



Real Estate Investment in China

THE LEGAL PERSPECTIVE

Introduction

Chinese real estate market had developed rapidly in the past decades, however, due to home-purchase restrictions on existing homeowners aimed at suppressing speculative home purchases, the market had encountered the downturn since 2014, which was later exacerbated by a slowdown of the economy and correspondingly influenced the economy and increases the local governments' risk accumulation. Under such background, the state issued a series stimulating policies, which lead to the recovery of the real estate market in Tier 1 and 2 cities as well as the significant gap against Tier 3 and 4 cities, due to the territorialisation.

For the purpose of healthy and balanced development of Chinese real estate market, and to prevent the burst of the potential assets bubble, since late 2016, dozens of local governments have passed or expanded restrictions on house purchases and increased the minimum down payment required for a mortgage, and the government also moved to

contain leverage and risk in the financial system to relatively tighten the liquidity conditions, which result in the capital overflow from the market of Tier 1 and 2 cities to Tier 3 and 4 cities.

Due to the continued tightening policies in different cities, the market has gradually changed in the past two years, and the sales and price have dropped obviously. In particular, the first-tier cities have ended the robust increase, with slightly change or stay flat on MoM and YoY growth. In 2018, the sales prices of residential house in first-tier cities tends to be stable, second-tier cities declined, and the upward momentum of third-tier cities was suppressed.

Required by the local government, and demand for upgrading the land use for development needs, property developers have rapidly transitioned to develop large-scale multi-function complex with commercial, tourism, and industrial building, this will become a new market niche.

As the return on property assets continues to decline and rental housing to be encouraged by central government under the background of "Houses are for living in, not for speculation", large property developers had speed up their transition to light asset operations. Innovative financing methods such as asset securitization have become the inherent needs of new property development.

While the overall Chinese real estate market is entering a new round of adjustment. The government has continuously introduced macro control policies on property market and strengthened supervision over real estate development loans, aiming to curb leverage and real estate bubbles and promote the positive development of the industry. With this round of adjustment, the Chinese real estate market will continue to transform and upgrade.



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1. Ownership of real estate

1.1 Granted land use right

In the PRC, a legal person including a company cannot technically own land as land is either owned by the State or peasants' collectives. State-owned land mainly consists of land of urban areas. Collectively-owned land consists mainly of land in the rural and suburban areas. While state-owned land may be used for various purposes, collectively-owned land is usually contracted to individual families or the village collectively for agricultural purposes.

PRC land laws provide for a land administration system that confers specific types of land use rights over State-owned land and collectively-owned land to individuals or entities in accordance with procedures prescribed under law. Generally, land use rights include the rights

to possess, use and receive any revenue generated from the land as well as the right to dispose of such rights.

Most real estate projects are developed on State-owned land in urban areas. There are three different types of land use rights which can be obtained from the State. The most relevant type of land use right to real estate investors is the Granted Land Use Right. Other types of land use rights ("Allocated Land Use Rights" and "Leased Land Use Rights" are only granted in limited circumstances and are not as freely transferable. For instance, Allocated Land Use Rights are only granted to public sector entities following approval by the government as it is a right to use land for free and without a time limit. This right can usually only be

transferred if it is converted into a Granted Land Use Right and a user fee paid to the State. Leased Land Use Rights are usually granted for temporary use of the land only.

Granted Land Use Rights are granted to the initial user by the State for a fee and for a fixed period of time with certain conditions attached, for example, requirements as to the use and the timetable for development. Where a site is used for development purposes, Granted Land Use Rights are usually granted in accordance with the government's strategic economic and social development plans.

Below is a summary of the maximum term for each land usage of the Granted Land Use Rights according to PRC land law.

PURPOSE OF LAND USE	MAXIMUM TERM
Residential	70 years
Industrial	50 years
Education, science, culture, public health and sports	50 years
Commercial, tourism and entertainment	40 years
Comprehensive development	50 years

Under the PRC Property Law, the term of the Granted Land Use Rights for residential property will be extended automatically, whereas the term for other types of property will be extended if the applicant submits the renewal application no later than one year prior to expiry of the term.

Since the current PRC land administration system that allows granting and transferring land use rights was not established

until the 1990s, there is no live case how the land authority would determine the rights and procedure for extension of the tenor and the amount of land grant fee for the extended period which is likely to be determined by the State in delegated legislation at a later stage. It is the general market understanding that:

(a) for residential properties, renewal is automatic and land grant fee would most likely be waived

or charged at a nominal level that is affordable by most of the home owners given that this would affect vast majority of people and peaceful transition is what government would need to achieve;

(b) for non-residential properties, except for public interest reasons, renewal would be approved by application as of right subject to renewal fee being paid. This rights are also often stated in the land grant contract as a contractual obligations

of the State. It is generally understood that the State would not easily invoke public interests to object to a renewal application since the State would otherwise have to compensate the owner of the building based on the residual value of the buildings. Renewal fee will likely be discounted benchmark fee (which is substantially lower than the market price) or discounted market price. On one hand, the level of discount to be applied matters to the State as land revenue is traditionally the major revenue of the State, but on the other hand, it also matters to the State to ensure a peaceful transition. So the State will need to consider very carefully to achieve a balance. No one can anticipate how the calculation formula of the renewal fee will be introduced.

There were limited examples of renewal of tenor of the Granted Land Use Rights in certain cities due to historical reasons. During the 1980s to the 1990s, some local governments (such as Shenzhen) granted the non-residential land use rights for only 10 or 20 years in order to reduce the land cost to attract investors. Shenzhen promulgated a local regulation (深圳市到期房地产续期若干规定) in 2004, pursuant to which such short-term non-residential land use rights may be renewed for a period equal to the difference between 40 years and the period already elapsed during such short term land use rights subject to payment of 35% of the applicable benchmark land price. It is generally understood that the way Shenzhen was dealing with the special situation did not serve as a reference case for future renewal under normal circumstances.

PRC land laws require the owners of the Granted Land Use Rights to register the rights with the relevant property registration authority and to obtain a real estate rights certificate. Title insurance has traditionally not been necessary in the PRC because any title or encumbrance on such Granted Land Use Rights must be registered for them to become valid and effective and therefore the registration information over such Granted Land Use Rights will be conclusive evidence of the title and encumbrance on such Granted Land Use Rights.

1.2 Forms of building ownership

PRC law permits ownership in buildings and other structures over land. Building ownership can be sold, transferred, leased or mortgaged. Similar to land use rights, registration of building ownership is the best evidence of title under the law. A real estate right certificate is issued in respect of building ownership following the completion of construction or transfer of building ownership.

As a general principle, the ownership of land use rights and any building located on the land to which such land use rights relate are registered in the name of the same person.

In the case of unit owners of office buildings or apartments, the unit owners also own an equivalent amount of land use rights in proportion to their unit holding although no separate land use rights certificate will be issued in their respective names. Each unit is owned by the respective owner in his own capacity independent from other unit owners.

The common areas and the building as a whole are collectively owned and should be managed and maintained for the common benefit of all unit owners. Accordingly, each unit owner is deemed to have collective interest in the common area and such interest is a right to use and benefit rather than a right to possession. The function of common area is to be determined by laws and by the owners' association.

1.3 Foreign ownership of real estate in the PRC

Prior to 2007, foreign entities or individuals are not subject to any restrictions or limitations on the acquisition and ownership of real property in the PRC. However, since the coming into effect of a series of cooling-down practice rules on foreign investment in real estate market, any foreign company or individual that intends to purchase property in the PRC for purposes other than its own use must establish a business presence in the PRC.

In addition, the principle of business presence would also mean that each company is only allowed to hold and operate one property since the tax authority would require to see business presence in each location where properties are located.

Given the restrictions on direct foreign ownership, it becomes increasingly popular (and in most cases necessary) for foreign real estate investors to set up special-purpose vehicles (SPV) offshore, which in turn incorporate or acquire an onshore (PRC) real estate enterprise (FIREE) to purchase and hold real property in the PRC,

which FIREE is regulated by the PRC Foreign Investment Law which has taken effect from 1 January 2020.

In addition, one FIREE can only acquire or hold one particular real property (either development or operation), and cannot acquire or hold multiple real properties unless such multiple real properties were developed on the same piece of land acquired from land authority.

Traditionally, the establishment and changes of FIREEs were subject to an approval of the competent Ministry of Commerce (MOFCOM) prior to the registration with the competent company registry (i.e. State Administration of Market Supervision). Since 1 October 2016, foreign investment projects (like real estate projects) which are not falling under the so-called foreign investment negative list have been changed to the MOFCOM online filing regime which is operated as a formality procedure and should be done either before or after the registration with the company registry depending on local practice.

Please note that, according to the PRC Foreign Investment Law which has become effective since 1 January 2020, the MOFCOM will conduct supervision to the foreign invested entities which is not subject to the special access administrative measures by way of reviewing the online information report submitted by such entities, and therefore the MOFCOM filing formalities are under transformation city by city and/or province by province. For Shanghai, instead of MOFCOM filing, FIREE established after 1 January 2020 will only need to submit an information report containing the fundamental information of the entity, investor's

or shareholder's information and the deal related information (if any) to MOFCOM via a newly built online enterprise registration system (网上企业登记系统). The alternation and deregistration of the FIREE (no matter when it was incorporated) occurs after 1 January 2020 shall apply to the same approach. In addition, the FIREE is requested to submit its annual report via such online system for MOFCOM's routine monitoring.

Each PRC incorporated company will be issued by the company registry, upon its due incorporation, with a business license which shows an identity number of such company, the registered business scope, the registered business address, the registered capital, the operation term and the legal representative of such company.

Each PRC incorporated company is required to have the committed capital subscribed by its shareholder(s) registered with company registry in the name of the "registered capital". Since 1 March 2014, the timely contribution of the registered capital of a company in compliance with applicable law is no longer a regulatory requirement and the timetable to contribute the registered capital can be decided by its shareholder and stipulated under the company's articles of association. Although a PRC company is incorporated in the form of a limited liability company, under the PRC Company Law, a shareholder should still be liable to the company's liabilities up to the unpaid amount of the registered capital it subscribed for even though the contribution schedule may not yet be due under the company's articles of association

and those claims may be initiated by the company itself, the other shareholder(s) of the company, the creditors of the company, or the administrator of the company in a bankruptcy procedure. A good way to ring-fence the risk is to ensure that the shareholder of the PRC incorporated company is also a limited liability company based on the laws of its incorporation without substance.

A PRC incorporated company is only allowed to carry out business within its registered business scope, which is set out in its articles of association and the business license. The shareholder(s) of a PRC incorporated company has autonomy to choose the business lines it wishes for the company to engage in and dictate the wordings of its business scope, subject to the obtaining of special approval for restricted industries (if any) or subject to the compliance with foreign investment guidelines (real estate sector is not among the industries that are restricted to foreign investment). A company engaging in business activities beyond its registered business scope, especially those subject to special approvals and permits, will be subject to penalties or even the suspension of business license.

A PRC incorporated company is also required to prepare its articles of association on its own volition and have it filed with the company registry. Such filing is for recording purposes only as long as nothing therein goes against the laws of the PRC. In case of a PRC incorporated company with more than one shareholder, a shareholders' agreement may be required to document the privately negotiated

commercial arrangements among the shareholders which is not required to be filed with the company registry.

The management and operation of a PRC incorporated company shall be carried out in accordance with the PRC law and its articles of association. As the result of the promulgation of the PRC Foreign Investment Law, corporate governance mechanism as set out in the PRC Company Law which used to govern domestic companies will equally be applicable to the FIREEs. Generally, day-to-day operation of such company is controlled solely by its management with the highest authority being its shareholder(s). The shareholder(s) will appoint (i) one certain individual as the executive director or no less than 3 individuals to form a

board of directors, which will act as the execution authority and be responsible for the shareholder(s); and (ii) 1-2 individuals as the supervisor(s) or no less than 3 individuals to form a board of supervisors, which is responsible to safeguard and supervise the operation of the company and exercise supervision over the work of directors and senior managements. The executive director or the board of directors will further appoint an individual as the general manager to take the responsibility for the daily operation. In a PRC incorporated company, subject to the articles of association of the company, either the executive director or chairman of the board of directors, or the general manager will act as the legal representative of the company, who generally has the legal power to represent and bind

the company he/she represents in all external matters. The detailed functions and powers of each management will be set out in the articles of association, and all the senior management should perform the duty of care and fiduciary duty for the company.

As a general note, the equity in a PRC incorporated company with real estate asset and business is freely transferable, subject to the restrictions in the land grant contract as mentioned elsewhere herein. Transfer of the equity in such company requires registration with the applicable company registry which in most of the cases operates as a formality procedure instead of an approval with discretion. Registration on transfer usually takes around 10-15 days.



2. Acquisition of ownership

2.1 Acquisition of granted land use rights

There are two tiers in the land market in China. In the primary land market, a real estate investor directly purchases or leases the Granted Land Use Rights from the State either by private negotiation or by public bidding or auction. The land use right grant exercise is carried out by the land authority at municipal or county level and approved by the authority designated by the provincial congress.

In the secondary land market, a real estate investor may acquire or dispose of the Granted Land Use Rights to other entities by way of sale, lease or mortgage. As a general principle, the fixtures on the land are deemed to be acquired or disposed of together with the Granted Land Use Rights.

It should be noted PRC land law imposes a number of restrictions on the disposal of Granted Land Use Rights. An real estate investor may sell or transfer Granted Land Use Rights only after (i) it has paid the land use fees in full and obtained the appropriate real estate rights certificate, (ii) it has invested in developing the land to the extent required by law (for example, in the case of land granted for the purposes of real property development, at least 25% of the proposed development must have already been completed or, in other cases, the land must be levelled and ready for construction) and (iii) it has developed and used the land in accordance with the terms of the grant contract.

In addition to the general restriction as mentioned above, nowadays, in order to control property price or to monitor the development and use of the granted land, some land grant contracts may also impose restrictions such as strata-title sale of units in a building, sale of a building as a whole, or sometimes direct or indirect transfer of the project company holding the Granted Land Use Rights.

2.2 Acquisition of building ownership

Building ownership can be sold, transferred, leased or mortgaged. The sale and purchase of a building or any units of a building must be in writing and then registered with the relevant real estate authorities. Please refer to Section 2.3 for a detailed discussion on registration procedures.

In principle, the building and the corresponding Granted Land Use Rights should be owned by the same entity and the building must be sold together with the corresponding Granted Land Use Rights.

2.3 Registration

Title to real estate is evidenced by registration in the PRC. There are generally two types of title registrations in the PRC, namely land use right registration and building registration.

- The land use right registration is effective after a land use right certificate has been issued by the relevant authority to the land owner evidencing that the land owner has obtained land use rights which can be assigned, mortgaged or leased.

- The building registration is effective after a building ownership certificate has been issued to the building owner evidencing that the building owner has obtained building ownership rights in respect of the building.

Since March 2015, the titles of land use rights and buildings has been registered under an unified real estate ownership certificate.

A lawful and proper transfer of a real estate is effected where the transfer is registered with, and the purchaser is entered in the registry of, the relevant local land bureau at municipality or county level. The processes of registration of local land bureaus may vary from region to region.

The property registration system protects a purchaser acting in good faith in a property transaction. Once the purchaser is registered with the relevant government authorities as the new owner, it is protected against claims brought by third parties that have not been registered.

2.4 Structuring the acquisition

A foreign investor (or its PRC subsidiary) may acquire property in the PRC by (i) acquiring the property itself by way of an asset purchase, (ii) acquiring the equity of the Chinese entity that owns the property, or (iii) acquiring shares in the overseas holding company of the Chinese entity that owns the property.

The following are some of the features in asset deals and equity transfers, with a focus on various factors that must be taken into account.

A. ASSET DEALS

An asset deal is where a piece of property is acquired directly by the purchaser from the seller. The asset deal must be in writing and then registered with the relevant property registration authorities.

As mentioned above, a foreign investor cannot acquire a property in the PRC directly in its own name and it has to incorporate or acquire a PRC entity to acquire such real estate.

Generally, the purchaser will not inherit any hidden legal liabilities of the property that existed at the time of acquisition other than liabilities specifically assumed within the acquisition agreement. In addition, in contrast to a share or equity deal, an asset deal allows the acquirer to “cherry pick” the desired assets.

The purchaser must carry out due diligence on all aspects of the property prior to signing on the property transfer agreement. Such due diligence will generally cover the following:

- check if the seller has a valid and clear title to the target property.
- identifying any encumbrances on the target property.
- check if all the planning and construction consents and approval are in place (if applicable).
- check if the completion inspection approvals of the target property issued by a number of different competent authorities have been obtained.

If the target property is subject to a mortgage or if the target property is jointly owned, the seller must obtain the written consent for the sale from the mortgagee or other joint owners, otherwise the property registration authority will not register the proposed sale of the property (the registration authority in some cities even require the mortgage to be deregistered before the registration of the title transfer).

An asset deal will require both seller and purchaser to pay substantial amount of property transfer related tax which are described in details in section 7. That's why asset deal is not a common approach that a foreign investor would adopt.

Transfer of Construction-in-Progress

In the light of the general restriction on transfer of Granted Land Use Rights, by the time when 25% of the proposed development amount has been deployed, the development should generally have completed its design stage and obtained construction commencement permit. Therefore where a development or a building is to be transferred before its official construction completion, it will be treated as transfer of construction-in-progress. The requirements for transfer of construction-in-progress is very complex, involving applying for approvals from land authority, planning authority, construction authority and a number of other authorities in order for the development related approvals and permits to be reissued in the name of the purchaser, and involving negotiating with the existing architects, contractors and service providers on the assignment, termination or re-negotiation of their existing agreements so that contractual relationship will be with the purchaser instead of the seller.

Because of its complexity, it is very rare for foreign investor to adopt this approach to acquire property in the PRC.

Pre-sale

The pre-sale arrangement for property in the PRC is primarily designed to allow individual buyers of units to enter into binding purchase contracts before completion of a property. A key approval document for initiating the pre-sale process is the pre-sale permit issued by the real estate authority. Certain conditions will need to be met for the issuance of the pre-sale permit, including, among other things, that the progress of construction is sufficiently advanced and the estimated date for completion and delivery have been confirmed by the developer of the property. The title certificate for the purchased unit will not be issued until after the big title certificate is issued in the name of the developer.

Transfer of a Completed Building

Once the title certificate of the building ownership is issued to either the developer or second-hand owner, the transfer of the completed building ownership by the seller would become a straightforward process simply by way of lodging a transfer application with the applicable registry and a new title certificate will be issued in the name of the purchaser.

B. EQUITY DEALS

Another way to acquire property is to acquire the legal entity which owns the property. As of the end of the year 2019, a foreign investor acquiring a PRC real estate company, which is not subject to the special access administrative measures issued by the State, must file with Ministry of Commerce or its local counterpart (MOFCOM) and

update the shareholder change of that PRC real estate company with State Administration of Industry and Commerce or its local counterpart (SAIC). Please note that, according to the PRC Foreign Investment Law which has become effective since 1 January 2020, the MOFCOM will conduct supervision to the foreign invested entities which is not subject to the special access administrative measures by way of reviewing the online information report submitted by such entities. Please refer to Section 1.3 hereof for more details. The due diligence prior to a share deal should, in addition to the points mentioned in section 2.4(A) concerning the property itself, cover the following aspects:

- check if the target company has been duly incorporated and is validly existing;

- check if the target company has obtained all the required operational licenses, certificates, permits or approvals;
- if it is an operational property, review the management agreements, service agreements, lease agreements, property insurance in respect of the target property to ensure they reflect purchaser's understanding and expectation;
- review all other agreements or contracts the target company is a party to;
- review all the accounts of the target company to identify debts and liabilities; and
- check if the target company has any employees and the liabilities in relation thereto.

In contrast with an asset deal, the purchaser of an equity deal will inherit any existing or hidden

(i.e. off balance sheet) liabilities in the target company that exist at the time of acquisition, but it would save a substantial amount of property transfer related tax.

An even more flexible and convenient approach for foreign investor to invest in real estate in the PRC is to acquire shares in the overseas holding company of the PRC real estate company that owns the target property. This is a very common approach that foreign investors would adopt, however, this approach can be implemented only if the PRC real estate company is already owned by foreign investor so that there is an overseas holding company to be acquired. This approach can avoid the requirements of MOFCOM online filing and SAIC registration that would be required for equity sale of a PRC real estate company.



3. Other rights to property

3.1 Mortgages

A. OVERVIEW

Real estate developments are generally secured by mortgages over Granted Land Use Rights, buildings and other improvements on such land (or just granted land use right of a land where there are no buildings) owned by the mortgagor. The mortgaged property remains in the borrower's possession. The lender enjoys priority over the proceeds from the mortgaged property in the event of the borrower's insolvency, but ownership of the mortgaged property will not be transferred to the lender.

Buildings and land use rights are considered to be real estate over which security can be granted to a lender. Chattels may also be used as security. Mortgages over land and/or buildings are effective upon registration of the mortgage; mortgages over chattels are effective when the mortgage agreements come into force, but it cannot take priority over a bona fide third party unless it is registered.

PRC security law also recognises a mortgage over a construction in progress. Such mortgage takes effect upon registration. However, PRC security law does not provide further guidance on the mortgage over a construction in progress. In principle, security over future assets is not legally recognised under the PRC law. Consequently, it is generally understood that a mortgage over a construction in progress only covers the completed portion of a building.

B. PRIORITY

If the same property is mortgaged to two or more lenders, their claims will be prioritized in light of the sequence of registration.

Accordingly, a newly created mortgage will not be able to affect the priority of the existing mortgage, unless the existing mortgage has not yet been registered or consent is obtained from its holder.

The priority of mortgages can be changed with the agreement of the lender and borrower, and the corresponding mortgage registration should be updated to reflect the change. Such change, however, must not have an adverse impact on the other lenders (if any) unless written consent is obtained from them.

C. ENFORCEMENT OF MORTGAGE

A lender has rights to the proceeds arising out of a disposal of the mortgaged property but not the property itself under the PRC law. As a result, a lender does not have the right to have the mortgaged property transferred to it, except (i) as part of a court approved auction, sale or conversion or (ii) in the case where the mortgagor and the mortgagee agree to such transfer to offset the outstanding liabilities.

The lender may negotiate with the borrower to put the property up for auction. If the lender and borrower fail to reach an agreement, the lender must file a lawsuit in the people's court to seek a court judgment and an execution order in order to obtain the legal interests of the property. If the lender is successful, he can then

be paid off by converting the value of the mortgaged property into money, or by proceeds acquired through an auction or sale of the mortgaged property.

When the borrower is in default, there are two main types of enforcement for mortgage in the PRC, namely consensual enforcement and court-assisted enforcement.

Consensual enforcement: This type of enforcement requires the co-operation of the mortgagor. Notwithstanding the prohibition of a foreclosure provision in the mortgage document, the parties may agree on the disposal of the property after the borrower's default so long as it will not be unfair to the mortgagor. Consensual enforcement may take the form of private sale or public auction.

Court-assisted enforcement: The procedures are generally well established and the courts have experience with enforcement procedures. It is only where the borrower/mortgagor does not co-operate to realise the value of the mortgaged property that the creditors will have to consider involving the court in the enforcement process. Before initiating this court-assisted enforcement, a favourable judgment or arbitration award showing that a debt is owing is required to be obtained.

In such cases, the mortgagee may apply to a local court for enforcement by way of auction, sale or conversion of the mortgaged

property. The court has the power to freeze, auction or put up for sale that part of the property of the mortgagor which is sufficient to cover the award.

The amount which a mortgage secures may include amounts of principal, interest, liquidated damages and expenses provided that they are clearly specified in the security document. The amount secured by a mortgage is limited to the value of the mortgaged property.

3.2 Contractor's rights

If a developer fails to pay the price (which includes remuneration for workmanship and costs for materials) in accordance with the terms of the construction contract, the contractor may serve a notice on the developer demanding payment

within a reasonable time limit. If the developer fails to make payment within the time limit, the contractor may consult with the developer to make a discounted sale of the project, or apply to a people's court to auction the project off according to law – unless the nature of the construction project renders it inappropriate to be converted into its monetary value or auctioned off. The contractor has a right to enjoy preferential payment to proceeds derived from the discounted sale or auction. This preferential right has priority over mortgages or other security interests.

3.3 Tenant's pre-emption rights

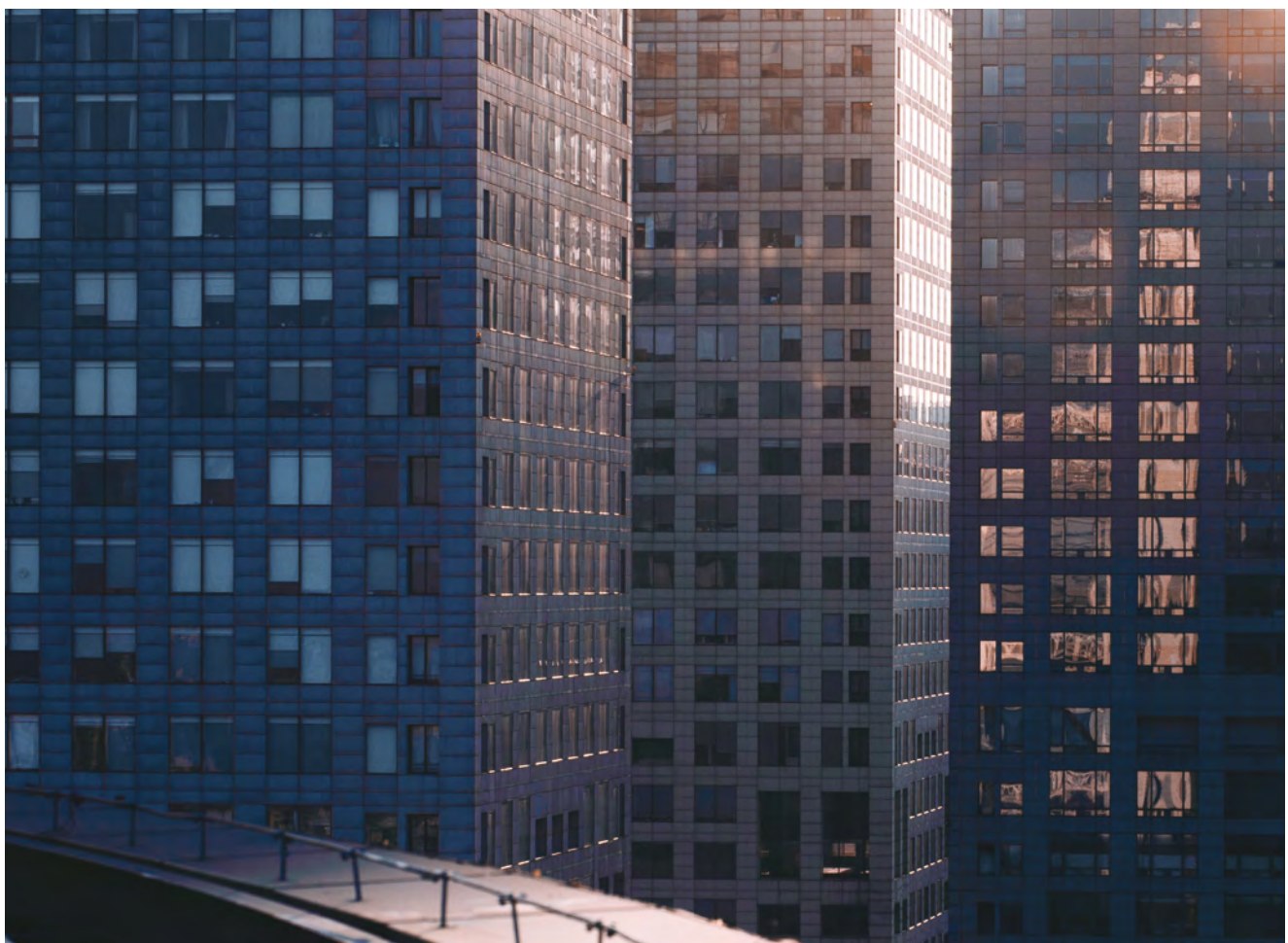
In the PRC, tenants have an implied right granted by law (unless it is expressly waived) to have first rights of refusal if the property which they

have leased is sold by the landlord.

Where there is a sale, the landlord is required to notify the tenant.

If the tenant is able to offer the same price and the same terms and conditions that the other third party offers, it will be given the preference and its first right of refusal will be upheld.

If the tenant chooses not to purchase the relevant property, the purchaser of the property will be required to take over all existing leases where these were granted prior to the transfer of the property and the terms of such leases may not be amended as a result of such transfer.



4. Zoning and planning law building permits

Real estate construction is a regulated activity in China.

In China land-use planning is one of the major functions of local government. It gives the local municipality the opportunity and obligation to control urban development. The municipality may set up a land use plan as a comprehensive municipal development plan that relates to the land usage in the area of the municipality and outlining the main features of land usage, such areas designated for development, public and private infrastructure, certain types of transport, green areas, areas with restriction on use, etc.

As far as a particular development project is concerned, the zoning and planning requirements for the development of a land will normally be set upfront by the planning authority which will be consistent with the comprehensive municipal development plan and will be included in the land use right grant contract for the particular land.

The parameters for such zoning and planning requirements for land development normally include, among other things:

- the permitted use of the land, such as commercial, residential, office, or mixed-use etc.
- the plot ratio to set the maximum construction area of the building that can be built on the land;
- the height restriction; and
- the greenery coverage.

If there is no land use or building plan in place which regulates the planned development permissibility of a project will have to be in accordance with the immediate surroundings, the security of public infrastructure, the requirements of healthy living and working conditions and the overall appearance of the locality.

In the course of the development, the developer will also need to apply for the relevant planning permits

from the planning authority at different stages of the development, including design, construction and completion stages, such that the planning authority will have the opportunity at such different stages to check if the design and construction of the development of the land are in compliance with the zoning and planning requirements set out in the land use right grant contract.

The key building permits in the PRC include construction project planning permit issued by the planning authority from zoning compliance perspective and the construction commencement permit and completion certificate issued by the construction authority from construction compliance perspective. Prior to apply for and obtain the aforementioned permits, a number of pre-requisite documents, approvals, permits are required to be submitted.

5. Environmental liability

The construction and use of real estate shall be subject to PRC environmental laws on the national level, including *Environmental Protection Law*, *Prevention and Control of Atmospheric Pollution Law*, *Prevention and Control of Water Pollution Law* and *Prevention and Control of Soil Pollution Law*, as well as local level, relating to promoting sustainable developments.

The pollution prevention and control facilities in construction projects shall be designed, built and commissioned along with the principal part of the project at the same time. The pollution prevention and control facilities shall meet the requirements specified in the approved documents regarding the environmental impact assessment and shall not be dismantled or left idle without authorization.

Upon completion of the construction, the contractor shall deliver a completion report to the developer. It is the obligation of the developer to secure

the inspection approvals from the environmental protection authority, which is responsible for granting environmental permits and conducting investigations and inspections of land and developments.

PRC implements the pollution discharge license management system in accordance with the law. Enterprises, public institutions and other producers and operators that implement the pollution discharge license management shall discharge pollutants according to the requirements of the pollution discharge license; those that fail to obtain the pollution discharge license shall not discharge pollutants.

PRC Environmental laws have generally adopted a “polluter pays” approach to liability. The *Prevention and Control of Soil Pollution Law* issued by the Standing Committee of the National People's Congress in 2018 provides that for pre-existing soil and groundwater contamination, the responsible

party (being the original polluter according to the relevant official's comments) is obligated to manage and control soil pollution risks and restore polluted soil. But where it is impossible to identify the responsible party for soil pollution, the land use right holder shall undertake the risk management and control for soil pollution and the restoration.

Where an enterprise that caused contamination has been altered due to merger, acquisition or divestiture of a business unit, the succeeding enterprise must take responsibility for remediation unless responsibility has been otherwise defined by contractual agreement between the parties, etc.

The purchaser of the real estate asset will not be responsible for soil pollution or contamination of the building if it did not cause the pollution or contamination.



6. Leases

PRC law recognises only one type of lease in the Contract Law of the People's Republic of China.

The landlord and the tenant are required to register the lease with the real estate authority within 30 days after execution. The lease becomes legally binding between the landlord and the tenant upon execution of the lease contract. However, failure to register a lease does not affect the validity and enforceability of the lease involved, nor the statutory rights enjoyed by a tenant. Non-registration of a lease works in landlord's favour as it avoids unnecessary trouble to de-register such lease when it expired or terminated.

6.1 Deposit

The lessee is generally obliged to pay a cash deposit or provide a bank guarantee to the lessor in an amount equal to 3-6 month rent to secure its performance under the lease.

6.2 Duration

The usual length of a lease depends on the nature of the lease, but cannot be more than 20 years during each lease term (inclusive of the automatic renewal term, but exclusive of the renewal term which will be subject to the parties' negotiation and execution of a renewal agreement) according to laws. Residential leases are usually for a length of 12 months with an option to renew for a second year. Commercial leases generally last between three and five years.

Leases with a fixed term may be renewed automatically on the same terms if, after the term expires, the lessee continues to use the premises and the lessor does not object. However, the renewed lease

will be for an indefinite term, and can be terminated at any time with reasonable notice.

6.3 Rent

Rent is usually calculated on the basis of a figure per square metre of usable space. Usually, rent payments are due on a monthly basis and are paid in advance. It is also common for retail leases to include turnover rent as well as fixed rent where the lessee pays whichever is the higher.

The rent is usually fixed during its initial lease term but subject to an increase during any renewal period, with either the total increased amount or the percentage being specified in the lease, or with such increase to be negotiated in line with the market condition.

6.4 Operating expenses and management fees

The lessee is generally obliged to pay utility charges for the use of the lease premises. Other operating expenses for the maintenance and repair of areas (including common areas) are normally allocated and paid by tenants through management fees calculated on the basis of a figure per square metre per month of usable area or gross area of the leased premises.

6.5 Insurance

The cost of insurance for the premises is usually met by the lessor and the insurance policy is taken out in his name. Many leases contain a clause requiring the lessee to take out an insurance policy to cover any damage caused to third parties or to its leased premises as a result of their activities on the leased premises.

6.6 Maintenance, repair and renovation at end of lease

The lessee is entitled to use the premises as agreed in the lease. If the lease is silent or unclear on this point, the premises must be used in a manner consistent with their nature or zoning.

The landlord is usually responsible to maintain and repair the common area of the building where the lease premises are situated, whereas the tenant is usually responsible to maintain and repair the installation, equipment or improvement installed by the tenant inside the lease premises.

The lessee is usually allowed to alter and improve the premises with the lessor's consent but should not alter load-bearing structures or indoor facilities without the required authorizations. Where the lessee makes alterations without the lessor's consent, he pays the cost in full and is also obliged to restore the premises to their original condition or compensate for any damage when the lease expires.

6.7 Assignments/transfers

Assignment of the lessor's interest under the lease is subject to the mechanism of contractual assignment under the general law. As between the assignee and the debtor/lessee, an assignment of the lease by the lessor without notice of the assignment being given to the lessee will not bind the lessee under the PRC law.

There are no specific articles governing the assignment by lessees in Contract Law. However, in the General Provisions of Contract

Law, either party to a contract may transfer its contractual rights and obligations collectively to a third party with the consent of the other party, except for: 1. the rights under the contract shall not be assigned in light of the nature of the contract; 2. the rights under the contract shall not be assigned in accordance with the agreement between the parties; and 3. the rights under the contract shall not be assigned according to law.

6.8 Subleases

The lessee may sublet the premises to a third party. The lessor's written consent is always required. If the lease is sublet by the lessee, the original lease between it and the head lessor will continue and the lessee will continue to have primary responsibility to the lessor for any damage to the property or breach of the lease terms.

Where the lessee sublets the leased property without the consent of the lessor, the lessor may rescind the contract. If the lessor elects to rescind the contract in such situation, the bona fide sub-lessee must vacate the premises but has a claim against the lessee. However, where the lessor knows or should have known of the sublease but fails to raise any objection within six months, if it requests terminating the lease or invalidating the sublease on the ground that the lessee has not obtained its consent, the people's court will not uphold such request.

6.9 Termination

The lease can be terminated early if the lessor gives written notice of termination for the reasons specified by law or in the lease. However, if early termination is not based on a specified ground, leases usually provide for compensation

by the lessor as well (e.g. several month's rent based on the rent payable that year).

The lease may also be terminated if the premises are expropriated or subject to demolition. If the expropriator is the government or if the demolition is a result of zoning or city planning, the government will usually pay compensation. The lease should provide for such situations. If the lease is silent, these circumstances are likely to fall under the force majeure clause.

If the lease is terminated and the lessee fails to vacate the premises, the lessor has a right to demand rent covering the entire period of the delay in vacating. All risks occurring during this period will be borne by the lessee. Penalties for the late return of the premises can also be set out in the lease contract. The lessor may also reserve the right to take the re-possession of the leased premises and dispose of any item left in the leased premises with disposal proceeds belonging to the lessee.

In most of the leases, the lessor may reserve its rights to cut off utilities in case of the lessee's breach of the lease terms, in particular the delay in payment of rent and management fee.

6.10 Break right

Break right is not often offered to the lessee in the light of a relatively short lease term, but may be requested by the tenant depending on the negotiation power.

6.11 Sale of leased property

If a lessor intends to sell a leased property, the lessor shall, within a reasonable time limit prior to the sale, notify the lessee and the lessee shall have the right of first

refusal under the same conditions.

It is common practice to specify the notification period in the lease. However, this right can be expressly waived and are in fact often waived by the tenant under the lease.

In the case of a change of ownership of the leased property during the lease term, generally speaking, the new owner of the leased premises has the legal obligation to honour the entire lease terms as if the lease were entered into between the new owner and the lessee. However, during the court enforcement of a mortgage which is created before the existence of a lease, the potential purchaser will have no legal obligation to honour the existing lease. Having said that, as a matter of practice, the PRC court may order the sale of the mortgaged property subject to the existing lease, unless the existence of the lease would adversely affect the auction/private sale process of the mortgaged property, in which case the court could remove/terminate the lease in order to facilitate the auction/private sale process of the mortgaged property. As mentioned before, the PRC Security Law does not permit foreclosure provision in a mortgage agreement and as a result a mortgagee only has priority right over the sale proceeds following auction or private sale of the mortgaged property. Therefore in the PRC, non-disturbance agreement in the context of a lease is uncommon.

Where lessor has informed tenant of the existence of prior mortgage at the time of lease signing, any loss suffered by lessee as a result of mortgage enforcement will be borne by lessee itself unless the parties agreed otherwise to be borne by lessor.

7. TAX

7.1 Asset deals

If the transfer takes the form of a conventional sale and purchase of the property, both parties to the agreements are liable to the tax authorities for transfer taxes.

The purchaser of the real estate shall pay:

- Deed Tax ("DT"). DT is levied and payable by the purchaser of real property on the transfer of real property or land use rights. The rate ranges from 3% to 5% (depending on the location) of the total value of the property or land use rights; and
- Stamp Tax ("ST"). ST is levied on certain dutiable documents executed or used in China, including property transfer documents and calculated at a fixed rate according to the contract amounts. For transfers of property, ST is at 0.05% of the purchase price.

The seller of the real estate shall pay:

- Income Tax. For enterprises, since 1 January 2008, FIEs and domestic enterprises are subject to a new Enterprise Income Tax ("EIT"). EIT laws govern the taxation of FIEs that directly own and realize rental income and gain from Chinese real estate. The rate is 25% as at 1 January 2008 (reduced from 33%) and no additional local income tax will be levied. Foreign enterprises not maintaining establishments in China are taxable on their income and gain on a gross withholding basis. The rate is 20% under the new EIT law.

- Value Added Tax ("VAT"). After the tax reform starting from 1 May, 2016, instead of Business Tax, sales of real property or land use rights should be subject to VAT at 9% under the general rules. Such VAT costs will be added on top of the purchase price and finally borne by the purchaser of such real estate property. The purchaser may use such input VAT (supported by valid VAT invoices) to offset its output VAT payable on its income generated from business operations. The tax reform program also offers transitional rules, under which the seller of real estate properties may opt for a simplified tax method if the aforesaid real estate properties were acquired by the seller before 30 April 2016, i.e. apply a reduced VAT rate of 5% on sale of real properties without claiming input VAT credit. If the seller of the real estate properties chooses for such simplified method, the purchaser's VAT costs will be reduced to 5% on the purchase price, but such 5% VAT will not be deductible against the purchaser's output VAT on its business income.
- Land Value Appreciation Tax ("LVAT"). LVAT is potentially the most expensive tax imposed on the seller on taxable gains derived from the transfer of real property, ranging from 30% to 60% depending on the amount by which the sale proceeds exceed certain prescribed deductions. These prescribed deductions include the cost of acquiring land use rights, developing the land and construction, as well as the value of any existing buildings and any tax paid in relation to

the land or property. Note that, as LVAT is a local tax, many local tax authorities have adopted their own tax collection method of calculation.

- Stamp Tax. ST is levied on certain dutiable documents executed or used in China, including property transfer documents and calculated at a fixed rate according to the contract amounts. For transfers of property, ST is at 0.05% of the purchase price.

7.2 Equity deals

If the transfer takes the form of equity transfer of a PRC incorporated entity, both sides to the agreement shall pay stamp duty tax at 0.05% of the share transfer price.

In addition, the following shall be paid by the seller of the equity transfer:

- if the seller is a PRC domestic enterprises, the income derived from the sale shall be a part of the total taxable income for that entity at 25% of enterprise income tax;
- if the seller is a foreign enterprises, the capital gains derived from the sale is subject to 10% withholding tax.

7.3 Indirect equity transfer

According to the Bulletin on Several Issues concerning the Enterprise Income Tax on Indirect Asset Transfer by Non-Resident Enterprises, an indirect transfer of China taxable assets conducted by non-resident seller through arrangements that do not have reasonable commercial purposes

shall be deemed as direct transfer of China taxable assets and therefore subject to enterprise income tax in China generally at 10% on the capital gain derived by such non-resident seller.

Therefore if a foreign seller sells the shares in the overseas holding company of a PRC real estate company that owns the target property, such foreign investors will be required to report to the PRC tax authority which will then determine whether the transfer of an offshore entity has reasonable commercial purpose and if not determine that the seller will need to pay 10% on the capital gain derived by such transfer of the offshore entity.

7.4 Other real estate taxes

The owner of real estate in China shall pay the taxes on a recurring basis as follow:

- Real Estate Tax ("RET").
The Real Estate Taxes is applied to the owners of real property at rates depending on how the property is used. RET replaced the Urban Real Estate Tax as of 1 January 2009. RET is imposed on the owners, users or custodians of houses and buildings. For self-used properties, the rate is 1.2% of the adjusted cost of the property (with a 10-30% deduction from the original cost); for properties held for lease, the RET rate is generally 12% of the rental value, but may be reduced to 4% for leasing residential property.

- Urban and Township Land Use Tax. Companies or individuals that occupy land within cities, counties, townships and mining areas are subject to an annual Urban and Township Land Use Tax calculated against the square metre size of the property. The rate of the tax is set at a local level and can vary from about RMB 0.6 per square metre for a poorer town to RMB 30 per square metre for a large city.
- Taxation of rental income from Real Estate. The landlord will be required to pay (i) real estate tax pursuant to the above; (ii) VAT at 9% of the rental income; and (iii) stamp duty at 0.1% of total lease value.



8. Real estate finance

8.1 Interest rate risks

RMB-denominated loans granted by Chinese and foreign lenders are both subject to the PBOC restrictions on interest rate. Unlike international financial market where the benchmark rate such as LIBOR is determined by the market, the RMB benchmark rate for loans is determined by the People's Bank of China (PBOC).

PBOC may adjust the benchmark rate from time to time to implement the government's monetary policy. As of 20 July 2013, there are no longer any lower or upper limits for commercial banks in setting loan interest rates by reference to the PBOC benchmark rate. However, it is still common market practice for commercial banks to adopt the PBOC benchmark rate as the starting point for negotiations.

By contrast, PBOC has largely liberalised the interest rate restrictions on foreign currency-denominated loans and allows the lenders to price the loan in accordance with the financial market condition.

8.2 Onshore financing

8.2.1 Onshore real estate financing refers to a loan where both the lender and the borrower are onshore entities (or PRC branch of a foreign bank). It can be categorized into three types, being development loan, asset acquisition loan, and equity acquisition loan:

- **Development Loan:** A development loan is a loan advanced to a borrower to finance the development of a real estate project owned by the borrower. The most important rules relating to real estate debt

are that real estate developers cannot borrow until: (i) the land use right has been obtained and the land use right certificate has been issued; and (ii) capital funds are available for development that amount to at least 35% of the total investment amount of the development project, or if the developer is a company owning logistics assets and data centres, 20% of the total investment amount of the development project. As a result of such restriction on borrowing, real estate developers will normally have to fund their own capital upfront at least for the purpose of payment of land grant fees such that the land use right certificate can be issued and that they can borrow money for construction and development.

- **Asset Acquisition Loan:** An asset acquisition loan is a loan advanced to a borrower to finance the payment of consideration by the borrower to acquire a property. The lender is required to ensure compliance of certain regulatory requirements, which include, (i) the construction of the property has been completed and accepted; (ii) the LTV ratio shall not exceed 60%; and (iii) the loan term shall be no more than 7 years.
- **Equity Acquisition Loan:** An equity acquisition loan is a loan advanced to a borrower to finance the payment of consideration by the borrower to acquire a project company which owns a property. The lender is required to ensure compliance of certain regulatory requirements, which include, (i) the LTV ratio shall not exceed 60%; and (ii) the loan term shall be no more than 7 years.

8.2.2 Securities for onshore real estate financing may include: mortgage on the real estate (which can include construction in progress mortgage for Development Loans), pledge over the equity in the project company holding the property, pledge over the account receivables, deposit pledge/account control, subordination agreements and assignment of contracts.

8.3 Cross-border financing

Cross-border real estate financing refers to a loan advanced by an offshore lender to an onshore entity, namely foreign debt. Foreign debt is broadly defined to cover all types of debts owed to an offshore lender, covering both bank loan and shareholder's loan. Although offshore lenders are outside of the jurisdiction of the Chinese authorities, the capacity of Chinese borrowers to borrow from offshore lenders is restricted by the State Administration of Foreign Exchange's (SAFE) foreign debt regime.

Generally speaking, a foreign invested enterprise in the PRC was traditionally permitted, without the need for SAFE approval, to borrow foreign debt up to the difference between its approved total investment and registered capital, and this was the way most of the foreign investors adopted to leverage its investment or create a structure to repatriate the surplus cash which could be used to repay the principal and interest of the foreign debt. However, in July 2007, regulations were issued which effectively prohibit the incurrence of any foreign debt by FIREE (other than FIREEs which engage in business of operation of logistics

assets and data centres) which is the only restriction that has not yet be uplifted for real estate FIREEs as of today . As a result, foreign investors can only inject capital from offshore to its owned FIREE through contribution in the name of registered capital. Notwithstanding the foregoing, the regulation does not prohibit a non-real estate FIE (i.e. FIREEs in the business of developing and operating logistics assets and data centres) from obtaining any foreign debt. Foreign debt is required to be registered with SAFE or its designated banks which registration is more a formality requirement.

Another method for an FIREE to utilize trapped cash is to provide cash deposit as collateral for loans obtained by its offshore shareholder or affiliate at offshore level. This could be achieved by providing the collateral to a PRC bank (which in turn extends the guarantee to the offshore affiliate bank providing the loan), or alternatively this could be achieved through providing the collateral directly to the offshore lender. Failure to secure SAFE approval and registration would affect the enforceability of the security and repatriation of enforcement proceeds. Although this scheme is legally allowed, practices differ city by city and whether or not such application can be approved is largely depending on the overall foreign exchange reserve of the State, the possibility of security enforcement in view of SAFE, and the willingness of banks to provide such arrangements.

8.4 Offshore financing

Given the restrictions on direct foreign ownership of a property imposed in 2007, it is somewhat common (and in most cases necessary) for foreign real estate investors to set up a special-purpose vehicles (SPV) offshore, which in turn hold the onshore FIREE to purchase or hold property in the PRC.

A foreign lender may provide foreign currency financing (i) to an offshore borrower to finance its acquisition of an offshore SPV which in turn holds an onshore FIREE which owns a property in the PRC, or (ii) to an offshore borrower to finance its equity contribution to its invested onshore FIREE.

The offshore borrower typically grants the offshore lender the pledge of equity in the onshore FIREE as security for such offshore financing. The offshore borrower may also grant other security over offshore assets held by the offshore borrower and if applicable the offshore SPV (usually full security over all assets, including bank accounts of the offshore borrower and the offshore SPV) and possibly also a sponsor guarantee in favour of the foreign lender.

As briefly mentioned in Section 8.3, granting outbound security (including all the commonly used security for onshore real estate financing) by a FIREE in favour of an offshore entity is legally possible, but subject to the approval of SAFE and the practices and requirements of the relevant local registration authorities.

8.5 Typical real estate financing structure

Because of the restrictions on both onshore and offshore financing imposed on FIREE as aforesaid mentioned, foreign investors normally finance their investment in real estate in the PRC through a very carefully structured onshore and offshore financing.

Typically, foreign investors will contribute its own capital to the FIREE by way of equity (in the name of contribution of registered capital) such that the FIREE could convert the registered capital into RMB to pay the land grant fees and obtain the land use rights certificate.

Following the obtaining of the land use rights certificate, FIREE can normally obtain a RMB development loan from an onshore bank to fund the construction costs up to 65% of the value of the land with a mortgage over the land use right being granted in favour of such onshore bank. Because of loan to value ratio that is normally required by the lenders, during the development stage, it would be difficult for the foreign investor or the FIREE to obtain additional loans if the only direct or indirect security is the development and the underlying land use right.

Once the development is completed and becomes an income producing asset, the foreign investors may be able to obtain offshore financing in foreign currency either to cash out some investments at offshore level or to further fund operational costs and expenses required by such FIREE. In such situation, the foreign

investors will grant to the offshore lender the pledge of equity in the FIREE as a security. The foreign investors may also grant other security over offshore assets held by the foreign investors (usually full security over all assets (including bank accounts) of the offshore SPV that the foreign investors own) and possibly also a sponsor guarantee in favour of the offshore lender. The offshore lender will normally require that FIREE also maintain or secure an onshore financing through the offshore lender's onshore branch such that onshore lender would be able to secure its loan by a mortgage over the real property.

In a typical onshore-offshore financing arrangement, the following arrangements are often put in place:

- Onshore Financing: The onshore FIREE borrower will usually grant a property mortgage, a pledge over its account receivables and other security commonly used for onshore real estate financing (as noted in Section 8.2) to the onshore lender in the PRC to secure the onshore debt. Since

both the loan and the security are provided onshore to the onshore lender, the foreign debt and foreign security regimes do not apply.

- Offshore Financing: The offshore borrower will usually grant a pledge over the equity interest in the FIREE, share mortgage of the offshore borrower, account charge and other security commonly used for offshore real estate financing (as noted in Section 8.4) at the offshore level to secure the offshore debt.
- Intercreditor arrangements: An intercreditor agreement will be entered into between the onshore and offshore lenders to address certain creditor arrangements, such as approval rights, enforcements rights, and distribution of enforcement proceeds. This will mainly be used to address the risk of the offshore lender, which will be structurally subordinated to the onshore debt.

As briefly mentioned in Section 8.3, granting outbound security by a FIREE in favour of an offshore entity

is legally possible, but subject to the approval of SAFE and the practices and requirements of the relevant local registration authorities. Sometimes, in an onshore-offshore financing arrangement, the offshore lender may request that the onshore FIREE provide a second priority mortgage to secure the offshore debt (with the first priority mortgage securing the onshore debt), if such arrangements are practically possible.

The above typical financing structure is also commonly used whereby a foreign purchaser acquires shares in the offshore SPV which directly or indirectly owns a FIREE and therefore requires acquisition financing at offshore level or the onshore FIREE needs financing for the existing onshore loan with a third party bank.



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