

## **Risk Prevention and Control in Primary Land Development Operations**

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The participation by private companies in primary land development activities has become a common method of investment in the real estate industry. The rules in this area, however, are incomplete, and the various local practices and legal theories are diverse.

Primary land development refers to those land development activities that are organized by the relevant government agency responsible for the administration of land development in accordance with the requirements of the relevant urban plan and civil infrastructure so as to meet the standard preconditions for a land grant, including the payment of compensation for the expropriation of the land, the removal and resettlement of existing land users, land levelling and the construction of municipal infrastructure and public facilities.

### **Legal and Policy Risks**

Currently, the laws and regulations that directly regulate primary land development activities are incomplete. In accordance with the *Measures for the Administration of Land Reserves*, a land reserve centre or development zone management committee responsible for the administration of a land reserve is a government agency or quasi-governmental institution. In practice such government agencies often entrust private companies to complete the primary land development on a for-profit basis. The legal relationship between the enterprise and the government agency, therefore, conforms to the relationship between the parties to an entrustment contract. In accordance with the basic features of such relationship, the enterprise is obligated to carry out the entrusted matters in accordance with the requirements of the contract and the applicable standards, while the government agency is obligated to inspect the primary land development activities and compensate the enterprise.

There are two common profit-making methods for a private enterprise to engage in primary land development: the basic revenue method and the floating revenue method. The basic revenue method involves payment of the stipulated compensation for the primary land development, plus bank interest for development activities conducted pursuant to cash advances made by the enterprise. In contrast, under the floating revenue method the enterprise obtains a share in the difference between the revenue generated by the land grant and the pre-agreed benchmark price for the land.

The activities of the parties using the basic revenue method meet the basic requirements under the relevant laws and regulations. By reference to a relevant interpretation of the Supreme People's Court, an enterprise that makes cash advances and collects bank interest also complies with the basic spirit of the law.

According to local policy in many regions of China, enterprises are encouraged to attract privately sourced funds and engage in primary land development activities, but there appears to be no legal basis for an enterprise to participate in primary land development using the floating revenue method. For example, under the provisions of the *Interim Measures of Beijing Municipality on Land Reserves and Primary Land Development*, the profit rate for an enterprise that engages in fundraising activities in regard to primary land development may not exceed 8% of the estimated cost. This provision indicates that the fundraising activities of such an enterprise are deemed to be cash advances, as opposed to investments, by the enterprise.

Moreover, according to the *Circular on Standardizing the Administration of Revenues and Expenditures in the Grant of State-owned Land Use Rights*, issued by the General Office of the State Council, the revenue from a land grant must be paid in full to the local treasury, and the local land reserve institution has no right to dispose of such revenue without authorization. Therefore, certain legal and policy risks exist for an enterprise that engages in primary land development activities in exchange for a share of land grant revenue.

In practice, however, the most common mode of operation is for an enterprise to participate in primary land development by assuming investment risks and responsibility for the management of the primary land development. In return, the enterprise obtains investment revenue commensurate to its assumed risks. Enterprises that engage in primary land development using the floating revenue method should be aware of the relevant issues and should actively seek counsel on the most prudent means of protecting their legal rights and interests.

### **Limiting the Risks**

Considering that the laws and regulations regarding investment by enterprises in primary land development are incomplete, it is especially important to limit the enterprise's risks during the investment process. Based on the circumstances we have encountered in previous projects, the key points are as follows:

Firstly, in accordance with the *Decision of the State Council on Reforming the Investment System*, construction projects funded by the government and infrastructure construction projects are subject to examination and approval. In addition, the project must satisfy the requirements related to the scale and quota for construction land.

Secondly, the enterprise's legal rights in regard to a primary land development must be determined in accordance with law. Pursuant to the principles set forth in the *Bidding Law of the People's Republic of China*, the successful bidder in all projects involving municipal construction or using state funds must be determined by means of a tender. Accordingly, enterprises that acquire specific primary land development projects are subject to the public tender requirements. Where a primary land development project is not acquired by tender, an enterprise would be well advised to obtain written approval or consent from the land reserve institution (or meeting minutes that indicate the determination of the status of the primary land development, the main principles for cooperation and so on) to reduce the legal risks regarding its primary land development activities.

In addition, we suggest that an enterprise engaged in primary land development should consider applying for qualification as a general contractor, so that it is legally permitted to accept the entrusted project and to subcontract certain specific parts of the project to third parties.

Finally, to reduce the risks related to the enterprise's investment, the enterprise should include receipt of all necessary government approvals and consents regarding the determination of certain key matters (including the status and content of the primary land development, the method of cooperation, the mode of investment revenue and any fund guarantees) as conditions precedent to its capital contribution obligations.

Before implementing a primary land development project, efforts should be made to include the revenue sharing and distribution items into the budget of the local fund so as to guarantee the security of the investment funds and the investment revenue. An enterprise also may cause the development funds to be paid through an entrusted loan from an authorized financial institution and thereby improve the security of the funds. Under mature conditions, we also recommend exploring the modes of raw land grant and reserved land-backed finance to ensure the security of the invested funds. Following completion, examination and acceptance and settlement of the primary land development project, audit procedures must be carried out in accordance with the relevant regulations.

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