

TO: Clients and Friends of the Firm

FR: Frishberg & Partners

RE: Unfinished Construction: Legal and Practical Considerations

From a foreign investor's perspective, two types of local developers exist: (1) those with deep pockets and excellent connections, and (2) companies and/or individuals who have lobbied their way into obtaining property rights (lease or ownership), but with no money for construction. The former often give up some ownership in specific construction projects in exchange for financing, while the latter typically attempt to cash out by selling 100% of their companies' corporate rights to any investor willing to pay the asking price, leaving them to deal with the local authorities and their whims.

In both cases, the potential investor (or creditor) will probably look at the so-called "objects of unfinished construction." As a general caution, should you see any "unfinished construction" properties on the market, be very careful. If the Ukrainian seller wishes to sell 100% of this object, it is a strong indication that the given property has fundamental problems, either structural, legal, political, or a deadly combination of all three, rendering the project unusable for all practical purposes.

To minimize the probability of inheriting the problems of the former owners, a potential investor must uncover the reason(s) why the unfinished construction site is for sale. This involves analyzing the legality of the ownership rights and land allocation documents, reviewing any architectural drawings and construction permissions, among many other documents. Performing due diligence is truly the only way of minimizing any risks related to significant investment.

As a first step, any investor (or a creditor) should be aware of special difficulties that exist in alienating unfinished construction objects. According to Article 182 of the Civil Code, property rights begin to vest only upon state registration (at the Bureau of Technical Inventory or the BTI) and "implementation" (i.e., commissioning). Until such time, the object of unfinished construction is not "immovable property," but rather a combination of construction materials and equipment that is used to create the "immovable property." Further, point 3 of Article 331 of the Civil Code expressly states that until the construction is finished (and duly registered), the owner of the construction materials and equipment used for such construction is the lawful owner.

Further, paragraph 74 of "Instruction on Procedure of the Execution of Notary Acts by Ukrainian Notaries," confirmed by Ministry of Justice Order No. 20/5, dated March 3, 2004, expressly permits alienation of construction materials and equipment, used in the process of construction. Based on

the above, the legal method for mortgaging unfinished construction is to use construction materials and equipment as collateral, not the actual “object of unfinished construction” itself (which does not exist in the eyes of the law). Or course, if the land under the construction object is leased, it would not become a part of the deal.

Extending this concept further to sale-purchase agreements involving unfinished construction objects, the investor acquires construction materials and equipment used in the building erection process. After the construction is finished, the new owner will have to register the property with the relevant authorities and put it into commission, which grants such lucky owner property rights to the finished building. Thus, before acquiring any “unfinished construction”, it is especially vital to review land allocation documents to learn whether the land is privately owned or leased from the state, the term of lease agreement (short, medium or long-term, any buyout rights) and the specific zoning classification (residential or commercial).

According to Ministry of Justice Order No. 20/05, an exception to the above method of alienating unfinished construction exists for any unfinished construction owned prior to January 1, 2004, when the Civil Code came into effect. Additionally, on December 15 2005, point 3 of Article 331 of the Civil Code was amended to allow “unfinished construction” objects to be entered into state registry of immovable property if they have documents confirming land ownership or use rights, approved architectural drawings, zoning, etc. Thus, Ukrainian legislation allows anyone to acquire unfinished construction, but only if it is duly registered.

Otherwise, alienation of “unfinished construction” (particularly in cases of leased land) carries greater legal risk than alienation of its components, materials and equipment, since it gives substantive grounds for lawsuits. In today’s volatile political climate, the local courts could very well use the opportunity to declare the transaction as being invalid from its inception, putting the new owner in a difficult predicament.

Because of the above legal impediments to purchasing “unfinished construction,” in most cases ownership is transferred via corporate rights (i.e., the investor simply purchases the company, or a part thereof, which has all the necessary “unfinished construction” site documents based on a carefully conducted legal due diligence).

As for creditors, most unfinished construction projects provide no reliable legal mechanism for enforcing a creditor’s rights by placing the collateral under arrest. This means that normal methods of financing construction do not apply until the building is registered with the BTI. As with the acquisition of “unfinished construction,” such issues are often resolved at the corporate level by pledging shares of stock as collateral. Note that Ukrainian legislation prohibits the founders of LLCs from using their corporate rights as a collateral, requiring LLCs to reorganize into closed joint stock companies.