

Following the Bouncing Regulatory Ball

Lessons Learned from a Construction Defect Dispute

Terence Wong and Conlyn Chan, Lovells Shanghai

As in other jurisdictions, companies doing business in China expect their operations to be profitable. The commercial reality, however, is that the market in China operates within a developing legal environment. By failing to vigilantly monitor regulatory changes, even the most carefully planned projects can become unprofitable.

Recently, the Lovells Construction Group was retained on a matter involving structural defects in an industrial facility. The client ("Buyer") purchased the property last year and expected to use the building to expand its electrical appliance manufacturing operations. A year later, the client's operations are stalled because it discovered the structural defects.

The seller ("Seller") was a company with a strong local presence and a well established distribution network. After learning of Seller's identity, Buyer became enamoured with the idea of purchasing the property from Seller and simultaneously developing an important business relationship with a strong local company. Shortly thereafter, Buyer entered into a contract with Seller to purchase the property.

Legal Issues and Potential Liabilities

All industrial structures in China are subject to load code regulations to ensure structural safety. There are two relevant load codes. The first is the Load Code for the Design of Building Structures GBJ9-87 ("Old Load Code"), which became effective on 1 July 1988. The Old Load Code was subsequently replaced by the Load Code for the Design of Building Structures GB50009-2001 ("New Load Code"), which came into effect on 1 March 2002. The *Notice on Enforcing Construction Project Investigation and Design and Construction Quality Acceptance Inspection* ("Notice"), issued by the Ministry of Construction on 12 August 2002, explained how to handle the transition from the Old Load Code to the New Load Code.

According to the Notice, construction works begun before 1 March 2002 are subject to the Old Load Code, while works begun after 1 January 2003 are subject to the New Load Code. The construction of the Property was completed in January of 2002 (i.e., before the effective date of the New Load Code). Hence, based on the provisions of the Notice, the Old Load Code governs the property, not the New Load Code.

To produce its large scale electrical appliances, Buyer planned to join three of the eight production halls it had purchased from Seller to create one large scale production hall. Before Buyer began the work on the building, it hired a structural engineer to conduct a review on the structural safety of the building in regard to Buyer's proposed changes. Upon receipt of the engineer's report ("Engineer's Report") Buyer discovered the defects to the property. According to the Engineer's Report, the snow load and live load of the property were in compliance with the Old Load Code, but they did not meet the requirements under the New Load Code.

To confirm the Engineer's Report, Buyer entrusted a quasi-government entity ("QG") to conduct another structural safety inspection of the property. The QG issued a report ("QG Report"), which agreed with Engineer's Report and confirmed the presence of the structural defects. In addition, the QG Report pointed out that the bearing capacity of the structure met the former requirements but did not meet the current requirements.

In an explanation of the QG's application of the New Load Code, it stated that it interpreted "current" to refer to the latest standards, rather than the standards that were current at the time the property was built (which is the view supported by the Notice). It reasoned that by using the most up-to-date standards, the QG can better ensure the safety of the building.

Reinforcement Work and the Responsible Party

The QG Report indicated that the property should not be used until proper reinforcement measures were adopted to remedy the defects. The major issue then became which party was responsible for the costs of incorporating the reinforcements. Based on the Contract Law, the responsibility for compliance with the regulations depended on the date the transfer occurred. If the New Load Code came into effect before the date of the transfer, the Seller would be responsible. In this case, the New Load Code came into effect in 2002, five years before the date of the transfer. Therefore, under a strict interpretation of the Contract Law the Seller was responsible to ensure compliance with the New Load Code when it sold the building to Buyer.

Despite Seller's apparent liability at the time of the transfer, however, Buyer also had its own legal obligations to carry out the reinforcement work. For example, Buyer was obligated as the owner / operator of the property to ensure its safety for the persons who work on or otherwise enter the property.

Lessons Learned

Buyer could have improved its situation if it had taken the time to investigate the property before deciding to purchase it. It is relatively easy to determine the structural type (concrete or masonry) of the property, the correct jurisdiction in which the property is located, and the regulations applicable to the property in such jurisdiction. Understanding the applicable jurisdiction is especially important for real estate transactions in China because different jurisdictions often apply different rules or interpret the same rules differently.

Though it is not mandatory to conduct a defect survey before purchasing real property, it can give a buyer peace of mind and save a would-be purchaser from future legal issues. If Buyer had conducted a defect survey before it purchased the property, it would have become aware of the defects and it could have adjusted the purchase price to account for the cost of incorporating the reinforcements.

Purchasing a property is an expensive exercise with no guarantee of success. However, the chances of success can be significantly improved by keeping to a focused and disciplined set of criteria and walking away from a deal that does not meet the criteria. In our example, Buyer may have overlooked some of the warning signs because of the possibility of developing a business relationship with a strong local company. As a result, Buyer lost a year's worth of production and incurred additional costs.

The regulations and construction standards frequently change in China. As an owner or operator of property, a company must be proactive in monitoring regulatory developments and may wish to assign a competent and dedicated person to maintain vigilance in protecting against these risks.

Terence Wong is a Consultant in Lovells LLP's Shanghai office. Mr Wong's practice is dedicated solely to providing comprehensive legal services in the real estate and construction industries. He regularly advises clients on real property transactions, the property development approvals process, the licensing and regulatory requirements applicable to companies involved in the property development industry, contract management planning and operations and construction dispute resolution. Mr. Wong is a member of the LEVY construction industry training group, a member of the Chartered Institute of Arbitrators (East Asia Branch) and an honorary legal counsel of the American Association of Civil Engineers (Hong Kong Branch). Mr. Wong can be contacted at terence.wong@lovells.com.

This publication is provided for your information and interest only. It is not intended to be comprehensive, and it does not constitute and is not to be relied on as legal advice. You should seek specific advice tailored to your circumstances.