



JONES DAY
COMMENTARY

CULTURAL DESIGN COLLISION—CHINA’S MINISTRY OF CONSTRUCTION INVESTIGATES FOREIGN COMPANIES INVOLVED IN CHINA’S CONSTRUCTION INDUSTRY

The world is becoming a smaller place, and when global meets local, conflicts and collisions are often the result. We can see just such a global vs. local collision in a notice issued by the Chinese Ministry of Construction (“MOC”) on September 6, 2006.

The MOC notice, entitled “Notice on Full Investigation on the Qualification Status of Foreign-Invested Enterprises in China,” states that the MOC is seeking to “fully and accurately understand the qualification status” of foreign-invested enterprises (“FIEs”) in China by conducting a full investigation of all such enterprises. The MOC has also decided to “analyze and evaluate the project contracting status” of FIEs in the Chinese market in a “scientific and rational manner, and to properly carry out the research and formulation of the opening-up policies of the construction industry.”

With China’s accession to the WTO, it was agreed that the design and construction industry would be opened and the formation of wholly foreign-owned enterprises (“WFOEs”) would be permitted. WFOEs would be allowed within five years in the design field, which includes architecture, engineering, and integrated engineering, and within three years in the construction field. While the construction market has allowed WFOEs since December 2002, two years ahead of schedule, the design market still remains effectively closed.

However, the five-year period for the opening of the design market will come to an end this December, and many foreign design firms are preparing to formally enter the China design market in 2007. Accordingly, the MOC notice is a timely “shot across the bows” of foreign firms involved in providing design and construction services in China.

DESIGN SERVICES IN CHINA—THE CURRENT POSITION FOR FOREIGN FIRMS

As a result of MOC Decrees 114 and 78, foreign design firms are required to incorporate local entities in China and to obtain relevant qualification certificates from the MOC if they are to undertake design works inside China beyond the conceptual/schematic design stage. The qualification requirements for a design FIE (*i.e.*, a design WFOE or a design JV) are essentially the same as those needed by local design institutes, but there are some additional requirements for foreign architectural and engineering staff.

The MOC has not yet issued any implementation regulations for Decree 114 that explain how the application process will operate in practice. This can be contrasted with Decree 113, where the relevant implementation regulations were issued four months after Decree 113 came into effect. Accordingly, the application process under Decree 114 remains somewhat uncertain.

Implementation regulations, however, have been issued for design FIEs established by Hong Kong and Macau investors, and these regulations provide preferential treatment for such FIEs. For example, the six-month residency requirement under Decree 114 will be satisfied for Hong Kong- or Macau-invested design FIEs if their key technical personnel reside in Hong Kong or Macau, not just Mainland China.

As far as we are aware, to date the MOC has “rejected,” or at least not approved, any applications by foreign design firms to establish design WFOEs. However, post-December 2006, the MOC will find it difficult to sustain this position.

With respect to offshore services (*i.e.*, design services performed outside China for projects in China), Decree 78 requires foreign design firms to work in cooperation with locally qualified design institutes if the offshore services involve design beyond the basic initial conceptual/schematic design stage.

BACKLASH AGAINST FOREIGN DESIGN FIRMS

There has been some publicity in the local Chinese press recently regarding the involvement of foreign design firms

in prestigious projects in China. Concerns have been expressed that foreign design firms have been circumventing the qualification regulations and have been involved beyond the basic initial conceptual/schematic design stage. Criticism has also been aimed at the supposed high fees paid to foreign design firms compared with the fees earned by local design institutes.

The Twenty-First Century Economic Report (produced by the Nanfang Daily Newspaper Group), for example, claims that foreign design firms have secured 30 percent of the market for the design of high-end projects in China. This report quotes Mr. Zhu Boshan, a member of the WTO research group for the MOC and the deputy secretary-general of the Shanghai Consultation Trade Association, as saying it is unfair that “the foreign designers do 10 percent of the work, but take away 90 percent of the money; while the Chinese designers do 90 percent of the work, but only get 10 percent of the money.” Various examples of this alleged unfairness are cited, including the Shanghai Jin Mao Tower and the National Theatre in Beijing, where it is stated that the foreign designer collected more than 10 percent of the total investment as a design fee, while the Chinese codesigner received only RMB 18 million.

This is not a new complaint: in 1998 more than 100 senior academics at the Chinese Academy of Sciences submitted a petition to the State Council in an attempt to veto Paul Andreu’s design of the National Theatre. Similarly, in 2003 another petition was circulated to stop the construction of the Herzog & de Meuron-designed Olympic Stadium. In both cases, concern was expressed that China was becoming a laboratory for experiments by foreign designers. In both cases the petitions were unsuccessful.

THE PERCEPTION THAT FOREIGN DESIGN FIRMS DOMINATE THE MARKET

According to a report by the Research & Development Center (“RDC”) of the State Council, the top five enterprises in each industry that has been opened up in China have almost all been controlled by foreign capital. The RDC report states that foreign companies hold majority control of 21 of the 28 main industries in China.

Largely on the basis of this report, the MOC has concluded that it should investigate the construction market to determine whether design and construction FIEs dominate the market as has been alleged. On the construction side, construction FIEs have a tiny share of the market, and other than in niche or high-technology areas such as oil and gas, nuclear, and petrochemical projects, construction FIEs are minor players. The story is different when it comes to design, and it seems to us that the MOC's underlying concern is whether the local design institutes will be able to compete with foreign design firms and design FIEs once the market is opened next year.

Presently there are many foreign design firms operating in China, predominantly as consulting WFOEs, where they cooperate with local design institutes to jointly produce designs for Chinese projects. Whether they undertake design services beyond the conceptual/schematic design stage is a moot point and one that the MOC would obviously like to investigate further.

At first glance, the notice appears to be a protectionist reaction from the MOC, and in line with recent regulations governing foreign investment in connection with mergers and acquisitions, property development and investment, and media distribution services. Regardless of whether or not the MOC harbors any protectionist sentiment, this is the view that is being advanced in the Chinese press as is evidenced by the Twenty-First Century Economic Report article.

THE EFFECT OF THE MOC'S INVESTIGATION

The MOC notice stated that the competent departments for construction of all provinces and municipalities must investigate the actual situation of FIEs that have registered in their local area and obtained qualifications as of the end of July 2006. The reports were to have been submitted to the MOC before September 20, 2006. What the MOC is looking for is not clear, but it is undoubtedly taking this seriously, as the MOC notice stresses that the provinces and municipalities must attach great importance to this investigation and must appoint special persons to be in charge of it.

At this stage, it appears that the MOC is focusing on FIEs that have obtained design, construction, supervision, or bidding qualifications and not those FIEs operating as "unregulated" design, construction, or project management consultants. That is not to say that the investigation will not, at some stage, move in this direction, and the concern is that the investigation has the potential to be a fishing expedition for the MOC.

Whether this investigation is the start of a protectionist backlash or simply a way for the MOC to better understand how design and construction FIEs operate, it is nonetheless probably an unwelcome intrusion for design and construction FIEs and could herald the start of further regulation aimed at foreign firms and FIEs in the Chinese design and construction market.

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