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Abstract
China's real estate market—including its commercial leasing sector—has grown at a remarkable rate since the late 1980s, notwithstanding the fact that China did not adopt its first modern property law until 2007. Most of China's recent real estate development thus has occurred in the absence of a comprehensive national property law. China has somehow managed to modernize its real estate market and attract foreign investment despite the fact that its legal system is incompletely developed and characterized by uncertainty.

In an effort to understand how and why investors and other professionals are willing to participate in such an unsettled market, I recently interviewed Chinese and Western experts in the real estate field, including lawyers, judges, developers, bankers, government officials, and academics. This Article summarizes my findings about China's commercial leasing market. The new property law provides some insight into how China's real estate market functions, but a full picture requires an understanding of how these professionals have operated in a legally uncertain environment, both before and after the new law became effective.

Keywords
Cornell, real estate, China, property law, modernize, stable legal system, rate of return, commercial law, guanxi, private ownership, evolving, commercial construction, internationalized, Shanghai, legal uncertainty

Commercial Leasing in China: An Overview

by Gregory M. Stein

China's real estate market—including its commercial leasing sector—has grown at a remarkable rate since the late 1980s, notwithstanding the fact that China did not adopt its first modern property law until 2007. Most of China's recent real estate development thus has occurred in the absence of a comprehensive national property law. China has somehow managed to modernize its real estate market and attract foreign investment despite the fact that its legal system is incompletely developed and characterized by uncertainty.

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Introduction

China's development during the past quarter-century has been astonishing. The nation has managed to upgrade a considerable portion of its antiquated urban housing stock even as tens of millions of people have migrated from rural areas to China's booming cities, particularly in the eastern portion of the country. Commercial and industrial buildings have been replaced and expanded. The nation has built or rebuilt its infrastructure, from roads and bridges to subway systems and airports.

Westerners tend to assume that a stable legal system is a precondition to this type of development. After all, why would an investor make a substantial investment in Chinese real estate if the nation did not appear to afford legal protection to property rights, did not make clear what an owner's contractual remedies were, did not have a developed bankruptcy law, and provided a judiciary that was less than transparent? The answer, apparently, is that the gains to be made and the rate of return available compensate the investor for this legal uncertainty. This does not mean that investors simply ignore these gray areas. Rather, they factor them into their investment decisions and then take whatever steps they can to minimize these risks.

During the course of several visits to China in recent years, I met with Chinese and Western experts in the real estate field, including lawyers, judges, developers, bankers, government officials, and academics. These experts, who were remarkably generous with their time, offered their insights into how China's market actually operates in this world of considerable legal uncertainty. They acknowledged that China still does not have a fully developed commercial law structure. They also emphasized that China's legal system is only beginning to incorporate the concept of rule-of-law, with personal relationships ("guanxi") continuing to play a key role. Thus, a complete understanding of China's real estate market requires an examination of more than just statutes, cases, and rules.

This Article summarizes my findings with respect to China's commercial leasing market.

It begins by providing a brief description of my research methods and some background on relevant Chinese law, with emphasis on the Chinese land use right. Although China does not allow the private ownership of property, the land use right allows investors to participate in the real estate market with a fairly high degree of confidence that their property rights will enjoy legal protection. This is an important development in a nation that still claims to be guided by socialist principles. The Article next provides some background on China's commercial construction market, which is essential to an understanding of the commercial leasing market. Finally, the Article focuses specifically on commercial leasing in China as actually practiced, and not just as set forth in written laws.

Research Methods

When I first arrived in China in 2003, I was amazed at the incredible amount of real estate development occurring there. I quickly recognized that a complete understanding of this market would require more than just book knowledge. To begin with, China was still debating its first comprehensive property law. Moreover, China's legal system was evolving so quickly that the few property law sources that did exist would become obsolete rapidly. Given how quickly the market had accelerated from a dead stop, there were few experienced practitioners in the field and few who could serve as mentors for China's many newcomers to the industry. The Chinese legal academy was still recovering from the Cultural Revolution, and the property field had barely started to attract interested academics. Nonetheless, China was in the process of drafting a major property law that would have to harmonize some of the elements of private ownership with Communist principles.

It quickly became obvious that the best way to unravel the puzzle of how this market operates was to interview Chinese real estate professionals and Westerners working in China. During two subsequent visits to China, I interviewed more than fifty real estate professionals. In addition to meeting with these experts, I also examined the relevant literature, attempting to merge my field research and my more traditional research into a coherent picture of China's real estate market.

My aim in this Article and in several related works is to portray China's real estate market not as it is supposed to function, but rather as it actually functions.[1] China's real estate professionals are still conducting their business in somewhat of a Wild West environment, with the rules evolving as they proceed and that evolution sometimes responding to their prior activities. There is little conventional wisdom in a field that, in China, is still so new. And these professionals still are operating under an authoritarian one-party government that severely limits freedom of expression while attempting to combine free markets with strict government control, and rule-of-law with rule-by-man.

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Background Law

The Chinese Communist Party assumed power in 1949 but may not have completed nationalizing all of China's real property until 1982.[2] Ironically, post-Mao China began its gradual move away from Communist ideology at about that time. Deng Xiaoping announced his "reform and opening" policy in 1992, as the Chinese commercial real estate market was awakening from its extended slumber. The land use right developed during

1 For my previously published work on the modern Chinese real estate market, see 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*]; Gregory M. Stein, *Mortgage Law in China: Comparing Theory and Practice*, 72 MO. L. REV. 1315 (2007) [hereinafter Stein, *Mortgage Law*].

2 PATRICK A. RANDOLPH JR. & LOU JIANBO, CHINESE REAL ESTATE LAW 11 (2000) [hereinafter RANDOLPH & LOU, CREL] (arguing that China did not complete the process of nationalizing all land until 1982).

this period and is now formally recognized in China's new Property Rights Law.[3]

The land use right allows private parties to acquire the right to use property for a fixed period of time, even while the Chinese Constitution and Chinese Property Rights Law 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 lease land, or unlawfully transfer land in other ways. The right to the use of land may be transferred in accordance with the law."[4] This provision makes it plain that a private party may not own land but that the government may grant a land use right to that party for a specified term. 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.[5]

The legal status of land use rights draws additional support from a 2004 constitutional amendment that contains language requiring the state to pay compensation when it expropriates land.[6] The government's compromise, which allows private parties to use land they do not own, afforded those parties the opportunity to develop property privately while it also "avoided abandoning the Marxist principle of state ownership."[7]

Chinese law imposes numerous restrictions on land use rights. Holders of a land use right must develop the land within a short period of time or they 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. In addition, the right to renew a land use right when it expires and the price for renewing the right have been left somewhat clouded under the new law.[8]

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Commercial Construction in China

In many ways, the real estate development process in China is similar to that employed in the United States. In either nation, a developer that plans to hold its completed project as rental property begins seeking out tenants early in the development process, while a developer that intends to sell individual units to owners similarly starts trying to sell them before the units are built. However, a much higher percentage of projects in China are built with the intention of selling them upon completion, particularly in the residential sector. Most new residential projects in China's urban areas are conveyed under a legal structure comparable to the Western condominium.[9] This means that much of the risk of post-construction depreciation falls on the buyers and their respective acquisition lenders. As a result, residential developers who build and sell their projects tend to have shorter time horizons than those who retain ownership for rental income.

In the commercial sector, the picture in China is more mixed. Many commercial projects are also built by developers who plan to sell them upon completion, either as a whole or in individual units that are analogous to commercial condominiums. But other Chinese commercial properties are built to be held as rental properties. In these cases, the developer and its construction and permanent lenders presumably take a longer-term view than they

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3 Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007) (P.R.C.).

4 XIAN FA [Constitution] art. 10 (2004) (P.R.C.). The first two sentences of Article 10 of the Constitution clarify that all land is state- or collective-owned but that the state holds the constitutional power to transfer the right to use land.

5 RANDOLPH & LOU, *supra* note 2, 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.*

6 XIAN FA [Constitution] art. 10 (2004) (P.R.C.) ("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.").

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

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

9 See Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), arts. 70–83 (P.R.C.) (discussing attributes of this type of residential legal structure).

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would for a typical residential construction project. Given the fact that future rental income will be used to pay off the developer's loans, these lenders take a more careful look at the rental market, the identity of potential future tenants, and the ability of these tenants to pay rent to their landlord during the terms of their leases.

Note also that in situations such as this, in which the developer intends to retain ownership of the property after construction is complete, it is more common in China than in the United States for the construction lender also to stay on after completion as the permanent, or "cash-flow," lender. This unitary lender obviously has a great interest in the long-term success of the project, since it will suffer directly if the project fails and the developer cannot meet its payment obligations. Of course, in the United States, where it is far more common for a construction lender to be "taken out" by a separate permanent lender when construction is complete, the borrower still must meet the permanent lender's lengthy list of closing conditions before the permanent lender will take out the construction loan. These conditions are likely to address issues relating to tenant occupancy. So the developer still must demonstrate the long-term viability of the project, both at the outset, when it attempts to persuade both lenders to agree to extend credit, and at the time it completes construction of the building, when it must demonstrate to the permanent lender that all conditions precedent to the permanent lender's obligation to take out the construction loan have been met. Under either system, the lender (or lenders) must monitor the construction process carefully.

As China's commercial real estate market has become more internationalized, it has grown more common for projects that will be held for rental income to be owned by entities in which one of the stakeholders is an overseas participant. This foreign investor often is expected to contribute a significant portion of the capital necessary for development of the property. These projects generally have lower loan-to-value ratios. This fact may provide these entities' lenders with greater confidence that their loans will be repaid. The lenders have less money at risk, and the borrowers, including their overseas investors, have correspondingly more to lose.

Commercial Leasing in General

The rental market in modern China is considerably less active and advanced than an observer might guess, given how energetic the overall real estate market has become in the past quarter century. Despite the overall hyperactivity in China's real estate market, much of the real estate that has been developed since the late 1980s consists of units that are owner-occupied or, in some cases, owned-but-unoccupied. The residential market exhibits these characteristics for several reasons. To a substantial degree, residential units have become a commodity, serving as one of the few investment vehicles available to the person on the street seeking a place to park some money and watch it grow. Some of these units are held vacant, purely for their investment value.

Beyond the simple investment value of residential real estate, just about any resident of China who seeks newer and more modern accommodations for their own occupancy would rather own than rent their home, in the belief that property values are appreciating so rapidly that to do otherwise would be financially foolish. Whenever possible, these prospective owners scrape together a downpayment and buy a unit as soon as they can. Developers quick to notice this trend have built units that they attempt to sell as rapidly as possible. The preference that both investors and occupants have shown for buying residential units does not appear to trouble residential developers, who are able to cash out of their projects more quickly than they would if they held them for rental income. These developers can skimp on construction quality, knowing that the repair or replacement costs that will inevitably surface down the road will be borne by someone other than themselves, and they can lock in their profits immediately rather than relying on the vicissitudes of an immature and volatile residential rental market.

The picture in the commercial market is somewhat more muddled, as noted above. Although a surprising number of commercial units are owned, the commercial rental market is far more active than the residential rental market. For example, some of the high-end shopping malls built recently in major cities are rental properties, similar to some American malls. In a typical case, the mall will be constructed by a state-owned enterprise—sometimes with a foreign partner—and the retail occupants will be tenants rather than owners. In these cases, the ownership enterprise bears a greater investment risk than it would have if it had sold the commercial units. If tenants fail to pay their rent, the landlord may find that its financial obligations, including debt service, exceed its ability to pay them. Thus, to the extent the economy takes a turn for the worse in the future, a developer that owns and rents out its property is bearing much of the risk of this economic downturn, while a developer that has already sold the units has cashed out of the project and ended its risk. The ownership enterprise benefits from any appreciation, of course. If the property increases in value, the developer enjoys these gains, both by raising the rent it charges when leases come due for renewal and by enjoying the growth in property value when it sells the project later on.

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Because the Chinese government often owns a partial interest in these rental projects, many experts view this ownership structure as the Chinese government's method of receiving some of the investment gains from the real estate boom. In essence, the government acts very much like a private real estate investor. It functions as a large and not-too-silent partner sharing in the equity appreciation of an enormous nationwide real estate development project.[10] Of course, the government also could, and sometimes does, benefit from the investment boom by selling off units right away, pocketing or reinvesting the gain.

It appears that smaller local developers are more inclined to sell off their completed projects than are larger or more established developers. These smaller entities face greater difficulties in obtaining construction loans. They generally need all the cash they can get and often will find it impossible to move on to their next project until they cash out of their previous one. Larger developers, by contrast, have the staying power, bank balance, and connections with lenders and government officials to be able to hold their completed projects while continuing to invest in new projects.

Commercial Leasing in Mixed-Use Projects

Some large retail malls are built as components of even larger mixed-use projects. In Shanghai, for example, a typical upscale shopping mall might occupy the lower five stories of one building in a much larger, multi-building complex that also includes twenty or thirty office floors plus a hotel and cinema. One expert suggested to me that the rental retail component in a complex of this type might be losing money, but the other portions are likely to be profitable enough to offset these retail losses. If a single entity owns more than just the retail part of the building, it is likely to be making money on its total real estate investment. The owner may view the retail area as something of a trophy property that is highly visible to upscale Chinese shoppers and foreign visitors, with this portion of the property subsidized by the office and hotel portions. A mall such as this may even serve as a loss leader for the other portions of the project, increasing the project's attractiveness to office workers and hotel guests who spend their money elsewhere within the complex, much as retail shops located in resorts may lose money but are essential to the overall success of the resort.

Even if the retail portion of a mixed-use project seems to have low foot-traffic, as many do, it may be losing less money than the casual observer would guess. High-profile overseas retailers have been willing to overpay for prime locations to some extent, even if they know from the outset that these retail locations will lose money. They simply want to be able to add trendy Shanghai to their list of locations. These high-end stores, with few shoppers and little merchandise, may serve more as billboards for international retailers than as traditional, profitable retail locations.

Lenders and Commercial Leasing

Lenders that are advancing money to developers that plan to hold a completed commercial project for rental income tend to be extremely concerned with the developer's long-term prospects, as they ought to be. These cash-flow lenders are analogous to permanent lenders in the United States. By contrast, so-called "project lenders" correspond to American construction lenders.[11] Unlike project lenders that know from the outset that the developer plans to sell the units upon completion and pay off the project loan promptly, cash-flow lenders have to maintain an ongoing relationship with the developer, in its capacity as landlord, perhaps for a prolonged period. In these cases, the lender will be far more concerned with the developer's creditworthiness, history and experience.

[10] China's new property law appears to authorize this type of public-private joint venture. Wuquan fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 67 (P.R.C.).

[11] For a more detailed discussion of Chinese project loans and cash-flow loans, and the distinction between the two, see Stein, *Mortgage Law, supra* note 1, at 1326–27.

“Lease terms in Chinese commercial projects are typically much shorter than in comparable Western projects.”

Banks—and, for that matter, developers—apparently are more likely to perform thorough feasibility studies when the developer plans to hold the property for rental income. One knowledgeable expert advised me that successful commercial buildings held for rental income typically recoup the developer’s cash investment within ten years and that the default rate on cash-flow loans of this type is extremely low.

Another expert advised me that the typical term for a cash-flow loan on a commercial rental building is three to five years, somewhat shorter than a comparable loan term in the United States. Perhaps these shorter terms reflect concern among Chinese lenders about the likelihood of receiving repayment from borrowers who are holding property for rental income. These lenders may view the Chinese commercial rental market as volatile and may seek to reduce their long-term risk accordingly, notwithstanding the dramatic and consistent appreciation in property values in China during the past two decades. Or perhaps Chinese cash-flow lenders are wary of longer loan terms simply because they have so little experience with this type of lending.

Commercial Leasing Terms

Lease terms in Chinese commercial projects are typically much shorter than in comparable Western projects. Office leases to mid-sized business tenants in China tend to have terms of two or three years, and rarely more than five years. If real estate values increase rapidly, as they have in many Chinese cities, tenants take the risk of rent increases when they need to renew their leases. By contrast, leases in Western markets usually are for longer terms and frequently include renewal options. Western landlords thus face the risk that the rent will seem low by the end of the term. They may mitigate this risk by including periodic rent escalations along with provisions that require the tenant to share in any increases in the landlord’s costs for taxes, insurance, and maintenance of common areas. Chinese leases, by virtue of their shorter duration, would seem to present far less of a need to include these types of provisions. Larger multi-national corporations do tend to seek longer lease terms—perhaps ten or twenty years—a fact that may reflect the greater real estate experience these non-Chinese entities have accumulated in markets outside of China.

Tenants believe that landlords have far more power than tenants and have better connections with government officials and the police. For these reasons, they generally do everything they can do to pay their rent on time. Tenants know that serious breaches of their leases will lead to eviction, a remedy they wish to avoid.

If a tenant does default, the lease typically allows the landlord to commence a legal action in court or to arbitrate. Landlords may receive contract damages or liquidated damages and also may seek to have the tenant evicted. The landlord's method of eviction is also lease-dependent. Landlords may be able to exercise self-help to remove the tenant and also can seek a court order compelling the tenant to vacate the premises. One expert described a fairly harsh self-help process in which the landlord can use its security guards to evict a tenant in default. This process appears even more drastic than the self-help remedy that used to be common in the United States but that has fallen into widespread disfavor in recent years.[12]

Conclusion

The development of China's real estate sector since the late 1980s has been remarkable. This development is even more noteworthy given that much of it happened before China had adopted a formal law of property. As a result of the legal uncertainty China's system has provided to participants in the real estate market, entrepreneurial Chinese have been investing money and developing property with only a vague idea as to what would happen in the future in the event of disagreements or disputes.

The government has recognized that China's legal system is struggling to keep up with changes on the ground. For this reason, it has looked the other way as participants in China's real estate market enter into informal arrangements that may or may not have legal support. Sometimes business structures that have developed in this improvisational manner trigger legal changes that recognize them retroactively.

This Article has attempted to show how the commercial leasing sector of China's real estate market has managed to thrive against a backdrop of considerable legal uncertainty. China's developers, investors, and lenders have created a real estate system that reflects legal and business conditions on the ground. While the Chinese system certainly demonstrates features familiar to the Western expert, it also possesses characteristics that are uniquely Chinese and that grew out of China's recent history and legal development. Because China's real estate market is changing so rapidly and dramatically, the only way to obtain an accurate picture of this market is from those who are participating in it directly.

"Sometimes business structures that have developed in this improvisational manner trigger legal changes that recognize them retroactively."

12 *See, e.g.*, *Berg v. Wiley*, 264 N.W.2d 145 (Minn. 1978) (departing from common law rule by holding that landlords may not exercise self-help to remove a tenant that is still in possession).