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Private and Public Construction in Modern China

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Private and Public Construction in Modern China

GREGORY M. STEIN*

ABSTRACT

During the past three decades, real estate development in China has proceeded at an astonishing pace, with much development occurring before China's 2007 adoption of its first modern law of property. Investors thus spent hundreds of billions of dollars in the real estate market of a nation that, during most of this period, had no formal property law. How can a huge nation modernize so rapidly and dramatically when its legal system furnishes such uncertainty? And how can this happen in a nation that still purports to subscribe to socialist ideology?

I set out to answer these questions by interviewing dozens of Chinese and Western real estate developers, bankers, government officials, lawyers, judges, economists, brokers, professors, and consultants. My goal was to learn how real estate development was actually proceeding on the ground and how these actors functioned in a world of significant legal

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ambiguity. Given the rapid evolution of China's modern real estate market, a complete understanding of this market requires more than just a thorough knowledge of published statutes and cases.

My earlier field research examined the Chinese land use right—which serves as a surrogate for property ownership in a nation in which private citizens may not own land—and then focused on real estate finance. This Article continues the analysis of how China's real estate market functions by turning to public and private construction in China. It examines the commercial construction process, the sale of residential units, and the construction of infrastructure in China.

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I. INTRODUCTION

During the past three decades, real estate development in China has proceeded at an astonishing pace. Cities invested enormous amounts of money in infrastructure, building new airports, subway systems, bridges, and modern road systems. Real estate developers began replacing decaying urban housing stock while also adding new residential units to house the tens of millions of workers who have migrated to cities from rural areas. Hotels, shopping malls, and industrial parks have sprung up across the country. Much of this development occurred before China's 2007 adoption of its first modern law of property.

This means that private and public investors spent hundreds of billions of dollars investing in real estate in a nation that, during most of this period, had no formal property law. Investors purchased and improved assets without knowing just how much legal protection those assets enjoyed, while banks lent money with only imperfect assurance that they would be repaid. Although Americans are prone to view property as the “guardian of all other rights,” Chinese investors appeared quite willing to invest now and worry about the legal status of these investments later,

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or never. How can a huge nation modernize so rapidly and dramatically when its legal system furnishes so much uncertainty? And how can all of this happen in a nation that still purports to subscribe to socialist ideology?

I set out to answer these questions several years ago, by interviewing dozens of Chinese and Western real estate developers, bankers, government officials, lawyers, judges, economists, brokers, professors, and consultants who are active in or knowledgeable about the Chinese real estate market. My goal was to learn how real estate development was actually proceeding on the ground and how these actors had chosen to operate in a world of significant legal ambiguity. Chinese conceptions of the rule-of-law have been evolving throughout this period, and China continues to place a much greater emphasis on communitarian concerns than most Western nations do. Even if China had adopted applicable laws and regulations earlier, a complete understanding of the functioning of this market would require more than just thorough knowledge of published rules, cases, and treatises. This meant that, even to the extent there are written laws, I could develop an accurate grasp of how China's real estate market operates in practice only from those working in that real estate market.

My earlier work has used this field research to describe two important facets of the Chinese real estate market. First, I examined the Chinese land use right, which serves as a rough surrogate for property ownership in a nation in which all land still is owned by the government or by agricultural collectives.¹ Second, I focused more closely on real estate finance.²

This Article continues the analysis of how Chinese real estate law actually functions by focusing on public and private construction in China. Part II offers a brief overview of relevant Chinese history and law, along with a description of my research methods. Part III describes the commercial construction process, emphasizing lender review of loans and lender credit decisions, along with the actual process of construction. Part IV then turns to the preselling and reselling of residential units. Next, Part V focuses on the murky distinction between the private sector and the public sector in the Chinese real estate market. Part VI uses this

1. Gregory M. Stein, *Acquiring Land Use Rights in Today's China: A Snapshot from on the Ground*, 24 UCLA PAC. BASIN L.J. 1 (2006) [hereinafter Stein, *Land Use Rights*].

2. Gregory M. Stein, *Mortgage Law in China: Comparing Theory and Practice*, 72 MO. L. REV. 1315 (2007) [hereinafter Stein, *Mortgage Law*]; Gregory M. Stein, *Commercial Leasing in China: An Overview*, 8 CORNELL REAL EST. REV. 26 (2010) [hereinafter Stein, *Commercial Leasing*].

public-private distinction as a springboard for examining construction of infrastructure in China, and Part VII concludes.

II. THE BACKGROUND HISTORY AND LAW

The Chinese Communist Party came to power in 1949 but, contrary to popular belief, it did not immediately nationalize all of China's land. The process of expropriation was slowed, at least in part, by a desire to ensure adequate food production,³ although much urban land remained in private hands after this point as well. Some scholars argue that the Party did not fully nationalize all of China's land until 1982,⁴ just as post-Mao changes were leading China to begin rethinking its land policy. Since Deng Xiaoping announced his "reform and opening" policy in 1992, reigniting China's private economy, the Chinese real estate market has developed rapidly.

Private parties in China may acquire the right to use property for a fixed period of time, although China's most recent constitutional amendments and new Property Rights Law⁵ continue to prohibit the private ownership of property. China amended its Constitution in 1988 to read, "No organization or individual may appropriate, buy, sell or otherwise engage in the transfer of land by unlawful means. The right to the use of land may be transferred according to law."⁶ These two sentences, when read together, clarify that private parties may not own land but that the government may grant land use rights for a specified term.⁷ The legal

3. Historian Jonathan Spence has noted that early land reform efforts were extremely violent but intentionally incomplete. JONATHAN D. SPENCE, *THE SEARCH FOR MODERN CHINA* 490-92 (2d ed. 1999) (estimating that more than one million landlords and their family members were killed during the early stages of Chinese land reform, while also observing that rich peasants often were left alone so that adequate food production could be maintained).

4. See PATRICK A. RANDOLPH JR. & LOU JIANBO, *CHINESE REAL ESTATE LAW* 11 (2000) (claiming that China did not complete nationalizing all land until 1982).

5. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007) (China).

6. XIANFA [Constitution] art. 10 (2004) (China). The first two sentences of Article 10 of the Constitution indicate that urban land is owned by the state and that rural and suburban land is owned either by the state or by collectives. *Id.* Thus the amended version of this Article clarifies that all land is state- or collective-owned, but that the state now holds the constitutional power to transfer the right to use state-owned land. However, the statutory structure supporting such transfers would have to wait until 2007.

7. The maximum permissible term for a land use right is seventy years for residential property, forty years for commercial property, and fifty years for industrial and other types of property. RANDOLPH & LOU, *supra* note 4, at 127-28. The constitutional amendment noted above authorized the granting of land use rights, but the State Council established the permitted durations by regulation. *Id.*

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status of land use rights draws additional support from a constitutional amendment that became effective in 2004, with language requiring the state to pay compensation when it expropriates land.⁸ These compromises afford private parties the opportunity to develop property privately while they also “avoided abandoning the Marxist principle of state ownership.”⁹

The Chinese land use right is limited or restricted in various ways that will seem alien to the expert in Western real estate law and finance. For example, holders of land use rights must develop the land within a brief period of time or risk forfeiting their right. There are limits on the ability of the holder of a land use right to transfer that right. The holder of a land use right also must own any building constructed on the land. And the right to renew a land use right when it expires along with the cost associated with renewing it have been left somewhat unclear under the new law. I have explored these and related issues elsewhere.¹⁰

III. COMMERCIAL CONSTRUCTION: LENDING SUBMISSIONS, CREDIT DECISIONS, AND THE CONSTRUCTION PROCESS

The commercial real estate development market in China operates in a manner that is not completely surprising to the American lawyer who is familiar with U.S. construction methods. Chinese real estate developers assess their local market in an effort to determine whether a particular real estate project will be profitable. If the developer plans to hold the completed building as rental property, it begins seeking out tenants; if it plans to sell individual units to owners, it starts trying to sell them before the units are built. The developer will approach lenders and seek to borrow the largest amount of money it can, thereby maximizing its leverage and overall return. The developer also will enter into a contract with a construction company to build the structure. In short, the overall goals and methods of Chinese real estate developers are similar to those of American developers.¹¹ There are important differences, however,

8. XIANFA [Constitution] art. 10 (2004) (China) (“The State may, in the public interest and in accordance with the provisions of law, expropriate or requisition land for its use and shall make compensation for the land expropriated or requisitioned.”).

9. STANLEY B. LUBMAN, *BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO* 184 (1999).

10. See Stein, *Land Use Rights*, *supra* note 1, at 41–49; Stein, *Mortgage Law*, *supra* note 2, at 1319–26.

11. Current Chinese law makes it clear that real estate developers may profit from their projects. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing

which reflect dramatic distinctions between American and Chinese law, history, culture, and custom. This Part will compare and contrast the approaches taken by American and Chinese real estate developers.

Early in the project, a real estate developer that seeks funding for construction in China must obtain a project loan, which is analogous to an American construction loan. The experts that I met with emphasized the fact that a borrower seeking a project loan from a lender is required to produce four documents. These documents all focus on legal requirements rather than on the financial viability of the project that is being developed.¹²

First, the prospective borrower must provide the lender with the land use right certificate, which serves as documentary evidence that the borrower owns the land use right covering the land on which the project will be built and can mortgage it.¹³ This document will specify the size of the parcel, the nature of the land, and the uses that are permitted on the land. The developer's possession of this certificate also proves to the lender that the borrower has paid the government for the land use right.¹⁴ In Western terms, this is analogous to the developer's deed or ground lease, but with some elements of a restrictive covenant included.¹⁵

Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 135 (China) ("The owner of the right to the use of land for construction use shall, according to law, be entitled to possess, utilize and obtain profits from the State-owned land, and have the right, by utilizing such land, to build buildings and their accessory facilities.").

12. See generally Stein, *Mortgage Law*, *supra* note 2, at 1332–33. Note that different experts translated the names of these documents in slightly different ways and also gave somewhat divergent descriptions of the purposes of each.

13. A party that acquires a land use right for construction purposes is entitled to possess, use, and profit from the land by building on it. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 135 (China). However, the government may include use restrictions when it transfers land use rights. *Id.* art. 138; Stein, *Land Use Rights*, *supra* note 1, at 45, 47–49. Ownership of the land use right automatically incorporates the right to mortgage the land use right, as long as the term of the mortgage does not exceed the remaining term of the land use right. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), arts. 143–44 (China).

14. The contract for assignment of the land use right is required to set forth certain statutory terms, including use limitations. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 138 (China). Any change thereafter in the use of the land requires government approval. *Id.* art. 140. The purchaser's use rights appear to vest upon registration of the land use right, at which point the purchaser receives the land use certificate. *Id.* art. 139.

15. The ground lease analogy is an imperfect one. In the Western ground lease, ownership of the land is severed from ownership of the improvements, often for financing and tax reasons. By contrast, under Chinese law, the owner of the land use right automatically owns the building. *Id.* arts. 146–47. See also *id.* art. 182 (requiring that lots and houses located on those lots must be mortgaged together); Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated

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Second, the loan applicant must provide its prospective lender with a zone certificate, which states how many buildings are permitted on the lot and sets forth the permitted height and bulk of those buildings. This document, like the land use right certificate, serves some of the same purposes as the Western deed and restrictive covenant, but here the focus is on the number and size of the proposed structures rather than their uses.

Third, the would-be developer must provide its lender with a land zone certificate. This certificate confirms that the proposed use is permissible. Finally, the developer must present the building or construction permit. Possession of this permit indicates not only that the building is permitted within the zone, in terms of both its size and its use, but also that the local government has granted the developer permission to build. This document serves many of the same purposes as the building permit that American jurisdictions typically require.

In the early days of the modern Chinese real estate market, before lenders required these four submissions, lending standards were widely viewed as lax. Developers pushed hard to develop so they could maximize their profit; lenders lacked the knowledge, desire, or incentive to know which loan applications should be approved; and projects proceeded whether or not they were financially viable. As a result, the developer would profit if the project was successful, while the bank suffered most of the risks of failure. Moreover, these banks were state-controlled rather than private, which meant that their focus was more on the political desirability of projects and less on the ability of these developments to create profits for the developer and the lender. This fact often created the impression that officers of state-controlled lenders would help their well-connected developer friends obtain loans, with the

by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 31 (China) (same, with respect to transfer or mortgage of residential property); Danbao Fa (担保法) [Guaranty Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 30, 1995, effective Oct. 1, 1995), art. 36 (China) (same, with respect to mortgage of residential property). *See generally* Stein, *Land Use Rights*, *supra* note 1, at 42–43 (discussing similarities and differences between Chinese land use rights and Western ground leases).

The restrictive covenant analogy is also an imperfect one: Although Chinese land use rights include restrictions on use, thereby creating a weak resemblance to a restrictive covenant, the “owner” of the underlying land and holder of the enforcement right is the government. In some senses, then, the use limitations contained within a land use right more closely resemble zoning restrictions.

banks quietly absorbing any losses that resulted if the project did not turn out as well as hoped. This perception has changed considerably, though not completely, as the Chinese real estate market has matured. More formalized and standardized lending requirements such as these also have served to put a needed damper on a market that had been overheated.

The four documents that lenders require today all pertain to legal requirements and demonstrate to the lender that the developer may proceed to construct the building. But it appears that prospective borrowers often must provide little else to the lender. Notably, most lenders do not appear to require the more detailed financial information that a Western lender would demand in making its credit analysis of the borrower's application for funds. Chinese lenders are verifying that the project is legal and may proceed, but are not predicting whether it is desirable or will succeed.

To be sure, the very nature of the four required submissions provides the lender with considerable comfort that the borrower is creditworthy. A borrower that can show its lender that it owns a land use right, for example, demonstrates to the lender that it already has mustered the financial capacity to acquire this valuable asset for cash. Thus, the borrower will already have made a considerable capital contribution to its own project before it seeks to borrow funds for construction. If the land was previously occupied, the borrower also will have had to relocate the prior occupants, at even greater cost. In other words, the borrower that owns the land use right has already made a financial commitment to the project that may represent 20–30% of the total project budget, and sometimes even more than that.

Nonetheless, this submission package required by Chinese lenders is markedly sketchier than the set of documents a Western lender would demand. A Western lender certainly would insist on reviewing the equivalent of these four documents, to assure itself that the borrower owns the land and legally may build the proposed structure on it.¹⁶ But this lender would demand considerably more than just these legal assurances. A Western lender would insist on reviewing the borrower's market research showing that there is a need for the proposed structure in the relevant market; the borrower's income analysis showing the cash

16. If the borrower could not demonstrate that it had received some of these documents already, such as the building permit, the lender certainly would make the obtaining of the outstanding documents a condition precedent to receipt of any loan advances. Similarly, loan applications often proceed while the borrower's ownership rights in the land are still executory. In fact, borrowers in the West often need to borrow these funds to be able to proceed with the acquisition.

flow that the building will generate over time;¹⁷ a study of the feasibility of the design; and a wide range of other financial and technical submissions. This lender will want to see that the borrower has “run the numbers”—and will want to do verify these numbers for itself—as a means of forecasting whether the project can succeed before it makes its underwriting decision.¹⁸

There are several possible explanations why Chinese lenders are so much less demanding than their Western counterparts. To begin with, some of the experts I interviewed were careful to distinguish between minimum lending requirements and actual lending requirements. Banks may not be required to see anything more than the four documents enumerated above, but some demand more anyway. The four documents thus constitute a threshold that banks are free to—and do—exceed. Perhaps developers who lack experience or who have not worked with a particular bank must submit a wider range of materials than developers with whom the lender has enjoyed a successful relationship in the past. In addition, Chinese lenders already know that their loan applicants have committed a significant amount of their own capital just to be able to acquire the land use right and obtain the three other documents. An American borrower that receives a nonrecourse loan with a 90% loan-to-value ratio has far less of its own money at risk than the typical Chinese borrower does, and the Chinese lender may feel correspondingly more comfortable.

Chinese lenders also know that many real estate developments in China are built with the idea that they will be conveyed to the ultimate occupants upon completion, if not sooner.¹⁹ This is particularly true of urban residential projects. Most new residential projects in China’s booming cities are conveyed under a legal structure that is comparable to the Western condominium, rather than rented out.²⁰ The developer begins marketing individual units as soon as it is legally permissible, often

17. MIKE E. MILES ET AL., *REAL ESTATE DEVELOPMENT: PRINCIPLES AND PROCESS* 177 (4th ed. 2007).

18. Before Chinese lenders began requiring the four submissions described in the text, they demanded only evidence that the borrower possessed the land use right for the property. I was told that the number of nonperforming real estate loans—always relatively small—dropped after lenders began requiring the three additional submissions.

19. See *infra* Part IV (discussing residential presales).

20. See *Wuquan Fa* (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), arts. 70–83 (China) (discussing attributes of this type of residential legal structure).

signing contracts with purchasers early in the construction process.²¹ These downstream purchasers pay a significant portion of the purchase price at the time they execute the contract, often make additional payments during construction, and fulfill their entire financial obligation at or before completion of the building.²²

If a project such as this is successful, the developer will have transferred most or all of the units by the time construction is complete, which means that neither the developer nor the lender has much concern with the long-term viability of the units. The developer will be in a position to cash out and repay the loan as soon as the building is complete, and the developer–lender relationship will last for a year or two, at most. Much of the risk of post-construction depreciation falls on the buyers and their respective acquisition lenders.²³ The construction lender that expects to receive repayment of its loan quickly may be less concerned with the developer’s long-range financial health.

By contrast, a much higher percentage of loans for construction of multi-family residential projects in the United States is made to developers that intend to hold the property for rental income after it is completed. In some cases, the construction lender plans to stay on as the borrower’s permanent lender. More commonly, the construction loan will be “taken out” by a permanent loan from a long-term lender such as an insurance company or pension fund.

In American projects in which the construction loan will be taken out by an unaffiliated entity once construction is complete, one may ask why the construction lender cares what happens to the project after its own loan has been repaid. The answer is that the construction lender knows that its ultimate source of repayment is the permanent lender’s funding of the permanent loan. Even though the permanent lender typically commits to this loan before construction begins, its commitment ordinarily includes a lengthy list of conditions precedent to its funding obligation. Many of these closing conditions focus on the continued financial viability of the borrower and the successful completion of the project in accordance with the original plans and specifications.

21. See *infra* notes 40–44 and accompanying text.

22. See *infra* notes 45–61 and accompanying text.

23. If the value of the units is dropping, the original developer and its construction lender still may suffer losses. For example, the percentage of buyers who breach their acquisition contracts will rise as the value of the units drops.

For a discussion of why lenders are willing to lend so readily to residential unit buyers, see *infra* Part IV; Stein, *Mortgage Law*, *supra* note 2, at 1334–35.

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In cases such as these, the two lenders often enter into a three-party agreement with the developer at the outset, addressing many of the permanent lender's long-term concerns. For example, the permanent lender commonly conditions its obligation to fund the permanent loan on the developer's having leased a certain minimum number of square feet. The construction lender, concerned in turn that the permanent lender might choose not to fund the permanent loan if the developer cannot meet this condition, has an incentive to address these types of requirements in the three-party agreement or in its own construction loan agreement with the developer, and ordinarily holds the developer to the same standards. This greater concern by both lenders about the long-term viability of the project probably goes a long way toward explaining the American construction lender's more searching due diligence review of the developer's pre-construction projections about the property.

With respect to commercial properties, the picture in China is more mixed. Commercial properties are somewhat more likely to be held by the developer for rental income after construction is complete, but even many commercial projects are sold upon completion—either as a whole or in individual units—and thus are analogous to commercial condominiums in the West. Other Chinese commercial properties are built to be held as rental properties, and one would assume that the lender to a developer who is building a structure that the developer plans to hold probably takes a longer-term view than do most other Chinese lenders. Although these developers and their lenders would be expected to face somewhat different issues as their loan relationship progresses from construction through completion and occupancy, this type of lender should have significant concerns about the developer's success.²⁴

It is also worth noting that, in cases in which the developer intends to hold the property after construction, it is more common in China than in the West for the construction lender also to serve as the permanent, or "cash-flow," lender. In other words, if the project is going to be held for rental income, not only must the initial lender worry more about the project's long-term success, that lender also is more likely than in the United States to be the permanent lender that will suffer directly if the project fails. This fact does not alter the overall issue, of course, for

24. For a discussion of the long-term financing of commercial projects that will be held for rental income, see Stein, *Commercial Leasing*, *supra* note 2, at 28–29 (discussing these loans in the context of a broader examination of commercial leasing).

rather than satisfying the lengthy closing conditions of an independent permanent lender that will be taking out the construction loan and thereby repaying the construction lender's funds, one would expect that the borrower instead must satisfy the nearly identical concerns of the unitary construction/permanent lender from the outset. Rather than worrying that the permanent lender will not provide the funds the construction lender expects to receive as repayment, this construction lender instead should be equally worried that the developer itself will never be able to repay the loan.

Nonetheless, when I asked more than one Chinese expert about the extent to which construction lenders look more toward the long term when analyzing loan applications from developers that are building rental properties, the general reaction to my question was bafflement. One lawyer advised me that developers have learned that Chinese banks are flexible on this issue—far more flexible than Western lenders would be—and generally do not impose stringent conditions on their funding obligations.²⁵

In at least some recent cases, Chinese commercial developments that will be held for rental income are owned by entities in which one of the stakeholders is foreign and is expected to put up a significant percentage of the cash that will be needed to develop the property. Loan-to-value ratios in these projects are likely to be fairly low, which may give lenders to these entities increased confidence that their loans are safe. The lenders have less money at risk at the same time that the borrowers, including their overseas investors, have more to lose.²⁶

Another possible explanation for Chinese lenders' willingness to lend after only a cursory review of a fairly short list of submissions is the fact that China's history as a nation with a modern real estate market is quite short. The process of construction and permanent lending that is so familiar to Western lawyers evolved before the development of China's modern real estate market. China's current real estate market dates back only to the late 1980s, and Chinese lenders have seen mostly boom times since then. China certainly has a large number of nonperforming loans, but those loans tend to arise in industries other than real estate. It is

25. This phenomenon may be explained in part by the fact that some of the larger real estate developers and most major lenders are state-owned or state-controlled. See Bing Wang & Richard Peiser, *Non-Performing Loan Resolution in the Context of China's Transitional Economy*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 271, 272 (Yan Song & Chengri Ding eds., 2007) (recognizing that loans to state-owned enterprises account for most nonperforming loans in China).

26. For a general discussion of the moral hazard problem that high loan-to-value ratios can create, see Gregory M. Stein, *The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan*, 55 *WASH. & LEE L. REV.* 1207, 1239–44 (1998).

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quite possible that the relative absence of market troughs during the careers of today's Chinese real estate professionals has led them to believe that conditions can never get any worse than they have been during the last twenty years. In short, China's lenders may believe, perhaps naively, that they have lived through the worst market conditions they will ever have to endure and simply may not see any point to demanding more information from prospective borrowers.

Finally, and perhaps most importantly, one should always keep in mind that the lending industry in China is largely controlled by the Chinese government. Western lenders, by and large, are privately owned entities.²⁷ Their shareholders are investors who will become dissatisfied if too many of the lender's loans perform poorly. Chinese banks, by contrast, lack profit-oriented private shareholders who can serve as corporate watchdogs. Rather, these banks are controlled by a government that is influenced by many factors in addition to the profit motive, ranging from political necessity to outright corruption.²⁸ If a project will produce an outcome that is politically desirable—perhaps by increasing tax revenues, moving a large number of workers from state-owned industries to the private sector, or bringing glory to a local government official who wants to leave his mark on a city—it may get a green light even if it is not financially meritorious in the Western sense.

None of this discussion is meant to suggest that Chinese lenders simply extend credit heedlessly. Each bank is bound by its own internal credit policies, which are set by its board of directors. In addition, Chinese banks are subject to government oversight. While these regulators do not approve each loan, they do inspect banks regularly and issue warnings if a bank has too many nonperforming loans on its books.

27. The Obama administration has gone out of its way to reassure the public that measures designed to bail out America's troubled banking industry do not constitute government nationalization of these banks. See, e.g., Paul Krugman, *Banking on the Brink*, N.Y. TIMES, Feb. 23, 2009, at A27, available at <http://www.nytimes.com/2009/02/23/opinion/23krugman.html> (arguing for a more direct nationalization of the banks, while lamenting that "[t]he Obama administration, says Robert Gibbs, the White House spokesman, believes 'that a privately held banking system is the correct way to go'").

28. See, e.g., Peter S. Goodman, *Lessons the Teacher Forgot*, N.Y. TIMES, May 17, 2009, at WK1 ("In China, ventures may be spectacularly unprofitable, yet enrich everyone lucky enough to get a piece. . . . Soon enough, [a] trophy skyscraper [can descend] into financial disaster, but the developers, bankers and party officials have already extracted their riches, and for long afterward they will still enjoy them."), available at <http://www.nytimes.com/2009/05/17/weekinreview/17goodman.html>.

Nonetheless, Chinese banks may be more willing than their Western counterparts to forego profits on individual loans in order to meet other, more general, pressing government needs.²⁹

In addition, several different experts advised me that, while Chinese lenders typically do not demand the types of feasibility studies and market analysis that Western lenders would require, some developers nonetheless undertake this type of due diligence anyway. These studies are for internal use only and give the owner's equity holders a clearer sense of the viability of the project before they risk their own funds. This two-track system reflects the fact that the quasi-capitalist owner has interests that differ dramatically from those of the government-affiliated lender: The owners want to make money, while the lender often is constrained by political needs. Thus, the submissions provided to the lender are presumably designed to persuade the lender that the project is necessary and politically defensible, while the internal reviews are designed to convince the investors that the project will be profitable.

It is important to note that, while Chinese banks require the four submissions described above, only the first of these—the land use right—serves as security for the construction loan. The borrower mortgages the land use right to the lender in much the way that any borrower in a common law system would.³⁰ The lender does not offer the other three documents as security for repayment of the loan. The remaining permits, while legally required, are viewed by lenders as little more than a necessary formality, although they do provide some assurance that the project is progressing without any legal impediment so far.

Construction loans tend to have shorter terms in China than they do in the West. Chinese real estate developers typically request construction loans with a term of twelve to eighteen months, a duration that will strike the Western real estate expert as frighteningly short. In part, these short terms may reflect the fact that construction in China proceeds at a frenetic pace, with job sites often operating around the clock and with

29. See *supra* notes 27–28 and accompanying text; *cf. infra* note 106 and accompanying text (discussing similar influences on private developers).

30. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), arts. 179–80, 182, 185, 187, 191, 198, 200 (China); Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 46–51 (China); Danbao Fa (担保法) [Guaranty Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 30, 1995, effective Oct. 1, 1995), arts. 33–62 (China). Note that any conflicts between the Property Rights Law and the Guaranty Law are to be resolved in favor of the former. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 178 (China).

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local concerns about neighborhood disruption taking a back seat to the desire to complete the project as quickly as the laws of physics will allow.³¹ These quick construction schedules also reflect the fact that loans of this duration are considered short-term loans, which means that they lead to less in the way of application formality and a lower level of loan oversight. If the building is not complete when this short term expires, it is fairly easy for the borrower to receive an extension from its lender, and the loan will still be treated as short-term from an administrative perspective. This constitutes a practical way for the developer to avoid the additional oversight that a loan with a longer term will bring without necessarily shortening the project schedule.

If a lender agrees to extend a construction loan to a developer, that loan will typically be for a principal amount of roughly 60% of the project budget. As in Western construction loans, the lender does not ordinarily advance this amount to the borrower in a single lump sum. The provision of a single payment at the outset would make the loan nearly impossible for the lender to monitor and could easily lead to the disappearance of the funds before the project is completed (although some experts stated that this does occasionally occur anyway), while the provision of a single payment at the end of the project would create insuperable cash-flow problems for the developer. Rather, the loan usually is disbursed in stages as construction progresses, though the borrower may be able to negotiate for a modest lump-sum payment at the beginning of the loan term.³² In addition, one developer indicated that borrowers with sufficient experience (or close connections with bank officials) may be able to negotiate more favorable terms than these.

31. Unfortunately, developers and government officials are sometimes heedless of the laws of physics. In a widely publicized recent case, a nearly completed thirteen-story residential building in the Minhang District of Shanghai toppled over and fell, nearly unblemished, on its side. Fortunately, the building was not yet occupied and the accident occurred in the early morning on a Saturday, so only one worker was killed. See Cao Li, *Building Collapse Kills One Worker in Shanghai*, CHINA DAILY, Jun. 27, 2009, http://www.chinadaily.com.cn/bizchina/2009-06/27/content_8330265.htm (last visited Jul. 27, 2010).

32. The Property Rights Law of China authorizes “mortgages of maximum amount,” but does not define this term. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), arts. 203–07 (China). See also Danbao Fa (担保法) [Guaranty Law] (promulgated by the Standing Comm. Nat’l People’s Cong., June 30, 1995, effective Oct. 1, 1995), art. 59 (China) (defining “mortgage of maximum amount” as a mortgage in which “the mortgaged property shall be used to secure the creditor’s claims which occur successively during a given period of time and to the extent of the total amount of the claims”).

The construction process itself also follows a pattern similar to that employed in the West. The developer enters into a contractual agreement with a builder. This builder, in turn, may subcontract portions of the work to companies with more specialized skills. However, the payment process in China differs significantly. More than one expert complained that Chinese real estate developers are notoriously slow to pay their contractors. One real estate expert advised me that a contractor may not receive any payments at all until it has completed one-third of the work, and the contractor may receive little or no interest on these payments as they are accruing.

The result of this practice is that the contractor acts as an informal construction lender, advancing money for materials, supplies, and labor for which it is reimbursed only weeks or months later. Although I pressed several professionals on the question of whether these payments were actually overdue, or whether the contractor simply had agreed to accept a delayed payment, I was not able to obtain a reliable answer to this question. Either way, though, the contractor is incurring obligations to its suppliers and workers which it must either meet before receiving payment from the developer (presumably by borrowing funds itself) or defer paying (thereby shifting this burden to its employees, subcontractors, and materials suppliers). Whichever pattern is present, someone involved in the construction process is indirectly financing the developer's project, perhaps at its own expense.

Contractors may well build these hidden financing costs into the prices they demand for construction work. A contractor that knows it will face this problem and agrees in advance to accept deferred payments anyway, or that negotiates its construction contracts under the assumption that it will be paid slowly, may attempt to build imputed interest payments into its bids. If this is the case, and if the developer accepts a contractor's bid that has been increased to reflect these interest payments, then the developer is paying the cost for its own slow payments. Numerous experts confirmed that, in China's cutthroat construction market, contractors do not have the market leverage to price this financing cost into their jobs.³³

At the same time, even in a very competitive market, contractors must recover these costs one way or another if they are to survive. It is easy to believe that China's large construction workforce, much of it made up

33. Cf. Bo-sin Tang & Sing-cheong Liu, *Property Developers and Speculative Development in China*, in EMERGING LAND & HOUSING MARKETS IN CHINA 199, 222 n.30 (Chengri Ding & Yan Song eds., 2005) (suggesting that many Chinese contractors are state-owned and thus have considerable leverage when working with developers).

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of workers from the provinces, is not in a position to protect itself against contractor employers that fail to pay wages in a timely fashion. These workers may not initially recognize how slowly they will be paid, or they may recognize this fact and nonetheless accept wages that are effectively lower than they appear. To the extent that they are surprised, and effectively underpaid, by slow receipt of wages from their employers, these workers may have little recourse, particularly since many of them have migrated to cities in which they cannot work legally. These workers may be the parties that ultimately bear most of the financial burden of slow payments from developers.

The government has sought recently to limit this problem, by insisting that developers pay their contractors as construction progresses. This approach is designed to reduce the ability of developers to force contractors to serve as unwilling financing entities. Some developers have managed to circumvent this restriction by pressuring their contractors into becoming minority owners of the development entity. Under this approach, the contractor no longer falls into the protected category of a contract party, to whom the developer must now provide prompt payment. Rather, the contractor has been transformed into a stakeholder in the ownership entity and is thus unprotected by the new restriction against de facto financing.

IV. PRESELLING AND RESELLING OF RESIDENTIAL UNITS

The average Chinese citizen, worried about supporting himself and his family in the future and no longer protected by a reliable social safety net, is estimated to save 30–40% of his or her annual income.³⁴ There

34. *Economists Defend China's High Savings Rate*, CHINA DAILY ONLINE, Jan. 7, 2009, http://www.chinadaily.com.cn/bizchina/2009-01/07/content_7375620.htm (last visited Jul. 27, 2010) (restating this frequently repeated number and noting low debt level of Chinese households as compared to American and European households). By comparison, American savings rates during the past six years have ranged between 1.2% and 5%, with the savings rate edging up slightly since the start of the recent financial crisis. *BEA: Personal Savings Rate*, Bureau of Economic Analysis, National Economic Accounts, U.S. Department of Labor, <http://www.bea.gov/briefm/saving.htm> (last visited Jul. 27, 2010).

The Chinese and American numbers are not directly comparable. Americans are more likely to be able to rely on income sources that may not be reflected in the savings rate, including future social security benefits; pre-tax savings accounts such as 401(k) plans and IRAs; capital gains; and home appreciation. *See generally* "What's Behind the Low U.S. Personal Saving Rate?," FRBSF Economic Letter, Milt Marquis, Senior Economist,

are few investment vehicles in which average investors can place these savings. Bank accounts pay low interest rates,³⁵ the volatile Chinese stock markets in Shanghai and Shenzhen are viewed with considerable trepidation,³⁶ and strict currency controls limit the ability to invest outside of China. That leaves real estate, and during the market peak in the late 1990s and early 2000s, residential real estate units were the hottest of commodities.

Middle-class Chinese with some money to invest have been buying apartments as investments, often flipping them within a few months of purchase so they can pay off their acquisition loans, recognize their gains, and, perhaps, buy more apartments. As one expert informed me, “In Shanghai, if you own only one apartment, you do not belong to the middle class. If you own two or more, you can step into the middle class.” A second expert agreed, stating, “People with two or more homes are rich.” At the peak of the market, I was told, units were appreciating at an annual rate of as much as fifty or even one hundred percent. Moreover, most investors appear to cash out of their real estate investments by selling them and reinvesting the proceeds in other units. Refinancings in which the owner recoups its initial cash investment or more, so common in the United States, are nearly unheard of in China.

As a result of the fact that apartments are widely purchased solely for investment purposes, a high percentage of residential units in urban markets such as Shanghai have never been occupied, but rather serve as symbolic vaults for wealth accumulation. Urban residential units in China typically are built without many of the interior features that an American buyer (or building inspector) would consider standard, such as

Federal Reserve Bank of San Francisco (Mar. 29, 2002) (No. 2002-09), <http://www.frb.org/publications/economics/letter/2002/el2002-09.html> (last visited Jul. 27, 2010) (noting complexity of calculating an accurate U.S. savings rate, while also observing that households save more when they perceive that they need to accumulate more wealth for future consumption).

35. The Industrial and Commercial Bank of China (ICBC) has paid a 0.36% rate of interest on current deposits, with rates that escalate up to 3.60% for 5-year deposits, since December 23, 2008. The benchmark 1-year rate currently is 2.25%. *RMB Deposit Rate*, Financial Information—ICBC China (Dec. 23, 2008), <http://www.icbc.com.cn/icbc/financial%20information/rmb%20depositloan%20rate/rmb%20deposit%20rate/default.htm> (last visited Jul. 27, 2010). See also Xin Zhiming and Wang Xu, *China Cuts Interest Rates to Bolster Economy*, CHINA DAILY ONLINE, Dec. 22, 2008, http://www.chinadaily.com.cn/china/2008-12/22/content_7329130.htm (last visited Aug. 31, 2010).

36. Many of the listed companies are state-owned enterprises that retain control of one class of shares and offer a second class to the public. I asked one expert what, exactly, the investors could expect when they buy these “B” shares, and he responded, “It is like a casino,” while also noting that he never buys stock himself.

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doors and plumbing fixtures, with this finishing work left to the purchaser of the unit. If a Chinese unit is being held vacant as an investment, this finishing work may remain incomplete for an extended period. The investors who hold these incomplete units plainly do not expect to generate any rental income and are not counting on any type of regular cash flow. Rather, their investment return will come entirely in the form of rapid appreciation in the value of the property.

Given how quickly China's middle class has grown during the past two decades, and given how difficult it is to find, clear, and rebuild desirable urban land, the residential real estate market has not been able to keep up with the demand for units in which to invest. This scarcity of desirable vacant land has contributed to the sharp spike in prices for urban residential units. China's new capitalist class thus has received a first-hand lesson in the laws of supply and demand, and prices for urban residential units have continued to rise rapidly.

Overseas investors have augmented this domestic demand. As foreign investors began to discover the Chinese residential market, prices for new units rose even further. These purchasers from Hong Kong, Taiwan, North America, and Europe had numerous reasons for wishing to invest. Some, like the domestic investors, simply did not want to miss this promising investment opportunity while it was still available. Others predicted—with only partial accuracy—that the Chinese renminbi would have to appreciate against Western currencies, meaning that they would make money on the currency exchange even if the unit's value stayed the same or dropped somewhat.³⁷ The fact that China has not yet dramatically revalued the renminbi may have the effect of keeping these investors in

37. The Chinese government partially “de-pegged” the renminbi from the dollar on July 21, 2005, at a time when one dollar purchased 8.27 RMB. Qing Wang & Steven Zhang, *An Exit Strategy for the Renminbi*, MORGAN STANLEY—GLOBAL ECONOMIC FORUM (June 10, 2009), <http://www.morganstanley.com/views/gef/archive/2009/20090610-Wed.html> (last visited Jul. 27, 2010). During the next three years, the dollar gradually depreciated to a range of 6.81–6.85 RMB, where it held steady after July 2008. *Id.* For the next two years, China pegged the value of the renminbi to that of the dollar, but under pressure from the Obama administration, China once again allowed the renminbi to appreciate in June 2010. Keith Bradsher, *China Signals a Gradual Rise in Value of Its Currency*, N.Y. TIMES, Jun. 20, 2010, at A1, available at <http://www.nytimes.com/2010/06/20/business/global/20yuan.html>. The renminbi has drifted up slightly since then against the dollar.

the market and attracting new ones, in the belief that a more dramatic revaluation, though deferred, is inevitable.³⁸

In addition to all of the urban residential units that are built primarily as investment commodities, plenty of other apartments are occupied by their owners. China's huge and swelling urban population is living somewhere, and many urban residents are eager to improve their living standard by moving to newer and more modern dwellings. For many Chinese, as for many Westerners, their home is both their place of residence and their most significant investment. China's new Property Rights Law confirms and describes the rights of the owners of these units, in language that will sound familiar to the owner of a Western condominium.³⁹

Developers have found themselves in the enviable position of not being able to meet this enormous demand for urban residential units. Despite government limits on the ability of non-residents to relocate to Shanghai, demand for residential units—many of which will remain unoccupied—has rapidly driven up their price. In the earlier days of the modern residential real estate market in China, there were few restrictions on advance sales, and developers were able to presell residential units at or above the asking price as soon as they placed them on the market, long before they built these units. During the peak of the market in China, it was not unusual for prospective buyers to line up around the block to purchase units off the plans whenever a new project was announced.⁴⁰ These buyers did not wish to miss a short-lived opportunity to purchase a unit in a new residential development.⁴¹ A bubble mentality

38. The United States government regularly asks China to revalue its currency, and China regularly declined until it acted modestly in June 2010. *See, e.g.*, Edward Wong & Mark Landler, *China Rejects U.S. Complaints on Its Currency*, N.Y. TIMES, Feb. 4, 2010, available at <http://www.nytimes.com/2010/02/05/world/asia/05diplo.html> (noting, before China's actions in June 2010, that economists then believed the renminbi to be undervalued by 25–40% as against the dollar, and that the gap was the widest it had been since July 2005).

39. *See* Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), arts. 70–83 (China) (enumerating the rights of owners of individual residential units within larger buildings).

40. *See, e.g.*, Michael Schuman, *Bubble Trouble: Why Real Estate Is China's Biggest Headache*, TIME, Nov. 16, 2009, <http://www.time.com/time/world/article/0,8599,1939768,00.html> (last visited Jul. 27, 2010) (describing prospective purchasers of residential units bringing chairs and folding beds so they could camp outside a real estate sales office for two days).

41. The real estate craze that has gripped China for much of the past two decades bears some resemblance to the frenzy surrounding initial public offerings in the United States during some parts of that same twenty-year period. *See, e.g.*, Peter Edmonston, *Google's I.P.O., Five Years Later*, N.Y. TIMES DEALBOOK (Aug. 19, 2009, 12:15PM), <http://dealbook.blogs.nytimes.com/2009/08/19/googles-ipo-5-years-later/?scp=1-b&sq=google+>

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such as this created numerous opportunities for corner-cutting or even outright fraud by developers, and the government later took steps to try to restrain this speculative frenzy.⁴²

Different real estate experts provided somewhat different descriptions of these government-imposed limitations and the effect they have had, possibly reflecting their own personal experiences, variations in the application of these new rules, and evolution in these restrictions over time. One expert, for example, stated that units no longer may be presold without government consent, and that this consent is not available until the building is two-thirds completed or until the building has been topped off.⁴³ This expert noted that before this limitation was instituted, buyers frequently would execute purchase contracts and then assign their contractual right to buy the apartment at a profit while the unit was being built. The assignee of these contract rights, in turn, would flip the contract to yet another buyer. Meanwhile, the developer minimized its risk and locked in its profit before breaking ground. Thus, the Chinese market had already matured to the point that it had learned to commodify not only real estate, but also the more ethereal contractual right to acquire real estate in the future.

Limitations on presales are designed to reduce the number of times an executory contract can, practically speaking, be assigned before the unit is even finished. One expert noted, though, that the demand for residential

ipo&st=nyt (last visited Jul. 27, 2010) (noting that Google's valuation immediately after its initial public offering was \$27 billion, but that it was worth more than \$140 billion five years later).

42. See *infra* notes 62–63 and accompanying text. See also Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 44 (China) (requiring, since 1995, that four conditions be met before residential units may be presold: (i) payment of fee for land use right and receipt of certificate; (ii) receipt of permit for construction; (iii) completion of 25% of construction; and (iv) registration with local government and receipt of certificate permitting presales; seller also must submit the sales contract for public registration and apply any sales proceeds it receives toward construction).

43. Another expert told me that the building had to be at least 60% complete; a third one told me 70%. These limitations appear to apply to contracts for the sale of the real estate and not just to actual conveyance of the real estate itself. The Law on the Administration of Urban Real Estate appears to prohibit both presale of housing units and actual conveyance of the real estate before the project is 25% complete. Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), arts. 38, 44 (China).

units is so great that developers nonetheless continue to sell units before the point in the construction process when presales are officially permitted. Prospective buyers apparently are so anxious to acquire units that they knowingly and willingly sign contracts that violate government restriction on presales.⁴⁴

Shanghai has established an official website that lists all developers that have received government permission to sell units in partially completed buildings. The website lists the number of units available along with the asking price for each. Even with recent attempts at transparency such as these in place, developers continue to try to drive up the price of individual units. One professional stated that some developers will engage in sham sales of new units to business associates, trying to create the illusion that a building is more popular than it actually is. Interested outside buyers then are forced to acquire units from these intermediaries, who retain a portion of the profits. The intermediaries, in essence, are buying the units in bulk at wholesale prices and reselling them individually at retail, sharing the markup with the developer while adding to the hype that surrounds the building. Developers apparently believe that this approach stimulates demand for the project and increases the total profit on the units.

It is important to note that the execution of a contract by the developer and the unit buyer holds a somewhat different significance in China than Westerners are accustomed to. In the United States, a contract of sale typically memorializes the agreement between the parties, sets forth the representations of the parties and the conditions precedent to each party's obligation to close, and provides remedies for breach. All of this may be true as well in China, but one American expert referred to Chinese contracts as merely the first phase in a negotiation process that continues after the parties have signed the document. American negotiations largely come to an end with the execution of the contract, but the contract is seen as only the middle of the negotiation process in China. Buyers of Chinese units who wish to terminate a contract, for example, regularly claim that conditions have changed sufficiently to release them from their contractual obligations. This may also be true in the United States,

44. In theory, if only occasionally in recent Chinese practice, unit values might go down during the construction period. If this were to happen, the ultimate contract assignee, who paid a premium to acquire the right to purchase the unit at a price that, at the time, seemed low, now will suffer a loss. His total cost for the unit, including the price to buy the flipped contract, will now exceed the market value of the unit. Such a buyer will be tempted to deny the existence of the contract, arguing that the developer contracted to convey something that, under these new restrictions, it did not yet have the legal power to transfer.

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of course, but the existence of a fully-executed contract probably has a greater impact on settlement negotiations or court action than it would in China, given the differing legal and social expectations in the two nations.

Once the unit can legally be marketed, the developer is free to enter into contracts with buyers. Upon execution of the contract, the developer often requires the buyer to pay a portion of the purchase price—which can run as high as 50%—immediately or soon afterwards. The contract also establishes a payment schedule for the balance of the buyer's obligation, with the buyer making the final payment before occupancy. One expert described buyers who get the key when they make their last payment. This payment schedule leaves the buyer in an undesirable position if the developer fails to complete the building, having paid for all or a large portion of the unit only to learn that the developer cannot complete it.

The Law on the Administration of Urban Real Estate, which dates back to 1995, appears to provide the buyer with some protection. As a condition to preselling a dwelling unit, the developer must, among other things, obtain permission to presell the home.⁴⁵ In addition, the developer must “submit the presale contracts to the departments of housing administration and departments of land administration . . . for registration and record.”⁴⁶ Moreover, “[t]he proceeds obtained from the presale of commercial houses must be used for the relevant construction purposes.”⁴⁷ Thus, the buyer is legally protected by public registration against multiple sales or further mortgages by the developer and enjoys some comfort that the sale proceeds will be used for construction purposes. In addition, developer breaches and malfeasance of this sort appear to have been a rare occurrence. In a market that is only about two decades old

45. Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 44 (China); *see supra* notes 40–44 and accompanying text.

46. Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 44 (China); *see supra* note 43 and accompanying text.

47. Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 44 (China). *See also id.* art. 45 (stating that “matters concerning the transfer of unfinished presale commercial houses that the buyers have purchased shall be prescribed by the State Council”).

and that has been quite successful for nearly all of that time period, most projects have been completed, and construction lenders tend to finish projects on behalf of the rare defaulting developers.

Many Chinese borrowers, like their counterparts elsewhere, do not have the financial capacity to acquire their residence outright and need to borrow a substantial portion of the acquisition price.⁴⁸ Even those buyers who are in a position to buy their units outright, including some investors, are likely to prefer the leveraging opportunities that borrowing funds provides. In the absence of a formal lending industry, borrowers would either have to save the entire purchase price before buying a home or borrow part of the price in the informal market, perhaps from relatives and friends. Rather than doing this—or doing *only* this—many Chinese borrowers expect to borrow significant sums of money from institutional lenders at the time they buy their home and plan to pay off this debt from their future earnings over a period of years.

Western lenders worry about extending a large loan to an untested borrower who possesses few assets beyond the real estate she will purchase with the borrowed funds, which is why these lenders demand a mortgage interest in the property that will be purchased with the borrowed funds. The asset the buyer will purchase with the borrowed funds often is the only asset the borrower owns that is valuable enough to repay the debt. This is the reason most borrowers need to borrow the acquisition funds in the first place, and it is why the lender will demand a first priority security interest in this real estate. Chinese lenders certainly are no less concerned about repayment. However, the Chinese model, in which the buyer of a new residential unit pays for the home in full before it is completed, raises obvious legal and practical timing questions for both the buyer and the buyer's acquisition lender.

The typical Chinese buyer, who intends to borrow most of the funds she needs to acquire the unit, will have to procure these funds and deliver them to the developer before the buyer owns an asset of sufficient legal stability or economic value to pledge to its lender. Lenders either will refuse to lend on these terms or will have to extend the loan before the developer completes construction. If construction is not complete, however, the principal amount of any loan almost certainly would have

48. China's new property law allows the owner of property to mortgage its property interest. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 40 (China) ("The owner shall have the right to establish . . . security right[s] in property rights with regard to its real and movable property."). See also *id.* arts. 179–202 (discussing attributes of mortgage law in greater detail).

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to exceed the value of the partially constructed home at that time. The practice of lending to residential buyers before construction is complete would place Chinese acquisition lenders in a position of far greater risk than their Western counterparts. If a developer fails to complete a building in which many of its buyers have already borrowed funds and used those funds to pay the developer all or a significant part of the purchase price, the borrowers are likely to default on their loans and their acquisition lenders will be forced to foreclose on security that is worth less than the debt, assuming Chinese law even allows them to foreclose at all.⁴⁹

In many ways, a mortgage crisis of this type would be far more serious—and also more foreseeable—than the mortgage crisis currently facing American lenders. American lenders, by and large, extended loans that arguably were adequately secured at the time they were made, but property values subsequently depreciated faster than the loan balances could be reduced. By contrast, Chinese lenders in the situation just described would be extending loans that are undersecured from the outset. Chinese lenders are aware of this problem, of course, which means that the buyer's "equitable" interest in a partly constructed unit may not be sufficiently well established to be able to serve as security for repayment of an acquisition loan.⁵⁰

49. Note that under China's property law, a mortgage on a construction lot does not provide the mortgagee with a security interest in improvements that are subsequently built on that lot. The land lender may foreclose on the lot after it is developed and the improvements will be sold along with the land, but the mortgagee of the raw land is not entitled to any of the foreclosure proceeds attributable to the improvements. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 200 (China). See also Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 51 (China) (allowing mortgages on lots that will be improved by housing but clarifying that mortgagee does not have priority with respect to portion of foreclosure proceeds that derive from these improvements); Danbao Fa (担保法) [Guaranty Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 30, 1995, effective Oct. 1, 1995), art. 55 (China) (same).

50. Although I refer to this type of title as "equitable," as it would be in common law practice, it is unlikely that Chinese law recognizes equitable title. The buyer simply does not own the unit yet. See *supra* note 49 and accompanying text (discussing mortgageability of lots on which construction is ongoing); JESSE DUKEMINIER et al., PROPERTY 483–84 (6th ed. 2006) (describing the common law concept of equitable conversion, and noting that "[t]he buyer is viewed in equity as the owner from the date of the contract").

Chinese bankers nonetheless are under great pressure to lend, as I was reminded repeatedly. Part of this pressure reflects the fact that local governments must house many newcomers even as they improve the quality of the existing housing stock for long-time residents.⁵¹ To meet these twin goals, the government is anxious to build new residential units as quickly as possible.⁵² In recent years, the government has preferred to leave much of this construction task to the private sector. As a result, local governments pressure banks to lend to private developers.

These local governmental units also want to see their home-grown real estate developers succeed, in part because it is good for the local economy and in part because many of these developers are well connected at the local government level. New construction leads to jobs for local residents and increased collection of fees and taxes and may in turn encourage still more economic development. Local governments also have a more direct financial stake in the real estate market. These government entities frequently serve as equity holders in the limited liability companies that are developing property within the jurisdiction and thus benefit directly when local projects are financially successful.⁵³

Even when they do not have such an ownership interest in the project itself, local governments profit enormously from the sale of the underlying land use rights—in fact, one of the most important effects of the creation of the land use right has been the access that local governments now have to the income stream that the sale of these rights provides.⁵⁴ One expert I interviewed estimated that approximately 20% of total national fiscal revenue derives from the sale of land use rights, with the number

51. One of the displays at the “Pudong 15” exhibit, held in 2005 to commemorate the fifteenth anniversary of the commencement of the massive Pudong development, advised that during the preceding twenty years, 4.281 million square meters of shabby and dilapidated houses had been pulled down across Shanghai and 900,000 households had been moved into new residences. A nearby exhibit stated that, during those same twenty years, 16.2 million square meters of new houses were built, totaling 53% of the gross area covered by housing in Shanghai.

52. Under the Law on the Administration of Urban Real Estate, “[t]he State shall . . . support the development of construction of residential houses so as to gradually improve the housing conditions of residents.” Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat’l People’s Cong., July 5, 1994, effective Jan. 1, 1995), art. 4 (China). *See also id.* art. 28 (“The State shall adopt preferential measures in aspects such as taxation to encourage and support real estate development enterprises to develop and construct residential houses.”).

53. Stein, *Land Use Rights*, *supra* note 1, at 15–17.

54. *See* Chengri Ding, *Policy and Praxis of Land Acquisition in China*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 77, 84–85 (Yan Song & Chengri Ding eds. 2007). The author notes that this benefit may be illusory, because local governments also became responsible for a greater share of infrastructure and public service obligations. *Id.* at 85.

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in Shanghai and Beijing approaching 50%. This reality often places local governments at odds with the central government, which has good reasons for wanting to keep the real estate boom from becoming too explosive.⁵⁵ Moreover, some benefits may accrue to individuals who work for the government as well. Government officials may openly invest in and profit from local real estate development projects, or they may receive direct or indirect benefits under the table.

Banks also need to cover the interest payments they owe to their depositors. Even though banks pay low rates on savings accounts, the Chinese population is large and growing, its wealth has increased greatly during the past two decades, and its savings rate is extremely high. Individual savings that have not been invested in real estate may well be sitting in accounts at Chinese banks, and the banks must pay interest on these deposits.⁵⁶

The incentive system that Chinese banks use also encourages lending even when it is not financially advisable. Bank officers must meet lending quotas, on which their annual bonuses depend. Banks reward employees' decisions to make loans, even if those loans are financially unwise. These banks are under pressure to lend money as fast as they can, and there are few consequences to the lending officers if a particular loan later proves to be a poor one. Finally, banks, like developers, have seen many good years recently, and may view high default rates more as a theoretical possibility than as an actual prospect to be greatly feared. In fact, one expert I met estimated the default rate by buyers of residential units to be about to be about 1.5%. This rate, which was provided to me before the recent economic decline, approximates the rate that was seen in the United States prior to the downturn.⁵⁷ Chinese

55. See Stein, *Land Use Rights*, *supra* note 1, at 26–29. Local governments also may go to great lengths to hide the revenues they receive from the sale of land use rights, since a percentage of the sale proceeds must be turned over to Beijing. See Weiping Wu, *Urban Infrastructure and Financing in China*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 251, 265 (Yan Song & Chengri Ding eds., 2007) (noting local government preference for “behind-the-door negotiation” over “transparent forms of bidding and auction at market rates”).

56. One expert estimated that 60% of Chinese bank income today results from the spread between the interest banks receive on loans and the interest they pay on deposits.

57. As recently as January 2008, the rate of “serious delinquencies” on single-family homes in Fannie Mae’s mortgage portfolio—defined as loans that are overdue by three or more consecutive months or in foreclosure—stood at only 1.06%. By October 2008, the rate had increased to 1.89%; twelve months later, the rate stood at 4.98%. The rate peaked at 5.59% in February 2010 and has edged down since then, to 5.30% in April 2010.

banks are viewed as having a high rate of nonperforming loans; I heard estimates of these troubled loans that ranged from 20–50%. But Chinese experts repeatedly emphasized that many of these loans were extended to obsolete state-owned manufacturing enterprises and that few of China’s troubled loans are secured by real estate.⁵⁸

Urban residential buyers are in a position in which they want to acquire real estate and generally must borrow money to do so, and Chinese lenders face strong internal and external incentives to make these loans. So the Chinese market for residential real estate loans has no shortage of willing borrowers and lenders. These two facts do not resolve the legal and timing questions noted above, however: Developers require buyers to pay them most or all of the purchase price before they have completed construction of the unit, while lenders sensibly want to receive mortgage interests in completed units before making large real estate loans to consumers who have few other assets.

These conflicting requirements can create a difficult cash-flow problem for the would-be buyer, who may have to borrow funds and even begin to repay this loan on a unit she cannot yet occupy, even as she continues to pay the mortgage or rent on her current dwelling. Even worse than this are the legal constraints facing this consumer, who needs to borrow a significant amount of money but may not yet own a mortgageable asset. The Chinese property law, which dates back only to 2007, is vague as to how consumer mortgage loan transactions secured by unfinished units can proceed, and various experts in China provided me with different—and not entirely persuasive—answers to this important question.

One expert insisted that the unit buyer receives an ownership certificate covering its land use right even before the unit is completed, to be followed by a second certificate for the unit itself after the developer completes construction. The borrower mortgages the first of these certificates to its lender while construction is progressing,⁵⁹ thereby

Investor Relations: Monthly Summary, FANNIE MAE, <http://www.fanniemae.com/ir/monthly/index.jhtml?s=Monthly+Summary> (last visited Jul. 27, 2010).

58. See *supra* note 25. In fact, some of these state-owned enterprises have been bailed out by real estate developers that have been willing to pay huge amounts to acquire them, simply to obtain the right to use the underlying land.

59. The Property Rights Law does make clear that both the land use right to the building lot and the houses and other structures built on that lot are mortgageable. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 180 (China). The law goes on to state that a mortgage of either the lot or the house on the lot automatically functions as a mortgage of both. *Id.* art.182. This Article, however, appears to assume that the structure already exists at the time of the mortgage, which means that Article 182 does not necessarily prohibit the type of bifurcated mortgage described in the text.

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securing its acquisition loan even before the unit is ready for occupancy.⁶⁰ This statement is legally plausible, but it fails to account for the fact that the portion of the value of the completed unit that is allocable to the underlying land use right will represent only a small portion of the value of the entire completed unit for which the buyer must obtain acquisition funds. Thus, the borrower still must borrow an amount that greatly exceeds the value of the asset it has available to mortgage—the first of these two land use right certificates—unless the lender is willing to accept a loan that is undersecured almost from the outset.

In addition, one must question whether the lender to the unit buyer will be willing to accept a mortgage of this certificate, given that the to-be-completed unit still is legally owned by the developer that is building it and thus remains subject to that developer's own construction financing. This means that, in addition to the fact that the value of the certificate is less than the amount of the unit buyer's total debt, the certificate also is owned by someone else and may be subject to a substantial senior lien arising from the developer's construction activities. Finally, the expert who explained this financing structure acknowledged that it may not be

By contrast, Article 200 states, "When land use right of construction lot is mortgaged, newly built houses on the land are not mortgaged property." The clear import of this Article is that lots on which houses are to be built are to be treated differently from lots on which houses already exist. This implication is buttressed by the last sentence of the Article, which states that the value of a house that is newly built on a mortgaged lot does not accrue to the mortgagee upon foreclosure. *Id.* See also Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 51 (China) (containing similar provisions).

60. Under China's new property law, a buyer may apply for "pre-notice registration," which serves as notice of the buyer's interest in the property prior to the official transfer of the land use right. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 20 (China). This registration presumably prevents the seller from later deciding to convey the property to a higher bidder, by putting the second buyer on notice of the original contract vendee's interest. However, the initial buyer's registration lapses if the transfer of the land use right is not registered "within three (3) months from the date on which such registration can be registered." *Id.* The new law does not appear to distinguish between a land use right for the underlying land and a land use right for the unit itself, nor does it clarify whether pre-notice registration creates a property interest that can legally be mortgaged.

Note also that the new law states that "[t]he establishment . . . of property rights due to such actions as legal construction . . . of houses shall become valid and effective upon the occurrence of such action[.]" *Id.* art. 30. This provision seems merely to indicate that the holder of a land use right is also the owner of the unit built on that land from the time the unit is built.

legal, even as he affirmed that it is common practice. Note, however, that there does not appear to be anything in the 2007 Property Rights Law prohibiting this type of loan financing structure.⁶¹

A knowledgeable real estate expert explained to me what he believes to be the current state of Chinese law and practice. He also noted that mandatory changes to this process are under consideration, reflecting both public and government sentiment that the current presale process leaves unit buyers exposed to unwarranted financial risk. Real estate developers may not begin to presell units in a new building until the building is 25% complete. This 25% figure refers only to construction costs and excludes the price of the land use right itself. Thus, the developer must have invested nearly half of the total cost of building the unit before it can be marketed: the roughly 30% of the typical budget that is required to obtain the land use right, plus one-fourth of the remaining 70%.

Once the developer reaches this threshold, it can apply for permission to presell, which takes fifteen days to receive. The developer then will begin to advertise nearly immediately. This is the point at which prospective buyers line up around the block, the developer holds a lottery, and the winners may select their apartments in sequence, based on their review of building plans and, perhaps, their inspection of a model apartment. The buyers also must pay a nominal amount of the purchase price at this point, which is nonrefundable but will be credited against the price. One month later, the buyer must put up the rest of the first 20% of the price, net of that initial downpayment. Two months after that, the buyer must pay the entire balance of the purchase price.

This last payment deadline is the point at which the buyer's cash flow problems become apparent, since it is borrowing the funds to pay the balance of the purchase price long before it can occupy the unit or mortgage it to the acquisition lender. Moreover, the buyer also will have to begin to repay this acquisition loan three or four months before the apartment is completed and ready for occupancy. So there is a period of three or four months late in the construction process when the buyer bears the costs of carrying two residences: the mortgage on the new one and the mortgage or rent on the one it is soon to vacate.

The borrower cannot mortgage the unit to the acquisition lender at the time of this last payment, because the buyer does not own the apartment

61. For further discussion of the presale of units and the cash-flow problems this creates for unit buyers, see Stein, *Mortgage Law*, *supra* note 2, at nn.55–56 and accompanying text.

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yet. But it can record a notice of the future mortgage, which will automatically become a mortgage when the buyer acquires the land use right in the completed unit. Of course, this notice is junior to the developer's construction loan. That priority problem is somewhat less problematic than it might at first seem, because the developer's construction lender often also serves as the acquisition lender to the various unit owners.

Nonetheless, this lender is now overextended. It has lent construction funds to the developer and also acquisition funds to the buyers. These buyers have each paid their entire purchase price to the developer, but the developer has not yet repaid the construction lender. To protect itself against developer insolvency, the lender also obtains a personal guarantee of completion from the developer, or perhaps one of the developer's creditworthy principals. Another expert advised me that, in the few cases in which developers had actually defaulted in a setting such as this, the government had invited a replacement developer to complete the project, and that developer had contributed additional funds and then negotiated with the unit buyers to share this additional cost. The unit buyers were relieved to obtain the apartment for which they had already paid, even at an increased cost, because the unit had appreciated during the construction process.

In the end, the developer's desire to require buyers to pay for the unit in full before it is complete amounts to both a shifting of the risk of price fluctuation from the seller to the buyer and a form of buyer financing of the seller's construction project. The seller, in effect, is borrowing money from its eventual buyers by requiring them to prepay for their units before they can benefit from them. This reduces the amount that the seller must borrow from its construction lender, thereby reducing the seller's interest costs. The buyers, then, are paying more than the stated acquisition price for their units, by subsidizing the developer's soft costs.

There is nothing irrational about a financing structure such as this, but the buyer needs to recognize that the price set forth in the contract actually understates the total cost that the buyer will pay. As long as institutional lenders—or informal lenders such as members of the buyer's extended family—are willing to provide loans to the units' ultimate buyers before the units are complete, this payment structure works as well as any other, and it appears to have succeeded in recent years in China. Meanwhile, the law and practice in this area of Chinese real estate law appear to be continually developing as the market matures.

The fact that residential units can be resold profitably demonstrates that there is also a significant resale market in addition to the market for new units. In fact, the market for new units is driven in large part by the success of the resale market, with many buyers of new units expecting to cash out as quickly as possible. The reason the resale market is so vibrant (to the extent these two markets can even be distinguished) is the same reason why new units sell so quickly: the possibility of significant and speedy gains from transferring residential units. Moreover, the fact that the unit to be resold already exists and the buyer can inspect a completed apartment rather than waiting for construction to proceed eliminates the construction risks buyers of new units face. And, of course, the buyer of an existing unit will be legally able to mortgage this finished unit at the time it borrows its acquisition funds, with none of the complexities described above that the buyer of a new unit faces. I was told by several Chinese lawyers that the transfer process for existing residential units is convenient, quick, and safe, even for the typical lay investor who is unfamiliar with the relevant law.

In an effort to cool the overall residential real estate market, including sales of both new and existing units and pre-completion flips of new units, the government raised interest rates, imposed new taxes, and stepped up tax enforcement, all of which adversely affect certain sellers. China's benchmark interest rate rose steadily in 2006 and 2007, peaking at 7.47%, but then dropped dramatically over a five-month period to 5.31% in January 2009, presumably out of concerns about the global economic crisis, and has held steady since then.⁶² Recent regulations will raise interest rates and minimum downpayments on second and third homes. The government has increased existing transfer taxes and gains taxes and has imposed new ones. Buyers must pay a transfer tax equal to 1.5% of the purchase price. In addition, if the seller is transferring the unit within five years of initially acquiring it—a time limit that was recently increased from two years—the seller pays an additional transfer tax of 5.5%.⁶³ To discourage investment in luxury units, the government assesses the latter tax on units larger than 144 square meters even after the seller has owned the unit for five years, and these larger units pay the former tax at a rate of 3% rather than the standard 1.5%.

62. *China Interest Rate*, TRADING ECONOMICS, <http://www.tradingeconomics.com/Economics/Interest-Rate.aspx?Symbol=CNY> (last visited Jul. 27, 2010).

63. I was told that this tax was originally a gains tax, levied only on the seller's profit, but was amended to become a transfer tax, calculated as a percentage of the entire sale price.

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At about the same time that these new taxes became effective, banks increased their minimum downpayments on residential units from 20% to 30%, with some banks requiring even larger initial payments. Interest rates are higher for second homes, to discourage investment in multiple investment units, thereby making more dwelling units available more cheaply for first-time buyers who plan to occupy the apartments they purchase. These policies, most of which were implemented before the recent global crisis, apparently succeeded, slowing down appreciation of residential units as the government had hoped to do. Moreover, investors who had purchased units with the goal of selling them at a profit within a few months likely ended up holding these units for far longer than they intended. Recent global conditions have led to a brief reversal of some of these policies, with the government apparently concerned about slowing the real estate market down too much.

V. THE MURKY DISTINCTION BETWEEN PUBLIC AND PRIVATE IN CHINA

Real estate development in modern China is not just a private enterprise. This reality may arise, at least in part, from China's recent attempts to harmonize the private right to use property with the public ownership of land that its nominally socialist system still requires.⁶⁴ The government has been an active participant in a national undertaking to upgrade basic public infrastructure.⁶⁵ China's local governments invest in infrastructure to meet public demand, to provide financial benefits to themselves, and to comply with national law.⁶⁶ Thus, a significant portion

64. For example, Article 3 of China's Property Rights Law states, "During the primary stage of socialism, the State shall adhere to the basic economic system, with public ownership playing a dominant role and diverse forms of ownership developing side by side." Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 3 (China). This Article also requires the state to "develop" the public portion of the economy, but only to "encourage, support, and guide the development of" the private sector. *Id.*

65. See, e.g., Jae Ho Chung, *Recipes for Development in Post-Mao Chinese Cities: Themes and Variations*, in *CITIES IN CHINA: RECIPES FOR ECONOMIC DEVELOPMENT IN THE REFORM ERA 1, 2* (Jae Ho Chung ed., 1999) (noting that, in the earlier days of China's real estate modernization process, local governments played an even more important role because of a "shortage of bourgeois entrepreneurs and private business groups") (footnote omitted).

66. The government is just as concerned with improving the quality of China's housing stock. "The State shall . . . support the development of construction of residential

of the construction in China today is public construction, initiated, planned, and largely executed by various levels of government for a primarily public purpose.⁶⁷

Local governments in China know that they must provide a diverse range of services to a huge population that is insisting on higher levels of comfort. This population includes the tens of millions of rural migrants who have been relocating to cities each year in search of construction and factory jobs. China's infrastructure, which was never adequate to begin with, is crumbling from decades of neglect prior to the 1990s and is being stressed by a growing and more demanding citizenry.⁶⁸ Governments at all levels, and local governments in particular, have been eager to update and expand their existing housing stock, upgrade substandard roads and bridges, and build new subways and airports.

Investment in infrastructure helps China's people, but it also may pay financial dividends to the local governments that provide it. "Urban infrastructure is considered to be a good form of public investment because it can increase revenue from land leases."⁶⁹ Not only do local governments find revenues generated by the sale of land use rights to be plentiful, they also have relative freedom as to how they spend these proceeds. "Revenues generated from public land leasing were regarded as extra-budgetary revenue, and their disposal was completely in the hands of local governments. Land revenues are the biggest share of extra-budget revenues, which play an extraordinary role in financing

houses so as to gradually improve the housing conditions of residents." Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 4 (China). *Cf. supra* notes 51–52 and accompanying text (noting similar government pressure on lenders).

67. These projects tend to proceed quite rapidly and with little or no public input. "Public participation in general has never been an established feature of the development process in China." Gerrit Knaap & Xingshuo Zhao, *Smart Growth and Urbanization in China: Can an American Tonic Treat the Growing Pains of Asia?*, in SMART URBAN GROWTH FOR CHINA 11, 23 (Yan Song & Chengri Ding eds., 2009). For example, Shanghai's Pudong airport was conceived and built in just over two years. By comparison, Denver's recently completed international airport took nearly six years from initial outlays to official opening.

68. "[I]mproved public infrastructure probably increases the productivity of all private factors For this reason, improvements in the public physical infrastructure in Chinese cities will be necessary for urban labor productivity to approach levels in the developed world." Jeffrey S. Zax, *Efficiency in China's Urban Labor Markets*, in URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH 209, 227 (Yan Song & Chengri Ding eds., 2007).

69. Weiping Wu, *Urban Infrastructure and Financing in China*, in URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH 251, 258 (Yan Song & Chengri Ding eds., 2007).

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local governments.”⁷⁰ The central government also is becoming increasingly cognizant of the environmental dangers it must address without delay and has encouraged public green projects as diverse as generating cleaner power and providing more public space.⁷¹

China’s City Planning Law seems to compel cities to engage in infrastructure planning. This law, which “shall be observed when the plan for a city is being formulated or implemented, or when construction is being carried out within a planned urban area,”⁷² demands that “[t]he construction of items of urban infrastructure as defined in the plan for a city shall be incorporated into the plan for national economic and social development . . . and shall be carried out step by step in a planned way.”⁷³ When urban areas are being redeveloped, “special attention shall be given to the construction of the infrastructure and public facilities so as to enhance the multiple functions of the city.”⁷⁴ Moreover, Article 13 requires the making of “a scientific forecast” from “actual conditions.”⁷⁵

The above discussion draws an artificially sharp distinction between public and private development of Chinese real estate, and assumes that infrastructure can be described as purely public while other, more profit-oriented projects can be contrasted as entirely private. But although public entities have the desire and responsibility to engage in infrastructure development, it is essential to remember that even so-called “private” development in China frequently has a significant public element.⁷⁶ Projects that, in the West, would be considered primarily private necessarily import some of the characteristics of public projects when

70. Chengri Ding, *Consequences of Land Policy in China: Deciphering Several Emerging Urban Forms*, in SMART URBAN GROWTH FOR CHINA 109, 123 (Yan Song & Chengri Ding eds. 2009) (footnote omitted).

71. Robert Ash, *Managing China’s Arable Land Resources in an Era of Sustainability*, in URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH 117, 139 (Yan Song & Chengri Ding eds., 2007) (noting how government’s “increasing emphasis on sustainability and harmony” may be undercut by rural migration and the stresses it can place on infrastructure, the environment, and social order).

72. Chengshi Guihua Fa (城市规划法) [City Planning Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Dec. 26, 1989, effective Apr. 1, 1990), art. 2 (China).

73. *Id.* art. 6.

74. *Id.* art. 27.

75. *Id.* art. 13.

76. See *supra* notes 27–28 and accompanying text; *infra* notes 91–92 and accompanying text.

they are undertaken in China.⁷⁷ The government controls the sale of land use rights and can use this power to influence what is built and where.⁷⁸ Government bodies thus can channel development as they choose, using the sale of land use rights as a basic form of zoning. Moreover, a variety of Chinese statutes require the government to control how land is used.⁷⁹ All of the major domestic lenders are controlled by the government. Development entities frequently have government stakeholders.⁸⁰ And the developer's need for *guanxi*⁸¹ ensures that even developers without government stakeholders maintain close links to government officials. For these reasons, all development in China is, to a significant degree, public development.

77. This uncertain boundary between public and private can lead to corresponding uncertainty as to responsibility for public improvements. See Randall Crane, *Public Finance Challenges for Chinese Urban Development*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 238, 239 (Yan Song & Chengri Ding eds. 2007) (observing that “service responsibilities, capacities, and costs change as cities grow, especially where the line between the public and private sectors is increasingly fluid”).

78. “Granting of the land-use right must conform to the overall planning for land utilization, urban planning and the annual plan for land to be used for construction.” Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat’l People’s Cong., July 5, 1994, effective Jan. 1, 1995), art. 9 (China); “[t]he State applies a system of control over the purposes of the use of land,” Tudi Guanli Fa (土地管理法) [Land Administration Law] (promulgated by the Standing Comm. Nat’l People’s Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 4 (China). See generally Stein, *Land Use Rights*, *supra* note 1, at 47–49.

79. See, e.g., Tudi Guanli Fa (土地管理法) [Land Administration Law] (promulgated by the Standing Comm. Nat’l People’s Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 1 (China) (describing purposes of law, including “protecting and developing land resources” and “making rational use of land”); *id.* art. 3 (stating that to “use land rationally . . . is China’s basic policy” and calling on government to plan uses of land accordingly); *id.* art. 17 (requiring “People’s governments at all levels [to] draw up overall plans for land utilization” to foster “national economic and social development”); *id.* art. 44 (requiring that certain formalities be met before agricultural land may be converted to other uses). See also Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat’l People’s Cong., July 5, 1994, effective Jan. 1, 1995), art. 24 (China) (“The development of real estate must be strictly subjected to the urban planning.”).

80. See Stein, *Land Use Rights*, *supra* note 1, at 15–17.

81. *Guanxi* refers to the complex web of personal and professional relationships enjoyed by two colleagues. “[T]he Chinese emphasis on relationships (*guanxi*) seems to have had a strength and durability for thousands of years that make it more powerful and pervasive than comparable Western emphases.” LUBMAN, *supra* note 9, at 304. “In China, rights and duties are contextual, depending on the relationship of individuals to each other, and each conflict must be addressed in terms of the alternative consequences with a view to finding a basis for cooperation and harmony.” *Id.* at 19 (internal citations omitted).

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Even in developments that are wholly or largely owned by private entities, the government may insist that the private developer provide infrastructure that is ancillary to the private developments. If a developer plans to construct a residential complex, it may be required to include the green space and parking for which its development will increase demand, rather than compelling the government and the public to bear the costs of externalities such as these. In booming regions such as Shanghai's Pudong New Area, a new project may be sufficiently profitable as a whole that a developer will jump at the chance to acquire land use rights despite significant and expensive government-imposed requirement that it build roads and sidewalks and install necessary utilities, or even construct off-site improvements with a more tenuous nexus to the new development. These requirements seem to resemble the rather standard exactions or impact fees that many American jurisdictions impose,⁸² but may display a considerably higher level of government intrusion.⁸³ Developments in urban areas also may require expensive and controversial relocations of current occupants and demolition of existing structures.⁸⁴ Such relocation and demolition may be undertaken by the government, the developer, or the two acting in concert.⁸⁵

82. For a brief overview of the law of exactions and impact fees, see ROBERT C. ELLICKSON & VICKI L. BEEN, *LAND USE CONTROLS: CASES AND MATERIALS* 634–35 (3d ed. 2005) (discussing exactions and describing the limits on exactions as “a central issue in land development law”). The authors provide greater detail on this topic at *id.* at 635–79.

83. See, e.g., Weiping Wu, *Urban Infrastructure and Financing in China*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 251, 259–60 (Yan Song & Chengri Ding eds., 2007) (discussing China's “infrastructure connection fee”).

84. Expropriation of private property for the public interest is authorized by both the Chinese Constitution and China's Property Rights Law, provided that the owner is compensated. XIANFA [Constitution] art. 10 (2004) (China) (“The state may in the public interest expropriate or take over land for its use in accordance with the law and provide compensation.”); Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), arts. 42, 148 (China) (similar provisions providing greater detail). Not surprisingly, the definition of “public interest” is no less controversial in China than it is in the United States. See *Kelo v. City of New London*, 545 U.S. 469 (2005).

85. A heavily publicized settlement of an expropriation claim occurred in Chongqing in 2007, after a lone couple held out for additional compensation while continuing to occupy their house in the middle of an otherwise fully excavated construction site. See “Nail House” in Chongqing Demolished, CHINA DAILY, Apr. 3, 2007, http://www.chinadaily.com.cn/china/2007-04/03/content_842221.htm (last visited Jul. 27, 2010). For a thorough analysis of the ongoing problem of holdouts under China's current property regime, see Chenglin Liu, *Informal Rules, Transaction Costs, and the Failure of*

The private development of land that is currently used for agricultural purposes is particularly problematic and will trigger even more intrusive government review and involvement. China's new Property Rights Law severely limits the ability to convert agricultural land to other uses, stating, "The State adopts special protection with regard to the agriculture land, strictly limiting the transfer of agriculture land to construction land so as to control the total quantity of the construction land."⁸⁶ The expropriation of "basic farmland" requires State Council approval.⁸⁷ The State has two primary concerns with loss of agricultural land. One is that the country will no longer be able to feed itself. More significantly, the government also worries about the social dislocation that loss of farmland might cause. "Since farming is their primary income source, quality of life for farmers depends on the amount and quality of land they own. Land acquisition (for urbanization, for instance) means that villagers lose farmland, which in turn reduces their economic well being."⁸⁸ Nonetheless, urbanization in China is inevitable, and other government land use policies encourage it.⁸⁹

the "Takings" Law in China, 29 HASTINGS INT'L & COMP. L. REV. 1 (2005); Stein, *Land Use Rights*, *supra* note 1, at 30–33.

86. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 43 (China). *See also* Tudi Guanli Fa (土地管理法) [Land Administration Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 4 (China.) (requiring that the State "rigidly restrict conversion of land for agriculture to land for construction" and "give special protection to cultivated land"); *id.* art. 18 (prohibiting "people's governments of provinces, autonomous regions and municipalities directly under the Central Government [from reducing] the total area of the cultivated land within their own administrative regions").

87. Tudi Guanli Fa (土地管理法) [Land Administration Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 45 (China). *See also* Erik Lichtenberg & Chengri Ding, *Assessing Farmland Protection Policy in China*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 101, 101 (Yan Song & Chengri Ding eds., 2007) (discussing Chinese government's concern about loss of farmland and describing failure of government measures introduced to stem these losses); *id.* at 107 (observing that "losses of cultivated area to urban uses have been concentrated in the most productive farming areas of the country"); George C.S. Lin & Samuel P.S. Ho, *China's Land Resources and Land Use Change*, in *EMERGING LAND AND HOUSING MARKETS IN CHINA* 89, 106 (Chengri Ding & Yan Song eds., 2005) ("The most striking feature separating recent land use change from the long-term trend since 1949 has been the net loss of large quantities of cultivated land.").

88. Xiaochen Meng & Yanru Li, *Urban Land Supply in the Chinese Transitional Economy: Case Studies in Beijing and Shenzhen*, in *EMERGING LAND AND HOUSING MARKETS IN CHINA* 125, 126 (Chengri Ding & Yan Song eds., 2005).

89. Robert Ash, *Managing China's Arable Land Resources in an Era of Sustainability*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID*

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All of this public involvement in private development can create difficulties for Chinese developers, conflicts of interest for local government officials, and problems for Chinese society more generally. Given how much money local governments earn from the sale of land use rights and how these governments have come to rely on developers for constructing essential infrastructure, there is great pressure to allow intensive development. “Driven by financing interest, local government forms a coalition with developers despite the fact that government is expected to supervise the real estate business and overcome market failure. Consequently, problems caused by the immature market are worsened by the coalition of power and money at the local level.”⁹⁰ Moreover, developers and local governments often prefer to expand at the urban fringe, regardless of whether this constitutes good urban planning. Such expansion displaces farmers and creates sprawl, but it is usually cheaper to pay compensation to displaced rural residents than to their urban counterparts.⁹¹

GROWTH 117, 139 (Yan Song & Chengri Ding eds., 2007) (“In the face of massive surplus farm labor, low agricultural labor productivity, and widespread rural poverty, accelerated urbanization has been a touchstone of China’s development strategy. There is no doubt that the process of urbanization will continue.”).

90. Tingwei Zhang, *Urban Development Patterns in China: New, Renewed, and Ignored Urban Spaces*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 3, 24 (Yan Song & Chengri Ding eds., 2007). The author notes that, despite central government interest in addressing these problems, local government officials often work to undercut these national policies. For example, Shanghai’s government lost an enormous amount of revenue when the central government implemented national policies in 2005 that were designed to slow the real estate market, and Shanghai quietly took steps to reverse these policies the following year. *Id.* at 24–25.

The same phenomenon is evident in villages and not just cities. “[L]and development undertaken by village committees can be understood as a set of strategies for strengthening local budgets” Michael Leaf, *Chengzhongcun: China’s Urbanizing Villages from Multiple Perspectives*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 169, 172 (Yan Song & Chengri Ding eds., 2007). Real estate development creates huge revenues for villages, and China’s many rapidly urbanizing villages need this income stream, both to build infrastructure and to provide entitlements to residents. *Id.*

91. See Gerrit Knaap & Xingshuo Zhao, *Smart Growth and Urbanization in China: Can an American Tonic Treat the Growing Pains of Asia?*, in *SMART URBAN GROWTH FOR CHINA* 11, 23 (Yan Song & Chengri Ding eds., 2009).

VI. CONSTRUCTION OF INFRASTRUCTURE

The previous Part described the quasi-public nature of some ostensibly private developments. Those projects, though, have a non-government interest holder that is using its real estate expertise to build something it wishes to build. The private developer presumably is motivated by the goal of turning a profit for itself. These developments are as private as current Chinese law and practice will allow.

The public developments on which this Part will focus, by contrast, have purposes that are purely or largely public. They are built at the government's behest, by the government or at the government's direction, for the benefit of the public, and with little or no profit motive. However, as this Part will demonstrate, even these ostensibly public development projects may have a quasi-private nature. They may be outsourced to private entities or otherwise have significant private components, further muddying the distinction between public and private in today's China.⁹²

The previous Part demonstrated that private projects in China involve substantial government intrusion. This Part, which examines public-private projects, will show that public infrastructure development undertakings may exhibit significant private influence and participation. Nonetheless, several of China's huge infrastructure projects of the past twenty years were undertaken largely by the government itself. This Part also examines some of these more traditional public projects.

Even when the government is building infrastructure on its own, it must find a funding source for these public developments. Local tax revenues are low, erratic, and unpredictable, given the absence of a

92. This "muddying" may be at least partly intentional, as China struggles to harmonize free market development with Communist principles. *See, e.g.*, Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 3 (China):

During the primary stage of socialism, the State shall adhere to the basic economic system, with public ownership playing a dominant role and diverse forms of ownership developing side by side. The State shall consolidate and develop unswervingly the public sector of the economy and at the same time encourage, support and guide the development of the non-public sectors of the economy.

Public-private partnerships of the type described in the text thus may reflect China's stated desire to merge socialist principles with the incentives that the desire to earn personal profit can create. *See generally* XIANFA [Constitution] pmb. (2004) (China) ("The basic task of the nation is to concentrate its efforts on socialist modernization by following the road of Chinese-style socialism.").

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broad-based *ad valorem* property tax.⁹³ Government entities need a more reliable funding source, and they depend on banks to supply much of the capital for infrastructure projects. Chinese banks lend to the government with a high degree of comfort that the government will repay these loans.⁹⁴ The banks are government-controlled entities to begin with, and they rely, in essence, on the full faith and credit of the Chinese government.

Although Chinese government entities that wish to build infrastructure are beginning to have access to capital markets, the government—particularly at the local level—more commonly borrows directly from domestic banks. The government later repays these loans from two funding sources: sales of land use rights, and revenues from user fees generated by the infrastructure project, such as subway fares and highway tolls.⁹⁵ When a local government entity conveys land use rights, the central government receives 30% of the funds the sale generates while the local government retains the remaining 70%.⁹⁶ The local government's

93. “[The] system does not now adequately stimulate own-resources (such as the property tax), while relying heavily on central revenues for local spending purposes.” Randall Crane, *Public Finance Challenges for Chinese Urban Development*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 238, 246 (Yan Song & Chengri Ding eds. 2007). Moreover, real estate transactions are taxed but real estate holdings are not, making municipal revenue streams erratic. Chengri Ding & Yan Song, *Property Tax for Sustainable Urban Development*, in *SMART URBAN GROWTH FOR CHINA* 57, 59 (Yan Song & Chengri Ding eds. 2009). As a result, “under the current taxation system, the revenue share for local governments is not commensurate with their responsibilities, such as providing major capital improvements and other local public goods for urban expansion.” *Id.* at 61.

94. Some of this lender confidence may be misplaced. See, e.g., Andreea Papuc, *China's Banks Said to See Risks in Loans*, BLOOMBERG NEWS, Jul. 23, 2010, <http://www.bloomberg.com/news/2010-07-23/china-banks-said-to-see-risks-in-23-of-1-1-trillion-public-project-loans.html> (last visited Jul. 27, 2010) (noting that “Chinese banks may struggle to recoup about 23 percent of the 7.7 trillion yuan (\$1.1 trillion) they've lent to finance local government infrastructure projects). But see Henry Sanderson, *China Regulators, Officials Aim to Ease Local Finance Vehicle Loan Concern*, BLOOMBERG NEWS, Jul. 27, 2010, <http://www.bloomberg.com/news/2010-07-27/china-regulators-officials-aim-to-ease-local-finance-vehicle-loan-concern.html> (last visited Jul. 27, 2010) (suggesting that collateral and guarantees provided in connection with these loans provide adequate backing).

95. See generally Weiping Wu, *Urban Infrastructure and Financing in China*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 251, 257–62 (Yan Song & Chengri Ding eds., 2007) (discussing financing sources for infrastructure projects).

96. Tudi Guanli Fa (土地管理法) [Land Administration Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29,

desire to fund infrastructure projects is often the primary motive for the government's sale of the land use rights in the first place. Investment in infrastructure, in turn, makes additional urban land available for development and increases its value.⁹⁷

This allocation of the proceeds of the sale of land use rights creates additional incentives for local governments to maintain high property values and sell off land use rights quickly.⁹⁸ The hotter the local real estate market, the more valuable the rights to the land; the quicker the local government sells off these valuable assets, the more rapidly it generates funds for capital construction. These infrastructure projects then fuel further price acceleration for local real estate. In fact, one academic advised me that the modern Chinese land use right evolved as the government initially sought a way to raise funds to invest in infrastructure. The government needed money for public projects and concluded that it could transfer the right to develop land that it controlled and then invest the proceeds generated by these transfers in public works.

Just as private projects in China inherently have a public element to them under Chinese law, custom, and practice,⁹⁹ public projects also can

1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 55 (2004) (China). This Article does go on to provide that both portions of the payment must be used exclusively "for developing cultivated land." By contrast, note that a provision of the Law on the Administration of Urban Real Estate requires that "[a]ll the fees for granting the land-use right shall be turned over to the State Treasury and incorporated into the budget so as to be used for the construction of urban infrastructure and for land development." Chengshi Fangdichan Guanli Fa (城市房地产管理法) [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 18 (China) (emphasis added). To the extent that the former provision applies to urban infrastructure projects at all, the people with whom I spoke gave no indication that it actually is being complied with. But even if this provision does apply and is being followed, the use of these funds for the purposes specifically enumerated in Article 55 would free up other funds that might otherwise have been dedicated to these purposes, so that they can be used for other important governmental purposes, including infrastructure development.

97. See Anthony Gar-on Yeh, *The Dual Land Market and Urban Development in China*, in EMERGING LAND AND HOUSING MARKETS IN CHINA 39, 45 (Chengri Ding & Yan Song eds., 2005) ("Land-related revenue is used to improve urban infrastructure, which in turn can improve accessibility and open up new land for development. This process increases land value, which then increases government revenue, providing further capital for building more infrastructure.")

98. "The revenue-sharing agreement between the local and central governments is blamed for problems such as chaotic and uncoordinated development. . . . Local government officials, interested in raising revenue, sell land use rights beyond the level of municipal need. . . . These overzealous practices yield profound, negative, long-term consequences." Chengri Ding & Gerrit Knaap, *Urban Land Policy Reform in China's Transitional Economy*, in EMERGING LAND AND HOUSING MARKETS IN CHINA 9, 23 (Chengri Ding & Yan Song eds., 2005).

99. See *supra* Part V.

have significant private attributes and components. Even a powerful and monolithic government such as China's has needed to enlist the budding private sector to ensure the success of huge public projects such as the ones described later in this Part.¹⁰⁰ For example, the government afforded sizable tax breaks to domestic and foreign private companies that located in Special Economic Zones (SEZs). When it wished to encourage the development of Shanghai's Pudong New Area, for example, it reduced the income tax that businesses that located in Pudong would have to pay to just 15%, as compared to 33% elsewhere in Shanghai.

The government sometimes uses its strength to provide more forceful inducements than these. When the government decreed that the Lujiazui district in Pudong was going to become Shanghai's financial center, it increased the likelihood that this project would succeed by granting business licenses to foreign banks that wished to open new offices in Shanghai only if they located in Lujiazui. Similarly, proprietors of international schools were advised that they would receive licenses to operate only in Pudong, further increasing the likelihood that foreign businesses would choose to place their offices in this new area.

Rather than building infrastructure itself, the government may outsource this traditionally public function to private entities, including overseas investors.¹⁰¹ China has authorized private entities to build some projects of this nature, such as toll roads; operate these projects for twenty or thirty years to recoup their costs and earn a reasonable profit; and then transfer control of the project back to the government at the end of this recoupment period.¹⁰² This Build-Operate-Transfer (BOT) structure, seen most often in developing nations, is also used occasionally in the West. For example, Toronto recently financed construction of a new airport terminal by structuring it as a BOT.

BOTs shift the initial construction costs to the private developer, along with some of the risk that project revenues will not cover the cost of construction debt service. They also defer the government's ability to

100. See *infra* notes 101–102 and accompanying text.

101. See Yeh, *supra* note 97, at 51–52 (Chengri Ding & Yan Song eds., 2005) (noting the increasing prevalence of Build-Operate-Transfer projects in China and the ability of this mechanism to attract foreign infrastructure investment).

102. Article 67 of the Property Rights Law implies that the government may enter into transactions of this type. Wuquan Fa (物权法) [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 67 (China).

collect the full revenues that the project generates and require the government to relinquish some control over the project for the duration of the BOT period. The private developer bears whatever share of the upside and downside construction and operational risk that is set forth in the parties' written agreement, while the government can remove the cost of constructing the project from its books.

Public-private partnerships are relatively new to China and do not always proceed seamlessly. In addition, there may be limits on the extent to which government bodies and private entities can work together at all. For example, Shanghai has established a modern subway system from scratch in little more than fifteen years. Nonetheless, the placement of subway stations and the rail linkages to above-ground developments appear haphazard:

Current regulations prevent the transit agency from involvement in property development above the ground. Therefore, there is no incentive for the transit agency to consider land use beyond its right-of-way. More often than not, the rail transit station and its neighboring land uses are simply adjacent to each other. There is lack of synergy and integration among them.¹⁰³

The many layers of Chinese bureaucracy, such as those exhibited by Shanghai, contribute to this problem. Mixed-use, public-private projects do not currently "fit into any existing categories for development evaluation and building permit approval"¹⁰⁴ and, in fact, are not currently permitted under Shanghai's regulations.¹⁰⁵ Public-private partnerships may be able to contribute positively to harmonious uses of land and successful development of infrastructure, but China seems not to be taking maximum advantage of this development and financing technique.

I was also told of cases in which the government induced a private developer to build a public project that was not likely to generate sufficient revenues for the developer to recoup its costs. The government typically persuaded the developer to undertake this project by promising the developer, either publicly or privately, that it would provide the developer with some other source of revenue that would more than offset development losses on the designated project. For example, the developer might construct a subway station that the government needed,

103. Ming Zhang, *Value Capture Through Integrated Land Use-Transit Development: Experience from Hong Kong, Taipei, and Shanghai*, in *URBANIZATION IN CHINA: CRITICAL ISSUES IN AN ERA OF RAPID GROWTH* 29, 40 (Yan Song & Chengri Ding eds., 2007). The author, comparing Shanghai's efforts in these areas to those in Hong Kong and Taipei, calls the Shanghai example "primitive." *Id.* at 39.

104. *Id.* at 42.

105. *Id.* at 43.

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despite the fact that the developer would not profit from the project, in exchange for receiving valuable land use rights adjacent to the station.¹⁰⁶ In some ways, these are just unusual public-private partnerships, in which the money-losing infrastructure project is coupled with an unrelated venture that serves as an inducement to the private developer. But the examples that were described to me were not negotiated openly, and it is not clear whether they actually were permissible under applicable laws.

By building its own projects in specific areas and creating muscular incentives for the private sector to do the same, the government seeks to channel development exactly where it wants it. Several experts told me that the government even subsidized the cost of residential land use rights in Pudong before the area became attractive to residents, essentially paying people to move into a new section of the city that the government desperately wanted to succeed. This combination of strong public action and guided private choice is common in China's modern era of redevelopment.

Huge, high-profile infrastructure projects have become the norm in China, as each generation of Communist Party leaders tries to leave its mark on the nation, just as emperors did during dynasties past. These projects typically involve significant investment by the private sector, catalyzed by government incentives. The government jump-started China's recent economic boom by creating a small number of SEZs and using tax breaks and other economic incentives to encourage private investment. One of the most striking of these is the city of Shenzhen, located just across the border from Hong Kong, which was designated as the first SEZ in 1979. Shenzhen grew from a small rural village with 20,000 residents to a modern city of approximately eight million people in just three decades.¹⁰⁷ Initially, the government designated four cities and one province as SEZs, adding many more as the experiment proved successful.

106. Behavior such as this by Chinese authorities bears some resemblance to the impact fees and exactions imposed by some jurisdictions in the United States. *Cf. supra* notes 82–83 and accompanying text (discussing how requirements such as these resemble American exactions).

107. Note that some of this population growth is due to a significant expansion of the geographical area of the city. For a discussion of the nearby SEZ city of Dongguan, with a recent history much like that of Shenzhen, see LESLIE T. CHANG, *FACTORY GIRLS* 17–43 (2008) (describing city from perspective of migrant women who work in Dongguan's factories).

On April 18, 1990, the government proclaimed Shanghai's Pudong New Area project, to be built in the sparsely populated eastern portion of Shanghai municipality, across the Huangpu River from Shanghai proper. Fifteen years later, 2.7 million people lived in Pudong. In that short span, the government had built and catalyzed the construction of a city the size of Chicago directly across the river from the existing city of Shanghai. Government construction of infrastructure came first, with private development following fairly quickly. The government also made strong efforts to encourage foreigners with needed talents to relocate to Pudong, particularly overseas Chinese living in Hong Kong, Taiwan, and the West. Domestic Chinese with similar talents were heavily recruited to Pudong as well. One Western lawyer summarized the government's top-down approach to projects of this type as "Let There Be Pudong!"

Pudong continues to boom. Pudong International Airport opened in 1999; shortly thereafter, the government ordered all international carriers to fly only to Pudong, rather than to the older and more centrally located Hongqiao Airport.¹⁰⁸ The Asia-Pacific Economic Cooperation annual meeting was held in Pudong in 2001. China's first magnetic levitation train began operation early in 2004, with trains from Pudong Airport reaching speeds of 270 miles per hour. The site of the 2010 World Expo straddles the Huangpu River, with about three-quarters of the land area of the Expo located in Pudong and the remainder of the site located in the older Puxi section of Shanghai.

One of the exhibits in Shanghai's Planning Museum does an outstanding job of summarizing the approach cities such as Shanghai have taken toward the modernization process. Although the language of the exhibit legend would seem out of place as the description of any Western democracy's efforts to upgrade its facilities, in China it serves as a fitting summary of the government's effort to rally public support for a major nationwide public endeavor. The exhibit describes Shanghai's overall credo as follows:

[W]e will make [a] great effort to develop various social undertakings, strengthen the construction of socialist spiritual civilization, constantly make innovations of spiritual civilization, satisfy the people's increasing demand for spiritual culture, and raise the overall quality of the citizens and the civilization development of the city, so as to provide incentive [sic] for Shanghai's modernization drive.

108. As part of the tourism upswing expected in connection with the 2010 World Expo, some international service was restored to the newly renovated Hongqiao.

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VII. CONCLUSION

Chinese real estate development during the past three decades truly has been astonishing, and all the more so because most of it occurred in a nation with no formal real estate law. Thus, entrepreneurial Chinese have been forced to invest and develop with no certainty as to how their private arrangements would be enforced in the event of disagreements. Anxious to increase standards of living, the government has allowed such informal arrangements to proceed. Often, structures that have developed quickly through trial and error become the blueprints for the formal laws to follow, perhaps persuading the government that there is strong public support for laws that might otherwise have been viewed as contrary to socialist dogma.

This Article has attempted to show how real estate professionals in China have been functioning in this vibrant but uncertain legal world. Through a combination of resourcefulness, willingness to experiment, tolerance for risk, and desire for material wealth, they have shaped a unique real estate system. It shares some elements of the Western systems with which Americans are familiar, others that are derived from Chinese history and culture, and still others that these entrepreneurs have invented on the fly as their legal system matures rapidly.

The participants in this huge and rapidly evolving system—who are writing and rewriting the rules on a daily basis—are more focused on pursuing their own projects than on authoring academic articles or treatises about recent changes in Chinese real estate law. As a result, it is difficult to get an accurate picture of the modern Chinese real estate market from published sources. The willingness of these actors to speak with me has helped to open a window onto this new and uniquely Chinese real estate market.

