

TO: Clients and Friends of the Firm
FR: Frishberg & Partners
RE: Financing Residential Construction Projects

I. Introduction

On Monday, February 6, 2006, a group of gullible investors arrived to the headquarters of an investment-construction group called “Elite Center” to learn that the owners had disappeared with more than \$100 million. Lacking the construction permits, yet having procured some of the necessary paperwork from the Mayor’s office, the owners pre-sold future apartments to more than one purchaser at below-market prices.

In all, this little housing scam left 1,500 apartment buyers with nothing. Many implicated Mayor Omelchenko in collaboration with the thieves. In reply, just before being kicked out of his office in the March elections, the good Mayor said the investors should have known better, adding that his political rival’s bank was responsible for the theft (a claim that was vigorously denied). Other components, adding to the mass robbery of Kiev’s citizens, were a lack of regulatory oversight from the National Bank of Ukraine and State Tax Inspection and unclear legislation. For all of the above reasons, there was a failure to protect investors.

Since then, restless apartment buyers all over Ukraine have begun asking the companies, which have accepted their payment for future apartments, about the necessary documents (licenses and permits) and state of finances. In many cases they discovered total failure to comply with the current legislation, which came into effect on January 14, 2006. At best, the investment vehicles (investment agreements) did not correspond with the new requirements (via deposits into licensed funds, bonds). In worst situations, intentional fraud was uncovered whereby the developers knowingly pre-sold future apartments without having the necessary construction permits in place (on Kniazhni Zaton No. 9, for instance).

Many developers and construction companies were caught unprepared for the unannounced changes in the legislation, especially those who financed construction with investment or financial agreements *other* than construction bonds or FFC accounts. These unfortunate entities had to promptly find their financial partners and issue the necessary securities to comply with the new construction finance legislation.

II. New Construction Finance Legislation

On January 14, 2006, the law “On Amending Certain Legislative Acts Concerning Mortgage Relations” (the “Law”) came into effect, trying to clear up numerous ambiguities contained in the laws “On Mortgages,” “On Mortgage Loans, Operations with Consolidated Mortgage Debt and Mortgage Certificates,” “On Financial-Credit Mechanisms and Management of Property During Construction of Residential Houses and Operations Involving Real Estate,” among others.

Significantly, the Law altered Article 4 of the Law “On Investment Activity” by clearly providing that public financing of residential property construction can take place *only* via licensed Funds for Financing Construction (FFC) or bonds, as well as largely theoretical instruments like Funds for Real Estate Operations (FREO), non-governmental pension funds, among others. In other words, it is finally illegal for construction companies to raise their own financing for construction projects without a licensed financial company.

Below we briefly review two of the more popular financing mechanisms, FFC’s and bonds.

A. Funds for Financing Construction (FFC)

FFC’s were introduced by Law “On Financial-Credit Mechanisms and Management of Property During Construction of Residential Houses and Operations Involving Real Estate,” dated June 19, 2003, which came into effect on January 1, 2004. According to this law, each constructed property must have its own FFC, and investors’ funds are used for construction of that specific property (and no other).

The financial company that creates an FFC is under strict state supervision from the moment such fund is registered. Specifically, the financial company must obtain a license to accept funds from natural persons to finance a given construction project and submit monthly accounting regarding each FFC. Plus, such company reviews the land allocation documents, construction permits, business plan, labor and material resources, any sub-contracts, and responds to investors’ queries regarding the status of construction. For the duration of the construction process, the financial company is responsible for technical supervision, procuring the necessary insurance policies, monitoring investors’ deposits, etc.

The financial company monitors the construction progress on a monthly basis by requiring the construction company to provide a statement of completed work and financial accounting, which the financial company forwards to the state authorities. Should the construction company fail to live up to any of its obligations, the financial company has the right to replace them.

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