construction market is inaccessible to foreign firms. And even for the projects that they can complete, foreign firms can only accept projects valued at less than five times the value of their registered capital. In order to qualify for a large scale infrastructure project, a foreign firm would have to raise an exorbitant amount of liquid capital.

Other regulations discourage cooperation between foreign and domestic construction firms. Consortium qualification laws require that firms working in a consortium must all meet the minimum qualifications for the project; international practice requires only the highest-rated member of a consortium to meet these standards. By requiring all members of a consortium to meet the qualifications standards, China has discouraged qualified firms from entering consortiums with smaller or less qualified firms. Furthermore, foreign firms cannot even enter into contractual relationships with Chinese-invested construction enterprises. Foreign investors must establish a Chinese entity before entering in to any contracts or beginning any construction work in China. Lehman, Lee & Xu recommends the relaxation of both the consortium regulations and the contractual regulations in order to bring China more in line with international standards and encourage foreign construction firms to enter the Chinese market.

Regulation of the Engineering and Design Sector

Similar to the regulations on the construction industry, foreign engineering and design companies are subject to strict personnel and capital requirements. Foreign engineering and design companies must establish a WFOE or partner with a Chinese company in a joint venture before they are allowed to access the Chinese market. Furthermore, the company must apply for an additional design qualification from the government, and meet stringent personnel and capital requirements. These barriers can prove too difficult to surmount for small and medium enterprises. Many of these firms are highly specialized, and could provide valuable work and expertise towards improving Chinese infrastructure, but are discouraged from entering the market to begin with.

Additionally, foreign firms face more difficult standards in qualifying as a grade A enterprise. Grade A design qualifications are only granted in initial applications based on previous performance records as contractors in China – this obviously excludes contractors that have never previously worked in China. There has been some relaxation of these regulations for new firms at the domestic level, but foreign firms are effectively prevented from beginning their practice in China rated at Grade A.

Regulation of the Project Management Sector

Foreign companies could also aid China's construction project management sector, but they too currently face high barriers to entering the market. A local entity must be established and local qualifications must be obtained before a foreign company can do any work in China. The local commerce bureau in Beijing has recently declared that it will accept applications from foreign companies to establish Foreign-Invested Engineering Service Enterprises (FIESE) and circumvent some of the above requirements. However, this practice has not been widely adopted, and the qualifications for establishing a FIESE vary widely across different cities. Lehman, Lee & Xu recommends relaxing these regulations across China, to make them more consistent with the model Beijing has adopted. Only then will foreign firms

be able to easily offer their prospecting, design, construction, and cost control services to Chinese projects.

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