

TO: Clients and Friends of the Firm
FR: Frishberg & Partners
RE: Land Mortgages and Due Diligence

I. Legal Background

In the beginning of 2004, a number of new legislative acts were passed allowed people and companies alike to place encumbrances on all types of property. In addition to the existing Land Code and Laws “On Collateral” and “On Mortgages”, Law No. 1255-IV “On Securing Claims of Creditors and the Registration of Encumbrances,” dated November 18, 2003 (hereinafter “Law No. 1255”), came into effect on January 9, 2004.

This law regulates legal relations between creditors and debtors, ensuring the fulfillment of obligations involving the pledge of immovable property. Along with the Law “On Mortgages”, Law No. 1255 broadens the provisions of the Law “On Collateral” and divides pledges into two specific types: (i) encumbrance of moveable property and (ii) mortgage of immovable property.

Next, the Ukrainian lawmakers passed Law No. 1952-IV “On State Registration of In Rem Rights to Immovable Property and their Encumbrance”, which introduced the long-awaited State Register of Rights to Immovable Property and their Encumbrance. At the end of July 2004, the Ministry of Justice passed Order No. 73/5 “On Approval of the Instructions on the Procedure for Maintaining the State Register of Encumbrances to Moveable Property and Filling Out Applications,” dated July 29, 2004.

Law No. 1255 introduced such new concepts in Ukrainian legislation as priority of pledges, levy of execution on property, public encumbrance, and private encumbrance. It also brought forth a transparent and comprehensive system for registering pledges on moveable property with a clear-cut system of prioritizing all pledges on one piece of moveable property. Theoretically, pledges are supposed to be prioritized on the basis of their moment of registration in the State Register of Encumbrances on Moveable Property

Despite these noble efforts, however, the land mortgage system does not function well in Ukraine for many reasons. One of them is the absence of a normal functioning unified land registry that would provide any creditor with a reliable, legal description of the property, or alert him about other outstanding credits secured by such property. The same applies to unfinished construction sites,

which are legally considered to be a combination of land and construction materials (until the finished structure is registered with the Bureau of Technical Inventory).

II. Practical Considerations

In cases of privately owned land, and even in cases of “permanent use of land”, an owner can freely mortgage both the land and any unfinished construction thereon. If the land is leased for construction purposes, however, serious legal impediments exist to mortgaging both the land and the unfinished construction on it. Unfortunately, most of the land for construction is leased. As for agricultural land, the moratorium prevents anyone from alienating such land by any means, including mortgaging the property (except for banks, who can not subsequently dispose of such land due to the moratorium).

A proper legal analysis of a land plot’s history is of enormous importance because it may reveal fundamental defects that would cloud the title, subjecting the creditor to future liabilities. For instance, various precedents exist where the local councils of people’s deputies issued land certificates to two or three different owners. Sometimes no notary seals were affixed to the sale-purchase agreements. These types of legal transgressions carry serious liabilities for future owners.

What happens to a mortgaged building when the land underneath is leased or has not been registered at all? The creditor would be able to recover the building, but not the land, of course, greatly decreasing the value of the property. That is why due diligence must cover both, the constructed property and the land underneath. Alternatively, the creditor may end up with a land plot which cannot be used.

In cases where company’s stock is being mortgaged, instead of the property itself, due diligence must also include the company’s background for any liabilities, confirmation of its property ownership rights, etc. Plus, surveyors must measure the land to ensure that no overlaps exist with the neighbors, that the land has no toxic waste buried underneath, etc. If the land has unfinished construction objects thereon, additional technical expertise regarding timeframe for completion and corresponding costs would be highly useful.

One last practical consideration: although ownership rights to a land plot begin to vest in the new owner from the moment the sale-purchase agreement is signed and notarized, such owner cannot dispose of the land until a state act on ownership is issued. This process can take anywhere from 6 months to 3 years, freezing the property.