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ATTORNEYS AT LAW

BRIEFING PAPER ON REAL PROPERTY TRANSACTIONS IN UKRAINE



COMMERCIAL



RESIDENTIAL



INDUSTRIAL



GREENFIELD

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CHAPTER 1

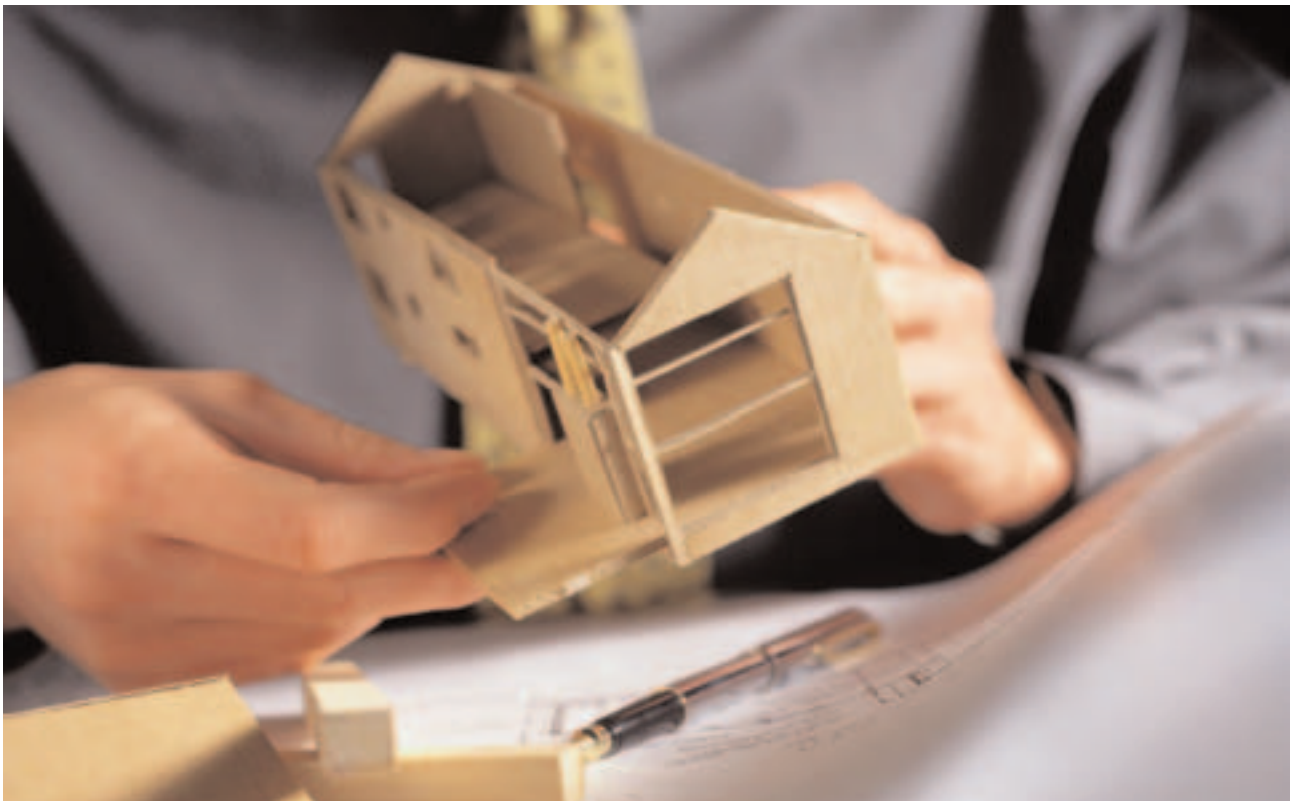
INTRODUCTION

TO REAL PROPERTY IN UKRAINE

Demand has always exceeded supply for commercial and residential real estate in Ukraine. In recent years, however, the prices have gone completely out of control. Today, residential prices in the center of Kiev are hovering at around \$6,000 per meter, threatening to increase anytime. Office rent goes for as much as \$85 per meter per month (see Leonardo, across from the Opera Theater).

Rent is also on the rise, and fast. Just in 2006-07, the lease prices in the center of Kiev have grown by 20-35%, finally reaching record numbers even for Western Europe. At the same time, the construction boom, which Ukraine is currently undergoing, is clearly not enough to satisfy the market. Whether it's warehouses, office buildings or hotels, Ukraine needs them all!

And yet, there have been no radical changes for the better in the Ukrainian real estate legislative system. The process for procuring land plots is well-known, and many Western players have entered the Kiev market either by partnering with local companies on unfinished construction sites or paying top



dollar for finished properties (i.e., registered at BTI). These days, large cities like Kiev, Donetsk and Dnepropetrovsk are hard to penetrate, but the rest of Ukraine is wide open for investment. In sharp contrast to the reception foreign investors get in Kiev, they are welcomed with open arms in places like Zaporozhye, Ivano-Frankovsk, and other smaller towns.

So how does an innocent foreign investor get in on the action? Before spending a penny, any investor should insist on seeing clear property title documents, unencumbered by any liens or risks of future litigation, as an absolute minimum requirement prior to effectuating any investment. Due diligence can easily uncover the various risks associated with investing in any Ukrainian property. When acquiring land, it is especially important to learn precisely how the land parcel was allocated (leased, sold or otherwise transferred) to the current owner. In certain cases, land that was improperly allocated by the Local Council of People's Deputies could be returned to municipal ownership by the subsequently elected Local Council of People's Deputies.

Due to legal barriers, investors usually do not acquire land per se, but instead wisely purchase the corporate rights of the legal entity that owns the land and has the necessary construction permits. This alternative greatly simplifies the land re-registration process and minimizes on taxes. An investor can acquire 100% of the company or any portion thereof. To have maximum control, however, we advise our clients to retain at least 75% + 1 share.

Immediately below we will review the basic legal and practical issues applicable to Ukrainian real property transactions (buildings and land, private and state-owned).

I. Agricultural and Industrial Land

(A) Agricultural land

Moratoriums on the sale of farm land are not new in Ukraine and, until recently, were never a serious impediment to the selling of farm land for logistical (warehouse) use. One only had to change the land allocation (zoning) to "OSG" status in order to circumvent the law. To become the lawful owner of OSG land, a foreign investor merely had to register a Ukrainian holding company.

The new and improved moratorium on the sale of agro-industrial land, which came into effect on January 1, 2007, specifically prohibits anyone from selling and even changing land allocation of their farmland, including OSG land. This temporarily slowed down the notaries, who were reluctant to alienate a farmer's "pai" (land share) or OSG land, especially in Kiev. However, in the summer of 2007, both "pai" (land share) and OSG land were very actively bought and sold on the thriving gray market notwithstanding the effects of the moratorium, especially in the surrounding Kiev area (Borispol, Brovary, etc).

Because many of the true owners were acting deputies to the local council or worked elsewhere in the government, they often included the illegal change of allocation (official re-zoning from farm land to industrial land) into the bargain. A very interesting condition precedent, indeed.

(B) Non-agricultural (industrial) land

(i) Privately owned land

Legal restrictions almost require foreign companies or individuals to invest through their Ukrainian resident company. For instance, a non-resident can acquire a land parcel within a city limit only, provided that a structure (building) already exists on such land, or to construct a building thereon. Outside city limits, a foreign investor may acquire land rights only when purchasing the building thereon. These limitations apply to non-residents and Ukrainian companies with foreign capital, regardless of the percentage of foreign ownership. Thus, foreigners often end up structuring their investment through at least two Ukrainian resident companies.

(ii) State-owned land

In general, state-owned land can be purchased by non-residents or resident companies with foreign ownership only with the permission of the Cabinet of Ministers and the consent of the Parliament. Sale to foreign investors of any land plots that are being privatized along with state-owned enterprises is carried out by the State Property Fund's branches with the Cabinet's permission and Parliament's consent. Privately owned land, except agricultural land, can be freely transferred.



(a) Land in Kiev

Unfortunately, very few parcels of land in Kiev are currently available to investors for construction. Most of such parcels have already been leased to various local organizations, which are currently looking for investment (sometimes via IPO on London's AIM). For example, a company called "Century XXI" obtained a lease of a .23-hectare prime land parcel on Melnikova No. 3 for construction of an office/hotel/trade complex with a total area of 25 thousand square meters. Another company, "Graal," acquired a prime, 2-hectare land plot on Kreschatik No. 5 for a reported 8,700,000 Hryvnia (4,300 Hryvnia per square meter). They are planning on building a 5-star hotel complex with class A offices, an investment of 160 million Euros.

Of course, there are plenty of local companies that are eager to sell off 100% of their corporate rights, along with the land allocated for construction and the accompanying architectural drawings, to any foreign investor willing to pay a tidy sum of money. In the past, potential foreign investors have been extremely reluctant to undertake a large construction project in Kiev without a strong local partner, and for excellent reasons. Times are changing, however, and at last foreign investors are beginning to enter the market.

For example, in 2007 an Israeli billionaire called Benny Steinmetz (reportedly the 583rd richest person in the world) announced that his company will finance three property projects in Kiev, estimated to cost more than \$1 billion: (1) a 1,200 unit residential complex called "Park Avenue" on the outskirts of Kiev (near Goloseevsky Park); (2) a 30,000 square meter office and retail building in the Podol district, overlooking the Dnepr River; and (3) a warehouse and logistics facility on 50 hectares near Borispol airport. Note that all of his properties were acquired via lease agreements for construction (see discussion below).

In fact, with so much construction going on in Kiev, the smaller construction companies that lease their cranes are out of luck. There are about one hundred construction companies working in Kiev today, using up to 500 cranes, but only a handful actually own them, including TMM, KievZhilStroy and Planeta-Bud. The rest either own a few cranes or, more likely, are leasing them from a company called "Stroimechanizatsia," which has no more cranes to lease for the upcoming year. And not everyone can afford to pay EUR 300,000-650,000 per crane. As a result, in a strange way, the boom in the capital's construction market spells out trouble for the smaller companies.

(b) Land Outside Kiev

Dealing with a government is never easy. Land auctions in the Kiev oblast were promised as early as 2006, including land parcels in the Borispol rayon, land adjoining the ring road around Borispol and Brovary, and the railroad branch between Borispol and the village of Kirovo. Parcels of land

along the main roads, Odessa, Chernigov, were also slated to be auctioned off for industrial and recreational uses. In most cases, however, the issues of transparent land valuations and truly open auctions (instead of the usual sole-source contracts) remain unresolved to this very day.

Because of the above reality, foreign companies usually end up buying land from private owners (LLCs) and build their own warehouses, cottage developments and even hotels. For instance, Vienna-based GLD Invest Group is investing \$240 million into three projects, two outside Kiev and another near Odessa. Incidentally, more than 1/2 of GLD's East Gate Logistic (40,000 square meter warehouse about 5 kilometers from Borispol airport) has already been leased to the German logistics provider, FIEGE Group. Also, DHL Excel Supply Chain (logistics arm of DHL) is developing its first big logistics center in Ukraine, consisting of 50,000 square meters (in addition to its 2 other warehouses). As an interesting side note, none of these projects required involvement of a local partner.

II. Buildings

(A) Commercial Buildings

Of the three fastest developing sub-sectors of Ukrainian commercial real estate (office, retail, and industrial space), the office sector has shown the most growth to date.

Perhaps that is because all commercial real estate in Kiev is grotesquely overpriced and tremendously undersupplied. Many reasons co-exist to explain this phenomenon. First and foremost,



the development process is extremely bureaucratic and corrupt. For instance, in order to erect a building, a company needs about 150 permits plus heavy-duty connections in the Kiev City Administration to obtain the coveted construction permits. Some foreign investors, who lack such resources, prefer to acquire completed buildings, registered in BTI. Others enter into partnerships with local companies that have access to choice land plots and the resources to overcome administrative/political barriers, obtain permits, etc. Everyone else, who tried to construct something on their own, had failed.

At the same time, foreign investors can get 10-15 percent yields on property in Kiev because rent levels in Kiev are twice those in Warsaw and Budapest. That is why companies like Quinn Group, with billion-dollar budgets for Eastern Europe, have acquired commercial properties like Leonardo, where rent prices range from \$50 to \$70 per meter, plus VAT and service charges. Others prefer to pay less for land outside the center, including London-based 1849 PLC, who acquired Pyramida Shopping Center for \$21 million and plans to buy 5-10 more shopping centers in the next 4 years.

At last, there is some activity in hotel sector. In addition to the five-star Opera Hotel, Premier Palace and Hyatt Regency, the second Radisson (near Borispol airport) is going to open, and InterContinental and Hilton are planning to open doors in 2008. Then there are smaller operations, like the Riviera hotel, Podol-Plaza, Golden Dome, and Pan Ukraine, among others. On the lowest level there is Polish Orbis Group, which has 68 hotels in Poland, setting up one and two star hotels in Western Ukraine.

(B) Residential Buildings

Unlike commercial properties, residential developments are strictly monitored to ensure no financial manipulations take place (like they did with the notorious Elita Center). Thus, Article 4 of the Law "On Investment Activities" provides that financing of residential buildings may be carried out only via FFCs, FONs, non-governmental pension funds or bonds. Some Ukrainian developers prefer to create FFCs (Funds for Financing Construction) in accordance with Law of Ukraine No. 978-IV "On Financial-Credit Mechanism and Management of Property During the Construction of Residential Houses and Operations Involving Real Estate", dated June 19, 2003 (as amended on December 15, 2005). Others rely on bonds. For more information, please see discussion below.

III. Industrial Property

Industrial property is the least profitable sector, presenting development opportunities primarily for foreign strategic investors.

Considering the value of land, especially in Kiev, the authorities will begin relocating some of the Kiev-based industrial plants outside the city zone. Of the 540 enterprises currently semi-working in Ukraine, 150 are prime candidates, including such factories as Zahid, Radon, Bolshevik, Kvant, Kiev Motorcycle Factory, etc. This process, however, will take place only after the privatization process is completed. Afterwards, new office buildings and retail centers will take their place.

For instance, according to Igor Balenko, deputy to Kiev City Council and co-owner of the supermarket chain, Furshet, an old and dilapidated factory called Ukrcable (located in the Petrovka district of Kiev) will soon become a shopping mall. Likewise, another well-located ship-building factory, "Leninskaya Kuznitsa," will probably be relocated elsewhere after the SPF sells its 27% stock via tender later this year, leaving the river-front property of Rybalsky Island for residential property development.

IV. Political Risks

Numerous risks exist in the construction business, including cost over-runs due to increases in price of materials and/or services, structural or geological defects, among others. The most common barriers, which cannot be discounted, involve the local authorities who stand in the way of getting access to land for construction, obtaining the necessary licenses and permits, etc. Plus the unstable political climate can easily derail virtually any construction project, at least in the city of Kiev.



For instance, in October of 2006, just 6 months before their scheduled elections, Mayor Alexander Omelchenko and the Kiev City Council suddenly and unilaterally cancelled eight of its resolutions, allocating land for construction. Soon, many other developers with seemingly valid lease agreements, officially approved architectural drawings and legitimate construction permits experienced similar problems. In the end, nearly 500 construction projects were frozen. Some of the developers went to court after the new Mayor Leonid Chernovetsky was elected. For instance, a company "Crown" went to court and managed to reverse the Kiev City Council's cancellation of their land rights. Many others were not as lucky.

Nearly one year later, in July of 2007, Mayor Chernovetsky and the Kiev City Council unilaterally cancelled a land lease agreement involving construction of a 23-story building by company "Mars" at 29 Milyutenko Street because of complaints by the neighbors. Six other lease terminations followed, involving the following construction companies: Interproekt, Aviakom, Olimpud, NVP-Construction, Center of Business Support, and Polus-Plus, all of which received their land allocations for construction under the former Mayor Alexander Omelchenko's firm rule. Allegedly, these companies lacked the necessary paperwork to undertake the projects. Some of these companies have already filed claims in a court of law.

Conflicts with the Kiev city authorities sometimes involve even the President himself. For instance, in March of 2007, President Yushchenko signed Order No. 208/2007, requiring the Kiev City Administration to prohibit construction of high-rise residential and commercial buildings in the historic part of Kiev (as soon as they determine the borders). He also instructed the Cabinet of Ministers to prepare similar prohibitions for other cities in Ukraine. Importantly, this Order also gave the General Prosecutor's office 3 months to review the legality of land allocation for all high-rise construction in central Kiev. Should the prosecutor's office find any unlawful allocations, those land plots will be returned to the city and the investor will recover whatever amount it officially paid.

Following Yushchenko's specific orders, the chief of Kiev city construction prohibited high-rise buildings from being erected in the historical part of Kiev. In the future, he said, any high-rises must be specifically approved by the Ukrainian Society For Protecting Historical Monuments, the National Council of Architects and the Ukrainian Committee ICOMOS. In response, acting Mayor Leonid Chernovetsky passed his own law, permitting construction of mid-rises up to 25 stories. As a result, the cost of constructing such "mid-rises" in the center of Kiev is widely expected to increase several times, since additional bureaucratic barriers were also introduced (i.e., increased number of permissions and dubious issuing authorities such as the National Council of Architects).

The above recitation of facts offers a hard lesson for any investor: re-distribution of property for political reasons is always a significant risk in Ukraine, and nothing can be ruled out until the project is completed and the property is registered with the Bureau of Technical Inventory.

CHAPTER 2

COMMERCIAL AND RESIDENTIAL REAL ESTATE

I. Introduction

Ever since 1991, foreigners have routinely purchased all kinds of real estate. Some acquired large communal apartments for personal use while others converted them for office use. Still others purchased free-standing buildings and have obtained that coveted "free and permanent use of land" thereunder. In other words, the real estate market in Kiev has been active for a long time.

In the early years of 1991-1996, only three Western-quality residential and commercial properties existed: Maculan, Regina Center and Kiev-Donbass. Each charged near-extortionate fees ranging from \$65 to \$85 per square meter per month, and used their monopoly positions to lock up multi-national companies in leases for up to 5 years. Competitors quickly followed in their steps, often demanding an up-front 6-month rent payment, typically wired to an offshore company. Then the regional economy crashed, rather abruptly, in early August of 1998. Many foreign lessees, including those unfortunate multi-national companies who locked in early at unreasonably inflated rents, tried to renegotiate their rent rates, and many succeeded.



Today, despite increased availability of quality residential and commercial properties, the prices continue to rise for both commercial and residential property. Another thing, which has remained consistent in the ever-changing Ukrainian real estate market, is legislation, which expressly allows foreigners to purchase real estate. Below we discuss the fundamental issues involved in acquiring real property in Ukraine.

II. Documents Confirming Property Title and Lessor's/Seller's Identity

In all cases involving real estate (purchase or lease), questions of security in the property's title and ownership rights predominate the agenda, frequently causing a great deal of confusion and distrust. The reason is quite simple: fraudulent transactions are abound and, as a consequence, all issues connected with title transfer and the identity of the true owner must be flushed out before the actual execution of a sale-purchase (or lease) agreement in front of the relevant officials (notary public or commodity exchange).

In the past, gullible companies incurred significant financial losses after effectuating substantial pre-payment (up to 6 months of the lease price) to false lessors only to find that their newly-leased premises actually belonged to an innocent third party. Other cases involved premature termination of poorly drafted lease agreements (often following repairs at the lessee's expense). Of course, recourse to the law has minimal, if any, effect on reimbursement of the expenses or provisions for alternative office space.

To avoid the various pitfalls, any potential purchaser or lessee must insist on reviewing the background documentation, which serves as the ultimate proof of ownership. The various documents include:

1. sale-purchase agreement, gift agreement or privatization certificate for the property;
2. the "technical characteristic" certificate from the Kiev City Bureau of Technical Inventory;
and
3. a certificate from the Kiev City Notary Public that the property is not secured by collateral or subject to encumbrances (i.e., it has no liens or arrests placed on it).

Other documents may be necessary, such as a waiver of a spouse's or children's rights to the property. In case the alleged owner is a legal entity, the seller's foundation documents, among other documents, are most helpful. Of course, if the alleged owner is a natural person (individual), his or her passport must be verified.

Various excuses, such as lost documents necessary to confirm ownership rights, or that a particular document original is somehow inaccessible, is an indication of a potential problem. Contrary to a popular misperception, property ownership records are kept in meticulous order somewhere in the state archives.

All of the above documents should contain the relevant seals of the state authorities, and should be collected within 3 months from the date of their presentation for professional review. Based on these documents, a legal opinion will be drafted, confirming or rejecting the ownership rights to any given property.

A title search, however, is only a part of the chain of legal dilemmas surrounding procurement of property. The supporting legislation concerning currency regulations and taxation can also play a large role in deciding the best way to structure real estate transactions and secure long-term possession and quiet enjoyment of premises.



III. Procedure for Purchasing Real Property

Procedurally, Article 657 of the Civil Code of Ukraine states that real estate transactions must be executed before a notary public in written form and are subject to state registration. Alternatively, the Law "On Commodity Exchanges" permits certain commodity exchanges to execute real property sale-purchase agreements.

In the past, purchasers had significant difficulties with state-employed notary publics and, because an alternative existed, 99% of all property transactions were executed at commodity exchanges. Since then, Ukraine has introduced a system of "private notaries" to undertake this role, with varying degrees of success. Currently, sale-purchase agreements are executed either before a state notary public or before a private notary. Below we review both alternatives.

(A) Closing Before a State Notary Public

With reference to real estate, the Ukrainian government is represented by various entities, such as notary publics (state and private), the Kiev City Bureau of Technical Inventory and the local ZHEK (literally translated as "Residential Exploitation Committee"). These state bodies attest to the Ukrainian seller's ownership and occupancy rights to any property.

State notary publics are usually state officials and, as a rule, use their own standard forms for most transactions. In the context of real property transfers, the standard 2-page notary form for sale-purchase agreements recites only the most fundamental information concerning the property transfer, such as the names of the parties, the property's address, etc., and bears the parties' signatures and the notary's seal. Negotiated provisions, including representations and warranties, are viewed as irrelevant.

To encourage sellers and purchasers to state realistic sales price in their sale-purchase agreements (instead of a fraction of such value, as was the long-standing practice to avoid property tax), in the spring of 2000, the government decreased the state fee for notarization of agreements on the alienation of immovable property from 5% to 1% of the amount of the transaction (i.e., the total amount indicated in the sale-purchase agreement).

(B) Private Notary Public

Ukrainian legislation generously permits the existence of private notary publics. Once licensed, their powers are equal to those of state notary publics without the drawbacks of the bureaucracy. By law, private notary publics cannot charge less than the current state fee to notarize real estate sale-purchase agreements. Although private notaries are permitted to take a higher percentage,

most private notary publics do not charge higher than the state notary publics due to the tight competition between private notary publics these days.

In all cases, however, follow-up registrations must take place with the Kiev City Bureau of Technical Inventory (establishing the new owner's identity), the notary public (central and rayon) and ZHEK.

IV. Conclusion

Today, due to the abundance of privately owned, Western-quality property in Kiev, foreign investors can easily purchase (or lease) virtually any real estate object. Reviewing ownership documents, drafting (and executing) the sale-purchase agreement, and registering the property at the Bureau of Technical Inventory are the necessary technical details that accompany any transfer of property rights. And, unlike old times, such follow-up registrations have become routine and quite easy to perform. All you need is lots of money.



CHAPTER 3

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.

(B) Bonds

The Law "On Mortgage Bonds," dated December 22, 2005, prescribes new rules for the slowly evolving mortgage securities market. For instance, issuers must provide bond purchasers certain guarantees or, alternatively, create a reserve or insurance fund to protect investors. The construction project is entered into a state registry and cannot be used as collateral in other transactions. Moreover, the bond issuance procedure is fairly straight-forward.

In a nutshell, after receiving the necessary land allocation act and construction permits, the construction company/developer estimates the total cost of the future building and issues bonds equal to that amount. These documents are submitted to the State Commission on Securities and the Stock Market, the issuance is duly registered and a project-specific prospectus is published, containing information including the term, purpose for issuance, information about the construction company and its founders, number of square meters in a defined apartment in a specified building, etc. The issuer then enters into sale-purchase agreements with investors via financial intermediaries. See generally, SCSSM Regulation No. 322 "On the Procedure for the Issuance of Bonds of Enterprises and their Circulation," dated July 17, 2003, and Regulation No. 942 "On the Registration Procedure of Bond Issuance", dated April 26, 2007.

Several other reasons exist to explain the popularity of bonds. Since bonds are debt securities, their issuance is not subject to taxation according to Article 7.9 of the Profit Tax Law No. 334/94-BP, dated December 28, 1994 (as amended). This makes bonds attractive to the issuers. Unlike funds sitting in FFC accounts, bonds can be re-sold or used as collateral. This makes bonds attractive to the banks.

In comparison to bonds, the FFC system is more cumbersome and expensive (due to increased state supervision over the fiscal management and the construction process). As a result, we predict that FFCs will not be as popular as bonds.

III. Conclusion

The Ukrainian mortgage system is far from being functional. FFCs are expensive to maintain and FREOs do not yet exist (the only licensed company got its license cancelled). Without getting massive foreign capital infusion via IPOs on AIM, or the flotation of depository receipts on international markets, how can a poor Ukrainian developer or construction company obtain financing? Bonds seem to be the only solution, given the present situation.

CHAPTER 4

BUILDING A ROOFTOP PENTHOUSE

Living in a two-tier rooftop penthouse in the center of Kiev can be a lovely experience. Or, better yet, why not rent it out to a wealthy lessee for a monthly fortune? Because the process of reconstructing a rooftop into a residential paradise is draconian at best and requires careful assessment.

I. Discussion

In total, the rooftop reconstruction process in Ukraine consists of 3 general, deceptively easy stages: (a) collecting the necessary preparatory paperwork; (b) completing the actual construction; and (c) obtaining final permissions to put the construction work into commission. Importantly, property ownership rights will legally vest only after the last step.

Immediately below we will attempt to identify the legal documents that are necessary to construct a rooftop penthouse.



(A) Collecting Preparatory Documents

Before construction can legally begin, the following background documents are required:

1. The Kiev City Administration's consent to begin technical drafts for construction (to be undertaken by a licensed organization);
2. Written, notarized consent of the other apartment owners in the building and their underage children;
3. Consent of various state agencies (fire department, sanitary-epidemiological and environment control, energy management, water supply, among many others); and
4. The Kiev City Council's approval and issuance of a construction permit. Note that additional unexpected conditions may be imposed at this stage, such as maintenance of nearby parks or other social infrastructure objects.

(B) Post-Construction Documents

After construction is completed, a thorough "review and approval" process begins.

1. The state agencies listed above in A3 must review the finished construction for technical compliance with the draft project and issue a corresponding act ("Act");
2. The Act is submitted to the Kiev City Administration, which sends it to the Bureau of Technical Inventory ("BTI") to measure the property and prepare the corresponding technical description, plans and drawings. Eventually, BTI places its seal upon the technical passport (note that such seal bears a restriction that prohibits operation of the building, which must later be removed);
3. The investor submits the technical passport to the Kiev City Administration again and obtains consent (from state agencies listed in A3 above) to put construction into operation (to commission the building);
4. The Kiev City Council resolves to commission the building and sends its resolution to BTI to rescind the restriction described in B2 above;
5. The final BTI plan, without any restrictions, is yet again submitted to the Kiev City Administration for a final time. At this stage, the investor can receive its ownership certificate for the finished construction; and

6. The ownership certificate must be submitted to the BTI for its final, final registration.

II. Conclusion

To avoid some of the pitfalls suffered by other investors, we strongly suggest that you read the latest property legislation. And, maintenance of a friendly, open dialogue with the local authorities responsible for issuing permissions and consents is of vital importance. In combination, you just might succeed.



CHAPTER 5

OPTIONS FOR ESTABLISHING LOCAL PRODUCTION FACILITIES

The August 1998 crisis caused many foreign investors to halt their projects or withdraw altogether. This resulted in a sharp drop in real estate prices, especially for industrial plants (whose asking prices decreased by as much as 40%). Since then, however, the prices for real estate, including production facilities, have risen once again.

In light of the integration of several former Soviet block countries into the European Union in 2004, Ukraine is quickly becoming an attractive target for companies looking to move east due to



the rising prices of labor and real estate in their own territories. For example, many Polish and Hungarian companies are looking to move their production facilities into Ukraine, which offers lower wages and cheaper production costs than the European Union requirements allow.

Today, many of the Ukrainian mid-size enterprises are already privately owned and, therefore, the State Property Fund (and its notorious bureaucracy) is no longer an impediment to acquiring stock in production facilities. As a result, many foreign investors (primarily Russian companies) are returning to snap up the bargains, which have become relatively wide-spread and fairly easy to take advantage of.

As always, with more than 48 million product-hungry people, Ukraine continues to provide a significant market for consumer goods. It is no wonder, therefore, that many foreign companies are reviewing their long-term positions in the vast yet vacant market with a view to establish inexpensive local production facilities in Ukraine. Unlike a few years ago, today the foreign investor has several options in establishing local production facilities, including:

- I. The acquisition of shares of stock in a Ukrainian enterprise;
- II. The establishment of a joint venture (with private and/or state-owned enterprises);
- III. The leasing of local factory space;
- IV. The undertaking of a greenfield project; and
- V. The establishment of local assembly of goods (including software programs and/or components thereof) on a contractual basis.

Below we discuss in brief detail each of the above options.

I. Stock Acquisition in a Ukrainian Enterprise

As a legal matter, the standard open joint stock company charter allows foreign and Ukrainian private legal entities, as well as natural persons, to purchase its existing stock. The shareholders can include any number of parties, such as former employees who purchased stock on preferential terms for privatization certificates and any third party purchasers who have acquired stock on a competitive basis through a tender or on a stock exchange, among others.

The transfer of existing shares to a foreign investor normally takes place on the basis of a sale-purchase agreement, but theoretically can be effectuated also by a barter agreement, inheritance certificate or a court decision. Such shares must be subsequently re-registered in the name of the purchaser by submitting a transfer order and a certified, notarized copy of the agreement (which will be kept by the registrar), indicating that the title is transferred to the new owner. If the agreement is concluded by a third party or the documents are submitted by a third party, the original

documents confirming the authorized powers of such third party, or a certified copy thereof, should be submitted to the registrar as well.

A proper legal review of the foundation documents of any given Ukrainian enterprise will reveal the procedure, and any potential restrictions, regarding employee stock transfer rights. As a practical matter, purchasing existing stock (a) usually results in a very limited control by the foreign stock purchaser over significant matters of the enterprise and (b) a Ukrainian enterprise's management can easily view such attempt to purchase the existing stock as a hostile takeover attempt.

Instead, most factory management bodies prefer to issue and sell additional stock to investors by offering a significantly larger stock package because private factory administrations are usually interested in obtaining an immediate infusion of capital and know-how. Therefore, strategic investors usually are asked to increase the company's capitalization in lieu of (or in addition to) acquiring existing stock.

In summary, the procedure for issuing additional stock begins with a general meeting of the shareholders. At the general meeting, the shareholders officially resolve in a protocol form to issue additional stock and approve the information and conditions of the public subscription. The information is then registered with the State Commission for Securities and Stock Markets (the "SCSSM") and, thereafter, it is published in one of the official governmental newspapers.



After such publication, an open subscription period allows foreign investors to purchase the additionally issued stock of the joint stock company after existing shareholders have exercised their rights of first refusal. Finally, the issuance results are published with the SCSSM and the general meeting of shareholders must formally approve the results of the subscription. Note that in consideration for the issued shares, the foreign investor can contribute virtually anything of value, including foreign currency, equipment and intellectual property.

II. Joint Ventures

Once upon a time, the most popular option for foreign investors to enter the Ukrainian market was by forming a joint venture with a Ukrainian partner that was able to contribute property and, hopefully, shared a complementary production profile for joint local production. Today, in many cases the shareholders in privately-owned companies fear bankruptcy as the factory employees (who are also often its stockholders) face termination in the absence of foreign investment. In fact, many privatized enterprises often cannot pay their outstanding debts, such as bills for gas, heat and electricity, among other obligations.

In such situations, well-informed investors are able to negotiate far better terms with a private company than with a state-owned enterprise undergoing or about to undergo the complicated (and often politically charged) process of privatization. The reason is quite simple: under Ukrainian legislation, a private stock company is able to independently dispose of any or all of its property, sell its stock to foreign or Ukrainian buyers, and enter into joint ventures, subject to certain case-specific exceptions. The legal ability of a privatized stock company to enter quickly and easily into all types of transactions, including real estate transfers, makes them a particularly attractive source of industrial real property.

III. Leasing Factory Space

Another possible option is to lease the existing factory space (on a 3 to 50 year lease, preferably with a buy-out option) and set up a production line by registering a 100% foreign subsidiary. This option simply requires the execution of a lease agreement between the foreign investors and the owners (shareholders) of the local factory. According to Articles 793 and 794 of the Civil Code, lease agreements for factory space are subject to notarization and state registration if their term is for three years or more.

Even state-owned enterprises can lease a portion of their property to interested foreign investors. Most foreign investors, however, do not widely use this option because they are weary of investing in premises where the lease can be terminated arbitrarily for any number of reasons.

With the passing of a new Land Code of Ukraine, which became effective on January 1, 2002, foreign legal entities with permanent representation in Ukraine (i.e., limited liability companies, joint stock companies, etc.) are able to acquire ownership of non-agricultural land on which their real estate is located. Up until this point in time, the Ukrainian authorities have yet to clearly and effectively implement the Land Code in favor of foreign investors. The expected rush towards the purchase of land by foreign companies has been delayed by the vague provisions of the Land Code and the expected introduction of amendments thereto.

While a discussion of the Land Code of Ukraine is beyond the scope of this brief overview, foreign investors should keep in mind that they have the right in most instances to purchase land under their production facilities. Notably, Ukrainian and foreign entities alike are prohibited from contributing the rights to land parcels into the authorized capital of a company until January 1, 2008.

IV. Greenfield projects

The favored option by many multi-national companies (including the US multinational Cargill and McDonalds) is a greenfield project (the construction of a 100% foreign owned building on a



parcel of land). While this alternative certainly fulfills many foreign investors' dreams of bypassing the central government bureaucracy, it is a relatively new practice under the Land Code, which legalized the allocation of land for industrial use (production purposes).

Cognizant of the tremendous investment amounts greenfield projects could generate, on July 12, 1995, President Kuchma signed Decree No. 608 "On Privatizing and Leasing Non-Agricultural Land for Business Purposes." Hailed at the time as a great leap forward in economic reforms, this decree called for the privatization and leasing of so-called "non-agricultural" (industrial) land. Unfortunately, the conservative Parliament ruled (several times) that President Kuchma overstepped his bounds by issuing such a decree without having the requisite legal authority to allocate Ukrainian land (industrial or not) for privatization to foreign investors. However, with the passing of the Land Code, many of the provisions of the Decree No. 608 have come to life. Nevertheless, Decree No. 608 finally lost its legal force on August 6, 2007 as a result of Presidential Decree No. 650 of July 20, 2007.

V. Local Product Assembly on Contractual Basis

Some foreign companies prefer to start their local production by entering into agreements with existing facilities for the assembly of goods on the territory of Ukraine. There are two separate ways to implement such projects. A foreign company may import raw materials and execute a contract for the assembly of goods in Ukraine, with the final product to be exported and sold abroad (also known as toll manufacturing, which is subject to a special regime of tax, customs and other benefits). Alternatively, the assembled goods could be sold in Ukraine. The tax consequences vary, depending on the option and the transaction structure that the foreign company chooses. In more recent times, many high-tech companies have been hiring Ukrainian programmers to assemble computer program components in Ukraine, which are then transferred to the company for final assembly and sale abroad.

VI. Conclusion

The most difficult part of setting up local production facilities used to be obtaining access to industrial property for production purposes. The Land Code has made this difficulty almost obsolete. Now, the focal and most vital issue is performing extensive due diligence in screening the right partner and verifying title documents to land.

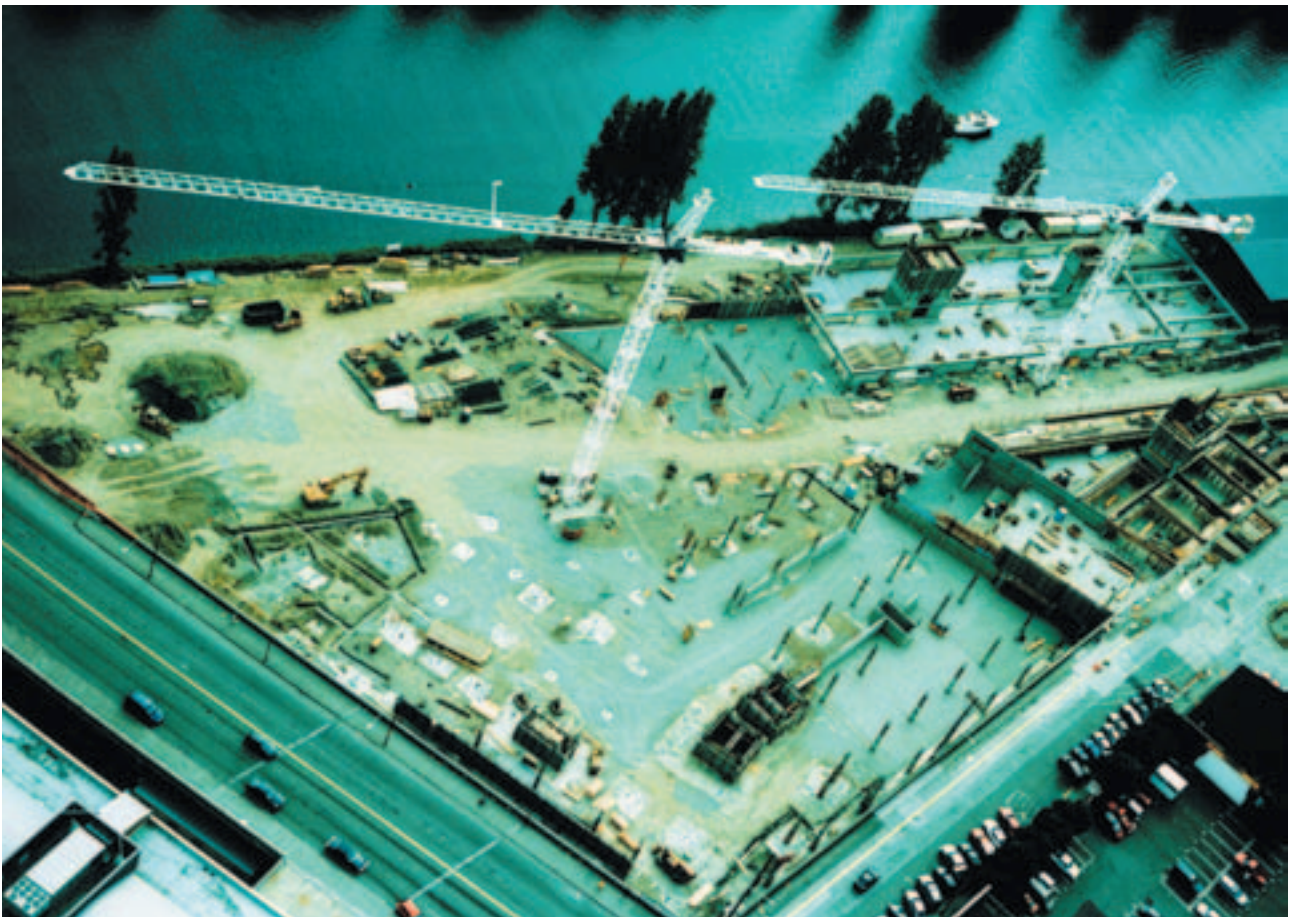
CHAPTER 6

FORMING JOINT VENTURES WITH STATE-OWNED ENTERPRISES

I. Selection of a Ukrainian State-Owned Partner

Signing a joint venture's foundation documents is usually the last step in a long and extensive preparation process. Presumably, the foreign investor has selected the state-owned Ukrainian company based on an informed decision concerning its legal status and property rights. In this process, due diligence must be performed, which will take the form of a comprehensive report concerning the Ukrainian partner's state of affairs and ownership rights. In fact, it is an indispensable tool in structuring any investment.

Sometimes, foreign partners entering into a joint venture with the Ukrainian government or quasi-government entities, including state-owned factories, face two separate yet related issues:



(1) compatibility of interests with the Ukrainian partner; and (2) the scope of the partner's authority to make the necessary capital contributions to the joint venture.

First, a foreign investor needs to perform due diligence to determine the identity and composition of the Ukrainian partner (e.g., a private company, a state-owned enterprise or mixture). In the case of state-owned companies, Ukrainian partners claiming rights to real property may fall into two categories: (1) an individual factory complex to which a state body has the right of administration; or, (2) an "association," typically uniting several sub-units or factories, only some of which are competitive and therefore profitable. Both types of government organizations may (i) be legal entities under Ukrainian laws (subordinate to the body of state power which created the company), (ii) maintain a corporate seal and bank accounts, and (iii) execute some (but not all) agreements and carry out obligations on their own behalf.

Depending on their legal form, such organizations may have temporary rights to use, and perhaps sub-lease, the real property in their possession. In any case, the Ukrainian partner's property rights should be confirmed in conjunction with its legal status. To avoid unpleasant surprises that may jeopardize future operations, the foreign investor should at least obtain and review a copy of the Ukrainian partner's charter (by-laws) to confirm its legal status. Among other things, the charter will reveal whether the Ukrainian partner is a separate legal entity and has its own bank account, or whether it is an association or a sub-structural unit of an association with an internal financial/governing board. The charter will also reveal the relationship between the association and each of the member factories.

If examination of the charter reveals that the Ukrainian partner is an association, the foreign partner may be faced with a politically difficult choice: either to marry an entire association (and suffer the consequences of dealing with bureaucracy and uncertainty) or to pursue a relationship with an individual member factory and/or sub-unit of the association (and possibly incur the wrath of the still powerful parent association holding supply contracts).

Generally, foreign investors prefer to enter into a long-term business relationship with an individual state-owned factory rather than a state-owned association. The main reasons for this preference include (1) the greater commonality of interests among the partners; (2) an association's longevity is more questionable than that of an individual factory; and, perhaps most importantly, (3) associations frequently have a limited right to contribute or lease the property necessary for production purposes.

The discussion below provides an overview of some of the issues involved in structuring and negotiating joint ventures with a Ukrainian partner, whereby such partner's real or in-kind property (not only Hryvnia) is contributed to the joint venture's authorized capital.

(A) Commonality of Interests Between Foreign and Ukrainian Partners

By way of background, associations were formed as a mechanism for protecting the non-competitive Ukrainian factories from facing bankruptcy during harsh economic times. The economic relationship amongst the association's members was similar to that of Ukraine's failing central administrative economic model: the association is designed to sacrifice efficiency and competitiveness in return for preservation of the status quo in light of impending bankruptcies and massive unemployment.

Under a typical arrangement, all of the association's members contributed their income to the association's central managing organ, which retained some of the funds and re-distributed the remainder among all of its members to ensure longevity of the non-competitive members at the expense of the very efficient members. As a result, a typical association's governing board was more politically oriented to satisfy the demands of the non-competitive members and frequently had a highly bureaucratic and inefficient board of directors.

In contrast, the foreign partner and an individual factory naturally have an easier time in the future resolving certain key issues connected with growth and profitability of the joint venture.



For instance, they are able to quickly resolve key questions, such as the foreign partner's option to increase the joint venture's capitalization (and, correspondingly, adjust upward its share in the ownership of the stock in relation to the Ukrainian partner) or issues connected with the reinvestment of profits.

(B) Ukrainian Partner's Longevity

A foreign partner should consider the relative stability of its potential Ukrainian partner to avoid the possible termination of a joint venture's operation due to the Ukrainian partner's privatization or liquidation in the future.

In the past, entering into a long-term relationship with associations proved to be an unfortunate experience given the tendency of similar Ukrainian quasi-governmental structures to dissolve. Dissolution of associations may occur for various reasons. Typically, the more profitable member enterprises of the association directly enter into joint ventures or undergo small-scale privatization by its employees. Naturally, as the profitable member enterprises exit the association, the remaining (unprofitable) member enterprises' struggle to survive as an association may ultimately fail and result in formal bankruptcy and unemployment. Obviously, the prospect of having a bankrupt partner is not appealing to most investors.

In summary, the relative stability of each association and individual factory should be separately evaluated on the basis of the general industry climate as well as its individual membership.

(C) The Ukrainian Partner's Right to Contribute Property

The first of many property laws, the Law "On Enterprises, Institutions, and Organizations Under Union Subordination Located within the Territory of Ukraine," effective as of September 10, 1991, transferred all property rights of Soviet enterprises on the territory of Ukraine to the State Property Fund (the "SPF"). The SPF's Instruction "On the Procedure for Alienating State-Owned Production Facilities [Listed on the Books] of State-Owned Enterprises," dated December 2, 1992, specifically required the SPF or its branches to issue permission prior to any state-owned factory's contribution or sale of any state-owned assets to private parties.

As a general rule, when state-owned property is alienated (either by privatization or contribution to joint ventures), the SPF is responsible for granting the final approval for such property transfer. Notwithstanding this fundamental legislative requirement, many directors of state-owned enterprises or quasi-governmental associations regularly exceeded their authority by disposing of buildings and equipment without the official knowledge of their so-called "higher-standing organizations" (i.e., Ministries, the SPF, etc.).

In summary, to avoid any subsequent misunderstandings concerning the Ukrainian partner's legal status and its property rights, it becomes quite important to perform extensive due diligence at an early stage in a project's development.

II. Negotiation with the State Property Fund

In negotiating the various provisions in a joint venture's founding agreement and charter (by-laws), a foreign investor must understand the areas of competence of the SPF and the state factory itself. The SPF not only plays a crucial role in the approval process, but also becomes a joint venture shareholder and the foreign investor's partner. Practically speaking, however, it is incapable of participating in the day-to-day operation of the joint venture.

In turn, the role of the state enterprise was that of a dependent production unit of the Ukrainian government, whose operational and managerial components are necessary to the creation of the joint venture, but which had neither the ownership nor the decision making powers related to the shares issued by the joint venture. Fortunately, this has changed since the advent of "corporatization." Corporatization is the re-organization of a state-owned enterprise into a stock company prior to privatization, allowing the factory management to make most of the decisions (except alienation of property).



Generally, entering into a joint venture with a state-owned enterprise can be a time-consuming and unsatisfying experience, especially if the investor selected a unique factory (i.e., military conversion factory), or several other potential investors are interested in the same opportunity. Thus, foreign investors should be prepared to spend months in negotiation sessions with the factory management and the SPF.

One of the many issues, which may arise during negotiations, is the SPF's refusal to contribute the ownership rights to the state factory's real property into the joint venture's authorized capital. Instead, the joint venture typically receives a "right to use" such property (i.e., free lease agreement) for the duration of the joint venture's existence. In most cases, the SPF carefully scrutinizes any provision relating to property contributions, comparative valuation, accounting rules and international arbitration. Other provisions are also subject to long and heated debates, depending on the nature of the transaction (e.g., joint ventures in the energy sector).

In negotiating access to state-owned industrial property, an investor should remember that the SPF disposes only of state-owned buildings, which means that the land continues to be under the jurisdiction of the local Council of People's Deputies. Accordingly, the SPF cannot transfer ownership of the land nor lease rights thereto, even if it wanted to.

III. Procedure For Entering Into a Joint Venture With a State Owned Enterprise

In 1991, joint ventures with state-owned enterprises were negotiated almost exclusively with the state enterprise chosen by the foreign investor and the relevant ministry in charge of the enterprise. Predictably, this led to near-criminal situations where, for instance, state-owned property was transferred/launched via a unique accounting method called "from balance to balance" to private Ukrainian companies on an extraordinarily favorable basis. Subsequently, such properties would be sold to foreign investors outright (e.g., office buildings) or contributed to the joint venture's authorized capital (e.g., small and mid-size factories).

Today, however, two separate decrees govern the procedure for entering into a joint venture with any state-owned entity, including Ukrainian private companies with more than 25% state-owned participation. As of January 13, 1993, Decree No. 24-92 of the Cabinet of Ministers "On Regulating the Activities of Legal Entities Created by State-Owned Enterprises," dated December 31, 1992, flatly prohibits state-owned enterprises (except for construction companies participating in joint ventures abroad) from establishing any enterprises, regardless of their form and type of activity. Further, state-owned enterprises may not participate in any business associations or cooperatives, which means that they are not only barred from entering into any ventures with foreign investors, but also with domestic companies.

Further, Law No. 185-V "On Management of State-owned Objects", dated September 21, 2006, requires the Cabinet of Ministers to give consent to the SPF to form a joint venture between a ministry's subordinate factory and a foreign investor. Although these legislative acts initially may appear to create additional barriers to the formation of joint ventures with state-owned enterprises, in reality they merely affirm the previous concept that fate of state-owned property lies with the Cabinet of Ministers (as the ultimate decision maker) and the SPF (as the controller of corporate rights and state-owned property).

From a procedural viewpoint, formation of a joint venture with a state enterprise has several components: first, the state enterprise must be chosen by the foreign investor for its technical compatibility, management, assets to be contributed and production capacity. Fundamental issues must be negotiated and documented in the form of a draft founding agreement and charter.



Second, the state enterprise must review such documents with the relevant ministry and obtain its approval via the Cabinet of Ministers. This may be difficult in the case of more competitive and profitable Ukrainian factories because, in effect, the rules cause the assets of a state-owned enterprise to be contributed to the joint venture company without the receipt of the corresponding shares by the relevant ministry in return.

Upon obtaining the necessary ministerial consent, the foreign partner must negotiate with the real owner of the property, the SPF, regarding the contents of the founding agreement and charter. Thereafter, the SPF becomes an official founder in the joint venture and the state-owned factory will carry out the day-to-day activities of the joint venture.

The aforementioned bureaucratic difficulties are not, by themselves, a sufficient reason for refusing to enter into a joint venture with a state-owned enterprise. A more significant reason is the change in control and the uncertainty with respect to the future partner due to privatization. In view of the imminent privatization of state-owned stock, provisions limiting the right to transfer the joint venture company's shares to third parties must be directly negotiated with the SPF.

IV. Miscellaneous Considerations in Forming a Joint Venture with a State-Owned Enterprise

(A) Privatization of the State Property Fund's Shares in Joint Ventures with Foreign Ownership

As previously mentioned, Ukrainian legislation allows only the SPF to enter into joint ventures with foreign investors with respect to state-owned enterprises. Thus, shares of the state's stock in a joint venture will be issued to the SPF and not to the state enterprise that participates in the operations of the joint venture company. The SPF has been inserted in the joint venture approval process as the owner of the state's shares in joint ventures for one reason: the SPF is the principal vehicle for privatizing the state's assets and, in particular, stock the state holds in joint ventures created with foreign investors.

Although Ukraine saw precious little privatization before 1995, the SPF was always intended to serve as merely a temporary holding entity prior to privatization. By its very function, the SPF is responsible for selling state-owned property. Much like state-owned buildings, the SPF's shares of stock in joint ventures are being privatized.

On August 22, 1997, the SPF issued Order No. 913, entitled "Provision on the Procedure for Preparing Shares (Equity, Stock) [That] Belong to the State in the Property of Enterprises with Foreign Investments and Other Companies for Privatization and Sale," which was registered with

the Ministry of Justice on October 1, 1997 under registration No. 450/2254. This Order provided a fairly straight-forward procedure for acquiring state-owned stock in joint ventures. Order No. 913 was subsequently replaced by the SPF's Order No. 1138 of the same name on June 16, 1999 (registered with the Ministry of Justice on August 3, 1999 under No. 525/3818). Essentially, state-owned shares can be purchased by the co-founder(s) in a joint venture or by the employees (workers' collective) in a joint venture, with the consent of such co-founder(s), in exchange for cash only.

Any foreign investor, interested in entering into a joint venture with a state-owned enterprise, must protect itself from potentially unforeseen consequences of privatization. This can be done by providing for a right of first refusal to purchase shares of stock and restrictions on the sale of stock to competitors, and also by selecting the method of sale and valuation of shares of stock. Unless these issues are specifically addressed in a founding agreement, a foreign investor's project may face uncertainties. For the investor, privatization of the SPF's stock will result in a new partner (or in case of the open sale of stock, several hundred new partners) in the joint venture.



This concept always presented problems for foreign investors, particularly where the investor makes available to the joint venture competitive technology or intellectual property. Without adequate precautions, such confidential information could easily be disseminated to competitors through minority shareholders.

Below we address in greater detail some of the issues relating to the possible future privatization of state-owned ownership in a joint venture.

(B) Controlling Change of the Joint Venture Partner in the Event of Privatization

Typically, partners in joint venture companies seek to maintain control over a change in their chosen partner, imposing mutually binding limits on the transfer of the joint venture company's shares to third parties (e.g., rights of first refusal). This way, in the event a Ukrainian partner is subject to a change of control, the sensitive foreign investor will have the option of insisting that its shares in the joint venture company be purchased by the other partner(s).

Short of a fundamental government restructuring, a change of control in the SPF is a highly unlikely scenario given the fact that the SPF has been created exclusively to privatize state assets. Therefore, change of control provisions are probably not necessary in a joint venture entered into with a completely state-owned enterprise. In light of the imminent privatization of state-owned shares in most joint ventures, however, restrictions on transfers to third parties, such as rights of first refusal and prohibitions of sale to competitors, become vital.

In any case, the provisions limiting the right to transfer the joint venture company's shares to third parties must be directly negotiated with the SPF. Foreign investors should be careful to negotiate not only for the right of first refusal and restrictions on sale to competitors, but also for the method of valuation. In the past, privatization legislation offered complex and frequently unclear methods of valuation, including special provisions applicable only to foreign investors that caused foreign bidders to pay significantly higher prices than local bidders.

In conclusion, a right of first refusal, granting the foreign investor a buy-out option subject to special valuation, should be made patently clear in the joint venture agreement. However, while the SPF routinely agrees to a right of first refusal for sale of stock, it almost always rejects a call option.

CHAPTER 7

THE LAND CODE

I. Introduction

While no shots were fired from the proverbial battleship Aurora, the passing of Ukrainian land into the hands of the "peasants" was accompanied by its own mini-revolution: on the day Parliament was to vote on the adoption of a new Land Code, Communist factions surrounded the podium in a futile effort to block the deputies from casting their votes. On October 25, 2001, however, the Parliament finally adopted a new Land Code, which was subsequently signed by the President. Since then, many have dubbed this event as the "Great October Land Revolution."

According to the Land Code, land is finally deemed as an "object of private ownership rights." In other words, landowners have the right to sell, exchange, donate or pledge their land plots. Unfortunately, these valiant provisions they do not have an immediate effect for all landowners: a



moratorium on the sale of agro-industrial land, which came into effect on January 1, 2007, specifically prohibits anyone from selling and/or changing land allocation of their farmland, including OSG. Thus, the owners of agricultural lands will not be able to exercise these rights until January 1, 2008, when the moratorium is due to be lifted. Despite the temporary moratorium, with agricultural land in the hands of private landowners and the introduction of a new law governing mortgages of land, the quality and condition of such land is likely to improve in the near future.

With this brief overview in mind, below we discuss in further detail the impact of the Land Code on foreign investment.

II. Discussion

Since January 1, 2002, the Land Code has taken full effect in Ukraine, expanding the rights of foreign governments, foreign legal entities, foreign citizens and persons without citizenship in the sphere of land rights. While this expansion of land rights is significant, it does not give the green light to foreign investors to take the fertile, black earth of Ukraine. In fact, the Land Code still contains certain limitations on the purchase of land by foreign governments and investors alike.

The Land Code places land into several categories, including agricultural land, land for residential and public construction, natural reserve lands, historical-cultural lands, water and forest reserves, recreational lands, lands designated for sanitary/health purposes (i.e., health resorts, sanatoriums) and, finally, lands for industrial, transport, communication, energy, defense and other purposes. The Land Code permits land to be transferred from one category to another upon a decision of the executive powers or bodies of local self-governance to transfer such land into ownership, use, the historical-cultural fund or natural reserve fund. If land is owned by a citizen or legal entity, the category of such land may be changed upon the initiative of such citizen or legal entity. This is quite important as many attractive land plots are not currently designated for private or business use (i.e., they are designated to other zoning areas).

There are three categories of land, which are of most importance for foreign investors and governments: agro-industrial, industrial and residential land. Importantly, the Land Code strictly prohibits foreign citizens, legal entities and governments from acquiring agricultural lands into ownership. Thus, lease arrangements are the only way for foreign investors to get access to agro-industrial land (including land for personal farming or gardening). Notwithstanding this restriction and the Land Code's moratorium on the sale of agricultural land until 2008, Ukrainian owners of agricultural land may still use their agricultural land plots as security in order to obtain credit or loans.

Interestingly, a foreign legal or natural entity may receive agricultural land into inheritance. However, such land will be subject to alienation within one year from the time of inheritance or the ownership rights thereto will be revoked. While the importance of agro-industrial land should

not be underestimated, an analysis of the possibilities within the agricultural sphere is beyond the scope of this discussion. Interestingly, despite heavy lobbying, there still have been no significant movements towards the liberation of agricultural lands for purchase by foreign investors. Therefore, savvy foreign investors are forced to seek loopholes through which they may gain access to agricultural land once this prohibition is lifted.

As a general overview, residential land includes land plots within populated areas, which are used for construction of residential buildings, public constructions and other structures of public use. Industrial land includes lands provided for the allocation and exploitation of principal and auxiliary buildings and structures of industrial, mining, transportation and other enterprises, including their means of access, communication networks, administrative-infrastructure buildings and other structures.

(A) Ownership Rights to Land

Under the Land Code, the right to land ownership includes the rights of possession, use and disposal of land plots, which are acquired and exercised on the basis of the Ukrainian Constitution, the Land Code and other laws issued in accordance therewith. For the first time since Ukraine's independence, the Land Code clearly provides that land can be privately owned.



The Land Code defines a land plot as a part of the land surface with established borders, a defined location and certain designated rights thereto. The ownership rights to a land plot apply within its borders to the surface (soil) layer and any water objects, forests and long-standing plantation thereon. Further, ownership rights to a land plot apply to any space above or below the surface of the plot of a height or depth "necessary for erecting residential, production and other buildings and structures." The Land Code does not explain further this vague provision.

Formerly, all bodies of water and forests belonged to the State. Therefore, the Land Code has significantly extended the meaning of ownership rights to a land plot. However, if the land to be purchased will be used in connection with the use of its minerals, then the new landowner will have to receive all licenses and permissions for the use of minerals and the restoration of land in accordance with an approved re-cultivation plan or concession agreement.

Ukrainian citizens may acquire the ownership rights to a land plot on the basis of (i) a sale-purchase, gift, rent, barter or other civil agreement; (ii) gratuitous transfer from state or communal ownership; (iii) privatization of land plots previously allocated to them for use; (iv) inheritance; and (v) an in-kind share to which they are legally entitled. In contrast, foreign citizens and legal entities may acquire non-agricultural land plots by way of (i) sale-purchase, gift, rent, barter and other civil agreements; (ii) buyout of land plots on which real estate under their private ownership is located; or (iii) inheritance. However, a foreign citizen may only acquire ownership rights to a non-agricultural land plot outside the limits of populated areas if they have privately owned real estate already located on such land plot.

Foreign legal entities may also acquire ownership rights to land plots if its founders contribute a land plot into its authorized capital. Foreign legal entities may acquire ownership rights to land plots of a non-agricultural designation:

- a) within the limits of populated areas in case of the acquisition of real estate and for purposes of constructing objects connected with their business activities in Ukraine (i.e., they must have the right to carry out commercial activity in Ukraine, which excludes non-commercial representative offices);
- b) outside the limits of populated areas in case of the acquisition of real estate already located on the plot.

The same rules applied to foreign legal entities also apply to joint ventures established with the participation of foreign citizens or legal entities. Additionally, foreign governments may acquire land plots into ownership for the allocation and construction of diplomatic missions and other organizations of equal standing on the basis of international agreements.

In essence, these provisions of the Land Code are what foreign investors have been waiting for since Ukrainian independence. Foreign investors now have the right to purchase the land under their privately owned production and storage facilities, provided, such land is not designated as agricultural or other land restricted for foreign citizens and businesses. Buyer beware, however, because foreign investors with real estate will have to carefully assure that the land on which the real estate is located is not re-allocated at a later date as agricultural land. If this happens, the land on which the real estate is located will be subject to mandatory sale or disposal within one year.

(B) The Right to Use Land

The Land Code permits two basic rights to land use: (i) the right to permanent use and (ii) lease rights. The former gives the right holder the right to possess and use a land plot under state or communal ownership without an expiration term. Unfortunately, this right may only be acquired by enterprises, institutions and organizations, which are "related" to state or communal ownership.

Significantly, the right to lease plots of land is a viable alternative for foreign investors, international organizations and foreign governments. Under the Land Code, leases may be either short-term (no more than 5 years - the former Land Code defined "short-term" as no more than 3



years) or long-term (no more than 50 years). The Land Code also allows the lessee to sub-let the land plot upon consent from the lessor. All other issues in connection with the lease of land are regulated by Law of Ukraine No. 161-XIV "On Lease of Land," dated October 6, 1998 (as completely re-written on October 2, 2003 pursuant to Law No. 1211-IV).

Apart from the mention of concessions, which also must involve lease arrangements, and Law No. 997-XIV "On Concessions," dated July 16, 1999, the Land Code does not contain many novelties on leasing; therefore, a cursory review of the Law "On Lease of Land" is required in order to comprehend land lease arrangements in Ukraine.

(C) The Sale of Land Plots Under State or Communal Ownership

The governmental bodies and bodies of local self-governance carry out the sale of land plots under state or communal ownership to Ukrainian citizens, legal entities-residents (i.e., joint ventures and resident companies) and, in some cases, foreign governments on a competitive basis (auction, tenders), except for the buyout of land plots on which real estate objects are located under the ownership of the buyer. For this purpose, the interested buyer submits an application (petition) to the relevant body of the executive power or local council, indicating the desired location of the land plot, the purpose of its use and its size. The following documents must be attached to the application (petition):

- a) the State Act on the right of permanent use of land or a lease agreement;
- b) the land plot's layout and the document, evidencing the issuance thereof in case of the absence of a State Act; and
- c) the certificate of registration of a subject of entrepreneurial activity.

The relevant governmental body must review the application within a month and render a decision on the sale of the corresponding land plot or a substantiated refusal. If the applicant wishes to acquire land that is not currently under its use, then the sale of the land will only take place after its application is accepted but no later than 30 days after the development of a land allocation draft by a land management organization.

The grounds for refusal to permit the sale of a land plot in the above scenario are as follows:

- a) the absence of documentation necessary for rendering a decision on the sale of such land plot;
- b) the discovery of unauthentic or false information in the applicant's documentation; and



c) if bankruptcy proceedings or other proceedings on the termination of the applicant's entrepreneurial activities have been initiated.

Once the relevant governmental body renders the decision, the applicant may enter into a sale-purchase agreement. Note that such sale-purchase agreement must be notarized and the document confirming the payment of the notary fees must be presented in order to receive the State Act on the ownership rights to the land plot and complete state registration. The value of the land plot in question must be set by a cash and expert valuation according to the method established by the Cabinet of Ministers.

The procedural rules change a bit if the land is under state or communal ownership. If land is under state ownership, then the land will be sold to foreign states or foreign legal entities by the Cabinet of Ministers of Ukraine only upon the consent of the Ukrainian Parliament. If there are objects on a land plot which are subject to privatization, then the land will be sold to foreign states or foreign legal entities by the privatization body authorized by the Cabinet of Ministers upon the consent of the Parliament.

However, if the land is under the ownership of a territorial community, the territorial community need only receive the consent of the Cabinet of Ministers to sell such land to foreign states and foreign legal entities. Once again, in all of these cases a foreign legal entity must register a permanent representation with the right to carry out commercial activity (i.e., no representative offices) on the territory of Ukraine in order to obtain consent to their purchase of communal and state-owned land.

Procedurally, foreign legal entities, interested in acquiring land plots, must submit a petition to the relevant state body (Council of Ministers of the Autonomous Republic of Crimea; the regional, Kiev and Sevastopol city state administrations or the relevant local council) and the relevant state privatization body, along with a lease agreement for the land plot and a copy of the certificate of registration of a permanent representative office by the foreign legal entity with the right to carry out business activities on the territory of Ukraine. As mentioned above, the relevant state body will review the application only after it receives the consent from the Cabinet of Ministers.

Having acquired a land plot in Ukraine, a purchaser is guaranteed the protection by the State of the right to own land, the right to demand the removal of any violations on its land or compensation due to damages caused by third parties, etc. Ukrainian courts, bodies of local self-governance and the executive bodies in charge of issues of land resources are responsible for deciding land disputes within their jurisdictions.

III. Conclusion

While foreign legal entities and individuals are not yet entitled to own agricultural land, they may freely own the land parcels where their Ukrainian factories and plants are located. Still, the State retains the right to exercise control over the use of land by its owners and can deprive such owners of their ownership rights if violations are revealed.

Incidentally, with the passing of the Land Code, more than 11 million Ukrainian citizens finally became lawful owners of their privatized lands due to the provision in the Ukrainian Constitution stating that full ownership to privatized land will only occur after a new Land Code is passed. While of no practical consequences for foreign investors, it is excellent news to those pensioners who may lease their land plots for much-needed income or as collateral for a loan.

CHAPTER 8

BASIC STEPS TOWARDS LAND OWNERSHIP

On October 25, 2001, a new Land Code of Ukraine (the "Land Code") was adopted and came into effect on January 1, 2002. In general, the Land Code is intended to facilitate the development of the real estate and land market in Ukraine. And, surprisingly, it actually has led to some long-awaited changes and sighs of relief.

The first, and probably most important change, is that land in Ukraine may be privately owned. Of course, the Land Code has retained the archaic, socialistic notions of communal and state ownership. Another provision of the Land Code stipulates that ownership rights to land are now acquired and realized on the basis of the Constitution of Ukraine and the Land Code. This is another step confirming that it is not a crime to be a proud owner of land.

Article 657 of the Civil Code of Ukraine (the "Civil Code") clearly states that agreements involving the sale of land must be notarized and are subject to state registration. Accordingly, failure to comply with the requirement to notarize and register a land sale-purchase agreement may render such agreement



null and void. Agreements involving the sale, exchange and gift of land in all cases are subject to notarization at the location of the land plot in question and such agreements are of equal legally binding force and effect regardless of whether a state or a private notary certifies the agreement.

With respect to the sale of land, prior to visiting a notary, the seller must prepare a number of documents, which are required for the proper processing and execution of the sale-purchase agreement. Notably, the right to dispose of land plots, and specifically, to enter into sale, exchange and/or gift agreements belongs exclusively to the owners of such land plots. Pursuant to this presumption, the notary will require the seller to present the relevant state act confirming his or her ownership rights to the land plot according to Article 126 of the Land Code. Any other documents evidencing ownership rights, such as a decision of a local council on the allocation of a land plot, will not be accepted by a notary.

Further, the notary will be required to verify the existence of any liens and other encumbrances on the land plot offered for sale. A notary receives this information from the Unified Register of Liens to Immovable Property, which accumulates such data from all over the nation. Should the notary find out that a lien is imposed upon a land plot in question, it will refuse to certify the sale-purchase (gift, exchange) agreement.

In case a spouse has acquired a land plot during marriage, written consent from the other spouse will be required in order to alienate the land plot. As an exception, however, such consent will not be requested if the land plot was acquired via privatization.

In order to process and execute certain land-related transactions, an official appraisal of the land plot by a licensed appraiser may be required, and the results of such appraisal must be compiled in an appraisal report. The general legal issues governing the value of the land are regulated by the Civil Code, the Land Code and the Law "On Appraisal of Land," dated December 11, 2003 (as amended) (hereinafter the "Appraisal Act"). In general, both Codes state that the sale of a land plot is executed at the price agreed upon by the parties. Please note, however, that other specific requirements are provided in the Appraisal Act and related regulations approved by the Cabinet of Ministers of Ukraine.

Notarization of an agreement to alienate land is subject to state duty, which in most cases will amount to one (1) percent of the value of the agreement. In cases when the value of the agreement has been intentionally decreased by a party and is lower than the value stipulated in an appraisal report issued by the state land management bodies, the state duty will be calculated on the basis of the larger value.

Interestingly, upon the certification of land-related agreements by a state notary, rather than a private notary, any provision of legal services by the state notary, such as the drafting of a proper

agreement, is free of charge. The parties to the agreement simply reimburse to the notary the value of the special blank form (currently seven (7) Ukrainian Hryvnias) on which the agreement is set forth in writing, as well as the value of the verification service with the relevant register with respect to liens and encumbrances (currently thirty-four (34) Ukrainian Hryvnias).

On the other hand, private notaries will not charge the state duty. The amount payable to a private notary is set according to an agreement reached between the parties to the land-related agreement and the corresponding private notary. However, a private notary should not, and in most cases will not, charge less than the minimum amount of the state duty for its services.

In purchasing land, one should clarify the designated usage "assigned" to the land plot, as land may only be used in compliance with its purpose (e.g., farming, industrial, residential, etc.). It is possible to apply for a change of the land's designated purpose (zoning). This change, however, usually tends to be rather expensive and extremely time consuming, especially with respect to a change from non-commercial to commercial or agricultural to non-agricultural designation.

Notably, the Land Code sets forth several direct prohibitions with respect to the sale or purchase of land. For the most part, foreign citizens, as well as foreign legal entities, are discriminated against under the Land Code. Specifically, agricultural land may not be transferred for direct



ownership to foreigners, persons without citizenship, foreign legal entities, etc. The said persons may use farming land and other agricultural lands only under lease agreements.

Further, foreign citizens and persons without citizenship may own non-agricultural land only within urban (city, town, village, etc.) limits. Outside such urban limits, foreign citizens and persons without citizenship may only own non-agricultural land if they privately own the immovable property objects thereon. As far as foreign legal entities are concerned, they are allowed to own non-agricultural land, provided that they have acquired the immovable property located on such land. Encouragingly, many foreign business organizations have been lobbying for changes to the Land Code to remove all discrimination against foreign citizens and companies. These efforts have proved semi-effective and further amendments to the Land Code are still widely expected.

If a legal entity wishes to acquire ownership rights to land that belongs to the state or a community, the procedure is different from purchasing land on the secondary market. Theoretically, state-owned or communally-owned land may be offered for sale to legal entities on a competitive basis, with the exception of cases when land is being sold to legal entities which already own real property located thereon.

Moreover, a legal entity is required to file a petition and other required documents with the relevant national or local body requesting the acquisition of the ownership rights to a certain land plot. Such body will consider the petition and, within one (1) month, will return its consent to the sale or decline the petition. If the legal entity in question receives consent to purchase, it would be able to acquire the ownership rights to the land plot in question upon preparation of certain technical documents, describing such land plot.

The sale of the land plot takes place upon the signing of a sale-purchase agreement, which is executed pursuant to the decision of the proper national or local body. Please note that in most cases, foreign legal entities should seek prior consent of the Cabinet of Ministers and the Parliament of Ukraine in order to purchase state-owned land, while communally-owned land only requires the consent of the Cabinet of Ministers. Alternatively, there is always the option of a long-term lease arrangement of up to 50 years.

In conclusion, a foreign buyer of Ukrainian land should remember that the land market in Ukraine is still under formation and malpractice is still quite common. Land prices continue to grow and, therefore, before taking any practical steps towards the acquisition of land and getting a fair deal, any potential buyer should seek professional legal guidance. All too many foreign companies are offered a cheap and quick deal to purchase land only to find out later that violations in the purchase procedure have endangered their ownership rights. Careful due diligence and verification of all steps in a land-purchase transaction all too often reveal that a seller's offer was really too good to be true.

CHAPTER 9

SECURING LAND RIGHTS FOR COMMERCIAL USE

As a starting reference point for any investor, Ukrainian land is either state-owned or it is already in private hands. This obvious distinction is absolutely vital, because no sane investor wants to deal with a government bureaucracy, especially a Ukrainian one.

Getting access to state-owned land for construction purposes, whether by leasing or auction purchase, requires significant time and financial investment. And yet, the government has the most land available in the best locations... So what's a poor investor (resident and non-resident alike) to do?

I. Every Investor's Dream

Every investor's dream ("Dream") is to acquire either ownership or a lease agreement to a legally defined parcel of land with a specific purpose allocation to construct a building to the investor's needs and specifications (e.g., a residential/office high-rise, a two-story restaurant, etc.).



Theoretically, such parcel of land exists somewhere on a secondary (private) market in Ukraine, but finding and acquiring such a parcel in Kiev at a reasonable price remains a Dream. Even if an investor finds an acceptable privately-owned land parcel in the center of Kiev, there will probably be a need to change the initially allocated "specific purpose" (see below) to fit its new owner's business profile.

The next best option, entering into a lease agreement with the Kiev City Council, is extraordinarily risky due to the Council's occasional unilateral cancellations of numerous lease agreements in 2006. This unprecedented event put a harsh spotlight on the fragile legal status of lease agreements in today's booming real estate environment. Hence, by default the next best choice is to purchase a desired land parcel from the government at land auctions.

II. Allocation for a Specific Purpose

In accordance with current legislation, land parcels can be (a) leased (short or long-term) or (b) purchased. Unfortunately, permanent free use of land is now granted only to non-profit organizations (invalids) and connected enterprises, as well as persons who already own finished buildings on the land. The latter are allowed to purchase the land they have always used at new, outrageous prices.

In either case, according to Articles 19-20 of the Land Code, the land has to be allocated for a certain, specific purpose (e.g., an office building or a restaurant). Subsequent deviation from the initial purposeful designation may result in termination of the land ownership or use/lease rights (see Articles 141-143 of the Land Code). Plus, to a far less significant degree, there is an administrative fine of between 3 and 25 of non-taxable monthly minimum wages.

If the party with land rights tries to transfer (sell) its rights to another entity, the original allocation purpose must be preserved. Should the subsequent land user alter the purpose of the land (e.g., change from an office building to a casino), it must legally revise the allocation accordingly. The terribly painful, drawn-out and expensive process is similar to the initial land allocation itself.

III. Sale of State-Owned Land

In accordance with the Law "On Land Valuation," dated Dec. 11, 2003, any state or communally-owned land alienation must undergo a "valuation" process. According to Article 127 of the Land Code, sale of state-owned land to legal entities and physical persons should take place on a competitive basis (auctions, competitions), except buy-outs of land with finished buildings thereon. Unfortunately, experienced land developers routinely complain that the best parcels never make it to auction.

IV. Foreigners and Other Non-residents

Foreign investors without political connections cannot buy land directly from the Ukrainian government, as the sale of federally-owned land to non-residents (i.e., foreign legal entities and governments alike) requires consent of the Cabinet of Ministers, together with approval of the Supreme Council of Ukraine (aka, the Parliament). On a local level, the sale of communally-owned land to foreigners requires consent of the local council of people's deputies, plus that of the Cabinet of Ministers. That is why foreign investors usually purchase land from private owners, and then easily change the "profile" (zoning) to suit their needs.

V. Conclusion

In cases where an investor expresses an interest in entering into a lease or a sale-purchase agreement (via an auction), the land bureaucrats have a "take-it-or-leave-it" attitude. No meaningful negotiations regarding specific provisions take place, even in cases of unreasonably short terms in lease agreements or near-extortionate prices in sale-purchase agreements.

Until recently, the government had all the best properties, so the negotiating power was truly on the side of its underpaid employees. These days, however, much of the land has been sold to private companies. Much of the land is currently for sale, with prices ranging from 100 USD up to 15,000 USD per "sotka" (0.01 hectare). The price difference throughout the nation is simply astounding and the land market continues to boom.



CHAPTER 10

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.

CHAPTER 11

INVESTMENT IN UNFINISHED CONSTRUCTION

The skyrocketing price of real estate in Kiev makes it an interesting, albeit incredibly challenging, market. Other major Ukrainian cities will undergo the same fantastic change in the near future. The question is: how do foreign investors get access to land and buildings in Ukraine?

The good news is that there are no impediments to purchasing property on the secondary market from a private party. Just review the background title documents and sign a sale-purchase agreement before a notary public. Dealing with the government, however, is an entirely different matter.

Below we review the legal and practical issues involved in obtaining from the city authorities access to land for construction of residential and commercial property.



I. Access to Unfinished Construction

International hotels would make millions in Kiev, but they are justifiably apprehensive of investing in existing unfinished construction projects. Instead, they prefer either to obtain a parcel of land and build to their own specifications, or wait until the risks inherent in construction process have passed and the building has been commissioned.

However, buying land from the government via competitive means, such as an auction or tender, is often an unrealistic expectation, especially in Kiev under the firm rule of former Mayor Omelchenko and the Kiev City Council. In many cases, therefore, in order to enter the market an investor is forced to join forces with a local partner who has future property rights and is better able to navigate the murky local waters.

From a legal viewpoint, two methods exist to obtain access to land for construction purposes: (a) entering into a lease agreement (for up to 49 years) with or without a right of buyout; and (b) acquiring shares of a Ukrainian company that owns or leases such land.

(A) Lease Agreements

The practice of government officials entering into land lease agreements with foreign companies varies throughout Ukraine, depending on the location (i.e., Kiev vs. Ivano-Frankivsk). In Kiev, for instance, only a select few "insiders" with close connections to the city authorities are allocated land rights for construction purposes. This, not surprisingly, expressly excludes foreign companies.

The reason the "insiders" prefer to enter into lease agreements to obtain land is because lease arrangements are signed without any auctions, and land transfer takes place after the construction is finished on a non-competitive basis. In contrast, buying state land takes place only via "open" auctions or tenders.

In other Ukrainian cities and regions, where government officials are more even-handed, anyone interested in obtaining land for construction purposes should insist on a buyout clause in their lease agreements to prevent any future ambiguities.

(B) Acquiring a Ukrainian Company With Property Rights

From a legal perspective, the acquisition of a Ukrainian company (or a share therein) that possesses land rights is not the same as signing a land sale-purchase agreement. Yet, the company's new shareholder exercises the same rights over the land (and other company assets, if any) as any rightful Ukrainian landowner. This investment avenue is widely used by foreign companies seeking to bypass the notorious Kiev City Administration (see section II, below).

In such cases, we highly recommend that any investor conduct full legal and financial due diligence, focusing on the target company's property rights, before assuming its existing debts and other obligations.

II. Barriers to Entry

As explained in greater detail in the next chapter, the single biggest impediment to entering the construction arena to date has been the city government. Specifically, former Mayor Omelchenko's office and the Council of People's Deputies, which allocate land for construction. During their heyday, they would hand out the choicest plots of central Kiev land to an inner circle of people, presumably in exchange for something of value.

For example, a company called "Mars-1" (with two founders and no employees or track record) mysteriously obtained two prime land plots in a sole-source deal; another well-connected company, "KievVisotBud," obtained Dnepr River frontage on Obolon without any auctions or tenders. Many of the "insider" companies had no intentions to actually build anything, but simply tried to sell their projects off to third-party investors. Later, when new Mayor Leonid Chernovetskiy came into power, he cancelled lease agreements with several companies connected to his predecessor, leaving investors in a tough predicament.

The corruption surrounding the construction industry is a widely acknowledged reality. The land allocation process has become so thoroughly riddled with inside deals that in December of 2005 the Antimonopoly Committee threatened to file a law suit against the Kiev City Council, claiming that its July 5, 2005, Resolution No. 810/3385 "On the Temporary Procedure for Acquiring Land Rights on a Competitive Basis" allowed the City Council to circumvent the competitive procedure and allocate land without holding auctions or competitions.



The Antimonopoly Committee recommended to the City Council not to sell land plots without auctions to single purchasers. It also said that inclusion of such conditions as "additional investment into engineering and transportation infrastructure" has a negative impact on competition and are not required by Ukrainian legislation. Then came the March elections, deposing the Omelchenko administration and welcoming the new Mayor Leonid Chernovetskiy, President of Privat Bank and Parliament member.

III. Risks Upon Entry

Entering into a lease agreement with the city authorities can be a lengthy process (up to 3 years in Kiev). It is an extraordinarily expensive and emotionally draining experience that consists of obtaining numerous permissions and signatures of countless city bureaucrats. After the lease agreement is signed, however, significant risks continue to exist, ranging from a unilateral increase in rent by the city to termination of the lease agreement itself.

By any measure, termination of a lease agreement is the most serious risk. For instance, a stock company "Alex Bud" (the "Company") had a long-term, ten-year land lease for construction of a residential building, signed off by the Kiev City Council on 2003. The company began construction in 2004, but residents of neighboring buildings began protesting, so in the end of 2004 the Kiev City Council promptly reversed its prior decision to enter into a lease agreement. By that time, however, the Company pre-sold more than half of the apartments in their building. Fortunately, Ukrainian courts (including the Appellate Court) ruled in favor of the Company, but the city appealed to the Supreme Court. Meanwhile, the investors were justifiably concerned.

Later, in November of 2006, the Kiev City Council cancelled land lease agreements for about 187 more construction projects, many in the process of laying the foundation. In all, about 83% of construction planned for 2005 was "frozen," according to Milan Paevich, director of company "Slav-Invest." Most of these sites were shut down despite the construction companies' ability and desire to finish their projects, and the investors' dreams of moving into their long-awaited apartments. The same thing occurred nearly one year later, during Mayor Chernovetskiy's tenure.

IV. Conclusion

Foreign investors are at a distinct disadvantage when dealing with the mighty Ukrainian bureaucracy, responsible for land allocation and construction permits. The intentionally complex system of procuring land and construction permits is only one of the reasons for the existence of only a handful of high-end hotels in the nation's capital. City hall corruption is another. For that reason, many investors prefer to by-pass the document preparation stage. Thus, the potential investors have two options: partner up with a local developer or buyout the company that owns the "unfinished construction object", hoping that it has all the necessary paperwork.

CHAPTER 12

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 architec-



tural 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). Of 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 sub-

stantive 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.



CHAPTER 13

INDUSTRIAL LAND LEASE

I. Introduction

Before the passage of the Land Code, which came into effect on January 1, 2002, foreign investors in Ukraine long dreamed of the time when they could by-pass the central government bureaucracy and run things on their own terms. As Cargill's foray into the uncharted Donetsk free economic zone confirmed, constructing a 100% foreign owned pre-fabricated building on a parcel of land has numerous advantages. Now that such treatment is equally extended to other Western investors, greenfields has become one of the favorite methods for foreign investors to establish quality production in Ukraine.

Until recently, no parcel of Ukrainian legislation dared to raise the topic of land allocation for industrial use (production purposes). True, the former Land Code governed many questions con-



cerning land rights, but these were concerned primarily with agricultural or "datcha" land allocations. Once, ex-President Kuchma made a half-hearted effort to allow investors access to land for industrial use, but it was virtually unenforced notwithstanding any attempts by foreign investors to secure its benefits. Several years later, in the crisis-ridden fall of 1998, a law on land lease was adopted, which once again attempted to grant some land rights to foreign and local investors alike.

For historical purposes, we briefly compare the laws passed in 1995 and 1998 (which was subsequently re-written upon the passage of the current Land Code).

II. The Decree "On Privatization and Leasing of Non-Agricultural Land for Business Purposes"

At the height of his power, on July 12, 1995, President Kuchma signed a very promising Decree No. 608 "On Privatization and Leasing of Non-Agricultural Land for Business Purposes" ("Decree No. 608"). This decree specifically permitted privatization and leasing of so-called "non-agricultural" (industrial) land and, therefore, was potentially quite interesting for foreign investors. Unfortunately, to the best of our knowledge, the Decree was completely ignored. Even foreign investors did not complain, realizing it was simply too good to be true. In fact, Decree No. 608 was eventually cancelled by virtue of Presidential Decree No. 650 of July 20, 2007 with no explanation as to why such cancellation was necessary.

For the record, the purpose of the Decree was to increase foreign and Ukrainian investment by finally opening access to industrial property for production purposes. The Decree expressly promised foreign investors clear land ownership rights, giving them greater security in controlling their investments. The Decree also aimed at solving the duality of real property rights, whereby an investor could formerly privatize a building located on a plot of land, but could not actually privatize the land thereunder. The land rights always remained with the State, as represented by the Local Councils of People's Deputies.

Decree No. 608 was unique because, for the first time, it expressly granted the purchasers of buildings the right to purchase the land underneath. Unfortunately, such rights were not extended to non-residents. However, by forming a Ukrainian resident company, the non-resident was able to effectively participate in the privatization process through its Ukrainian resident company.

Also, Decree No. 608 provided that many land parcels would be privatized on a competitive basis. The Decree further provided that new owners of privatized industrial land would enjoy full rights to their property, including the right to possession, use and disposal of by any means (sale, gift, will, exchange, collateral, lease, etc.). The owner of land could also contribute the land to the authorized capital of any business entity.

Indeed, the Decree was a breakthrough in land ownership rights. The only problem was the complete lack of its application and enforcement in practice. The Decree gave potential investors false hope that they would finally be able to purchase Ukrainian land and obtain full control over their production facilities, but this time nobody was surprised.

Because this precedent-setting, but useless, legislation found no application whatsoever before its cancellation, we will devote the bulk of our discussion to the more relevant legislation (which has proved to have at least some effect).

III. Law "On Lease of Land"

(A) Introduction

On October 6, 1998, President Kuchma once again attempted to provide land rights by signing Law No. 161-XIV "On Lease of Land." On October 2, 2003, this Law was completely amended under Law No. 1211-IV "On Amendments to the Law of Ukraine 'On Lease of Land'" (the "Lease Law"). The Lease Law permits anyone, Ukrainian or foreign legal entities and natural persons, including international associations and organizations and foreign governments, to lease land.



The Lease Law specifically states that the lease of a land parcel does not affect the rights of third parties with regard to that land parcel. In other words, protection of a third party's interests in land, such as collateral or debts, is theoretically in place in Ukraine. Upon concluding a lease agreement, a lessor is obligated to make known any existing liens, encumbrances and third party rights connected to the relevant land parcel. Moreover, land parcels subject to pledge may not be transferred into lease without the consent of the pledge holder.

As with most Ukrainian laws, the Lease Law refers back to the Land Code for the rights of lessees to lease and, eventually, own land. Fortunately, under the Land Code, foreign entities can now officially obtain ownership rights to Ukrainian land. The Lease Law also refers to the Civil and Economic Codes as the basis for the lease of land and it refers to the Law of Ukraine No. 2269-XII "On the Lease of State and Communal Property," dated April 10, 1992, for further peculiarities related to the lease of state or communal property.

(B) Legal Requirements

The legal requirements for entering into a valid lease agreement are quite straightforward: lease agreements must be in writing and may be certified by a notary public if the parties so desire. The Cabinet of Ministers of Ukraine has released a model form of a lease agreement taking into account all of the requirements of the Lease Law. Once a lease agreement is concluded, it must be registered with the proper state authorities. Land can be leased for any term agreed upon between the parties to the lease agreement, but cannot exceed 50 years.

The Law provides the material terms and conditions which must be included in all lease agreements. These mandatory terms and conditions include:

- 1) The object of lease (location and size);
- 2) The validity term of the lease agreement;
- 3) The lease payment (amount, indexation, form of payment, terms and procedures for payment and reconsideration and liability for failure to pay);
- 4) The terms and conditions of use and the purposeful designation of the land parcel;
- 5) The conditions for maintaining the condition of the parcel;
- 6) The conditions and term for the transfer of the parcel to the lessee;
- 7) The terms and conditions for the return of the parcel to the lessor;

- 8) All existing limitations and encumbrances with regard to the use of the land parcel;
- 9) The party (lessor or lessee) that bears the risk of accidental damage or destruction of the leased object, or any part thereof; and
- 10) The responsibility of the parties.

The absence of any one of these essential terms may serve as grounds for the refusal to register a lease agreement, and such lease agreement may thereafter be deemed invalid. In addition to the mandatory terms and conditions, the parties may include any other provisions concerning the quality of the land condition, the procedure for carrying out the obligations of the parties, the obligation to procure insurance for the land, security measures, circumstances which can change or terminate the lease agreement, among others. In summary, lease agreements can be very flexible, as long as the above obligatory terms are contained therein.

In addition, a lease agreement must be accompanied by certain documents, which become an integral part of the agreement, including (i) the plan or map of the leased property, (ii) the land survey with any restrictions (encumbrances) related to the use of the land, (iii) the act setting the legal boundaries of the land parcel, (iv) the transfer-acceptance act (this is a mandatory document in all cases of lease, which basically evidences that the lessor transferred the land parcel to the lessee and the lessee accepted the land parcel for possession and use pursuant to the lease agreement), and (v) the separation plan in case a part of the land parcel is being leased out. If a lease agreement calls for the protection and improvement of the land parcel, then an agreement regarding the compensation of the lessee's expenses for such measures must also be attached to the lease agreement.



(C) Procedure for Executing Lease Agreements

The procedure for concluding a lease agreement is deceptively simple. The lease agreement is concluded between the owner (lessor) of the land parcel and the entity (individual) who wishes to lease the land (lessee). If the lessee wishes to lease a parcel of state-owned or communally owned land, the lessee simply submits an application to the relevant executive body or body of "local self-governance" at the land parcel's location.

According to Article 124 of the Land Code, the transfer of a land parcel owned by the state or under communal property must be executed based upon a decision by the local authorities and must be concluded in the form of a lease agreement. The transfer of a privately owned land parcel for lease must be executed according to a lease agreement formed by and between the owner of the land and the lessee.

If the lease agreement provides for a use of the land that is essentially the same as the owner's use, without physically changing any boundaries, a simple lease agreement is all that is required. On the other hand, if the lessee intends to use the land for a different purpose, or if the land parcel was taken from the so-called "reserve fund" and is intended for use in construction, a land allocation project must be prepared in accordance with the form and procedure provided by Articles 118 and 123 of the Land Code. Such land allocation project becomes an integral part of the lease agreement.

If two or more applications for the lease of state or communal land are submitted simultaneously, then the corresponding state body must conduct an auction or tender unless otherwise established by law. The procedure for conducting an auction or tender for the lease of land is determined by law and is beyond the scope of this discussion.

After the lease agreement is concluded and notarized, if one of the parties requires notarization of the agreement, it must go through formal state registration. State registration of the lease agreement is evidenced by a stamp from the appropriate state registration authority, the signature of the authorized officer of the state registration authority and an indication of the date of registration. One registered copy of the agreement is kept by the state registration authority. In case of the lease of state or communal property, a copy of the registered lease agreement must be sent to the tax authorities as well.

Of course, the parties to the lease agreement have the right to amend their agreement by mutual consent. If an agreement cannot be reached, however, the dispute will be judicially resolved. A lessee, who fulfills all of the rights and obligations contained in a lease agreement, also has the right of first refusal to renew such lease agreement. If the lease agreement is extended for a new term, its terms and conditions can be modified according to the mutual agreements of the parties, unless the original lease agreement states otherwise.

(D) Payments

The issue of lease payments is subject to the agreement of the parties. Lease payments may be made in cash, in-kind (according to a certain quantity or a part of the production on the leased land parcel) or by so-called "working-off" (i.e., the lessee provides services to the lessor in exchange for use of the land parcel). Lease payments are not limited to the above forms, and any other form of payment the parties agree on may be included in the lease agreement. However, lease payments for land parcels under state or communal ownership may only be effectuated in cash (via bank transfers). A lease agreement may also take into account inflation in the calculation of lease payments.

The parties to the lease agreement are free to change the amount of lease payments pursuant to mutual agreement. Interestingly, the lessee has the right to demand a decrease in the lease payments when the condition of the leased land parcel worsens without such lessee's fault (i.e. negligent acts or omissions to act). As mentioned above, lease payments may also be increased in correspondence with increases in land taxes. Annual lease payments for state or communally owned land parcels are applied to a corresponding budget and are allocated and used pursuant to the law, but they may not exceed 10 percent of their normative cash value unless leased as a result of an auction or tender.

If a court of law deems a lease agreement invalid, then the lease payments for the factual term of lease will not be returned to the lessee. Finally, payments for the sublease of a land parcel under state or communal ownership may not exceed the amount of lease payments under the original lease agreement.

(E) Termination

Lease agreements can be terminated by mutual agreement of the parties. It can also be prematurely terminated at a party's request by court decision if the other party fails to fulfill its obligations under the lease agreement and/or Ukrainian law. A party may unilaterally terminate a lease agreement only if the agreement provides for unilateral termination or legislation provides for such termination. The Land Code and other Ukrainian laws provide additional grounds for unilateral termination.

Please note that the lease agreement for a land parcel also expires in the following cases:



- 1) expiration of the term for which the agreement was concluded;
- 2) the receipt of the land parcel into ownership by the lessee according to the procedure provided by the Land Code;
- 3) forced buyout (eminent domain) and alienation of the land parcel for "social needs" in accordance with the relevant procedure provided by the law;
- 4) the lessee's death or conviction (resulting in a jail sentence) or a party's refusal of the lease agreement; and
- 5) liquidation of a legal entity-lessee.

A discussion concerning the various consequences of expiration or termination of the lease agreement, the procedure for returning the land parcel to the lessor, compensation to the lessor for any damage inflicted upon the land parcel by the lessee, and the settlement of disputes, is beyond the scope of this brief overview.

(F) Inherent Defects to Land

As in the West, the lessor is liable for any defects that he knows about and fails to inform an unknowing lessee e.g., environmental contamination, infertility, etc. Such defects must be clearly disclosed in the lease agreement, and if so, the lessor will not be subject to liability for any damage caused thereby. If defects that materially impede the use of the land are subsequently revealed, and such defects were not described in the lease agreement, the lessee has the right to:

- 1) demand a decrease in the lease payment or the compensation of expenses for removing the defects;
- 2) retain the appropriate amount of lease payments for expenses incurred by removing the defects upon prior notice to the lessor regarding such defects; and
- 3) demand premature termination of the lease agreement.

IV. Conclusion

The Law "On Lease of Land" does not grant anything to foreign investors that was not already promised by Decree No. 608 "On the Privatization and Leasing of Non-Agricultural Land for Business Purposes." Unlike Decree No. 608, however, the Lease Law did not even attempt to give foreign investors the right to purchase leased land by merely deferring to the ultra-conservative former Land Code. However, this issue was subsequently settled on October 25, 2001, by the passage of a new Land Code which grants foreign investors the right to purchase certain types of land plots.

CHAPTER 14

LAND APPRAISAL

I. Introduction

The Law of Ukraine No. 1378-IV "On Appraisal of Land," dated December 11, 2003 (hereinafter referred to as the "Law"), entered into effect as of January 13, 2004, and was subjected to minor amendments in June of the same year. The Law describes several types of land appraisal, including monetary appraisal and the comparative appraisal of natural soil qualities, economic appraisal (i.e., appraisal of land as a natural resource, means of production in agriculture and forestry and based on indicators characterizing productivity of land, efficacy of their use and returns (profitability) per area unit). The Law states its principal objective as the protection of the lawful interests of the state and other entities in connection with land appraisal matters, as well as the provision of information with respect to taxation and the land market.

Monetary appraisal is further divided into (i) expert monetary appraisal (i.e., the result of a defined value of a land plot and the rights associated therewith) and (ii) normative monetary appraisal (i.e., capitalized rental (income) generated from a land plot). The method of defining the value of an object of appraisal and the sequence of appraisal procedures, which allow the realization of specific methodological approach is beyond the scope of this legal review.



The Law identifies the following "subjects of appraisal activity," which may officially carry out appraisal activity in Ukraine:

1. state executive bodies and bodies of local self-governance, which carry out administrative management in the sphere of appraisal;
2. legal entities and natural persons interested in practicing land appraisal, provided they obtain the relevant certificate of an expert appraisal;
3. legal entities, which employ certified expert appraisers and possess a license to carry out appraisal activity;
4. the legal entities and natural persons, which are registered business entities or entrepreneurs and which have obtained proper licenses according to the procedure established by law.

Article 13 of the Law provides a list of instances when monetary land appraisal is mandatory by law and, specifically, when determining:

- a) the amount of land tax;
- b) the size of lease payments for state-owned and communally-owned land plots;
- c) the amount of state duties in connection with the exchange, inheritance or gift of land parcels pursuant to law;
- d) losses in agricultural and forestry production;
- e) the indicators and mechanisms of economic stimulation for the rational use and preservation of lands.

In addition, expert monetary land appraisal must be carried out whenever:

- a) alienating and insuring state-owned or community-owned land plots;
- b) pledging land plots according to the law;
- c) determining investment contributions upon the realization of investment projects for land improvement;
- d) determining the value of state-owned and/or communally-owned land plots upon the contribution of such land plots into the authorized capital of a company;

- e) determining the value of a land plot for purposes of the reorganization, bankruptcy or liquidation of a company, which is the owner of such land plot and in which the state or a community holds a share;
- f) identifying the share of the state or a territorial community in jointly owned land plots;
- g) reflecting the value of land plots and the right to use land plots in accounting according to Ukrainian legislation;
- h) determining losses for owners or users of land in cases provided by law or agreement; and
- i) pursuant to a court decision.

In all other cases, the appraisal of land may be carried out pursuant to the agreement of the parties and in cases determined by the Law and other laws of Ukraine.

Moreover, the Law states that any land appraisal should be carried out pursuant to a decision of the relevant state executive body or body of local self-governance. A normative monetary appraisal may be carried out on the basis of an agreement concluded by the interested parties as provided by law. In this case, the grounds for carrying out the normative monetary appraisal will be either the agreement or a court decision.

The Law requires that a comparative appraisal of agricultural land be carried out at least once every seven (7) years. Further, the Act requires that an economic appraisal of the same catego-



ry of land be carried out at least once in every five (5) to seven (7) years. A normative monetary appraisal of agricultural land should be carried out at least once in every five (5) to seven (7) years, whereas the same type of appraisal of non-agricultural land should be carried out at least once in every seven (7) to ten (10) years. Of course, all of these appraisals may be performed exclusively by those legal entities, which have obtained proper licenses for land management.

An expert monetary appraisal of land should be carried out by appraisers in compliance with the requirements of the Act, as well as the Law of Ukraine "On Appraisal of Property, Property Rights and Professional Appraising Activity in Ukraine," and other relevant rules, regulations and state standards. Appraisal work may either be financed at the expense of the State Budget of Ukraine, local budgets, the funds of landowners and land-users or any other sources not expressly prohibited by law.

II. Discussion

Matters related to the appraisal of land were already regulated in detail by the Land Code of Ukraine (the "Land Code") prior to the adoption of the Law. Even more detailed rules have been provided in several rules and regulations issued by the Cabinet of Ministers of Ukraine (the "CMU") and the State Committee of Ukraine for Land Resources (the "SCULR"). On the other hand, the closing provisions of the Land Code required the development of the Law, while the land appraisal rules and regulations need constant updating.

For instance, the Methods of the Monetary Appraisal of Agricultural and Urban Land, approved by Resolution No. 213 of the CMU of March 23, 1995, have shed the title "Temporary" and are now called the "Methods of Normative Monetary Appraisal of Agricultural and Urban Land." The Methods also gained a new definition of normative monetary appraisal in synch with the Act. Similar alterations have been introduced to the Methods of Monetary Appraisal of Non-Agricultural Land, approved by Resolution No. 525 of the CMU, dated May 30, 1997. This notwithstanding, it would have been quite difficult to attempt to update these regulations without the adoption of a concrete law on appraisal of land in Ukraine.

Taking the above into account, we present below the most interesting "innovations" of the Law. It is important to note, however, the difference between the value, the appraisal and the price of a land plot.

As it was practiced prior to the enactment of the Law, it is likely that the owners and users of land will tend to use the normative monetary appraisal of land, which is applied in most cases for the calculation of land taxes. Moreover, Article 13 of the Law stipulates that the normative monetary appraisal of land should also be used for determining the size of the state duty in case of the

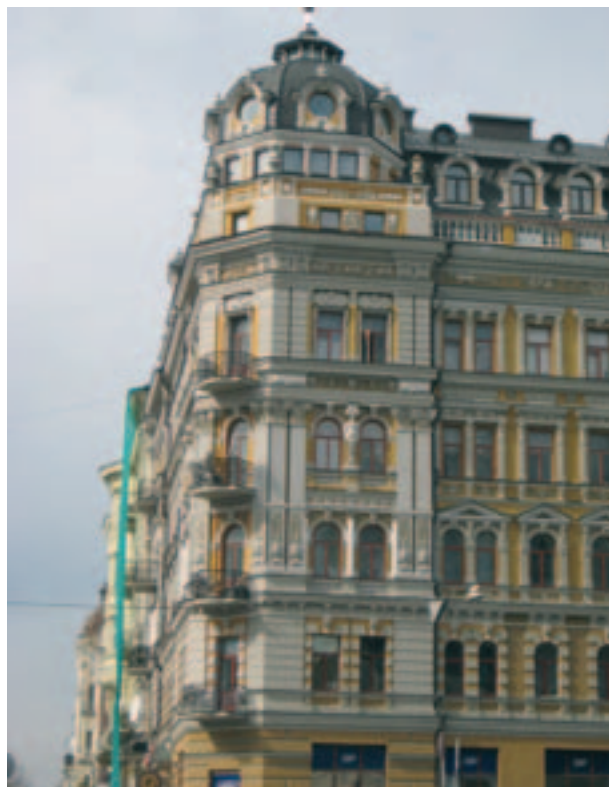
exchange, inheritance and gift of land plots. This is the standard procedure for charging state duties on the alienation of land plots.

Further, Decree No. 7-93 of the CMU "On the State Duty," dated January 21, 1993 (as amended) (the "Decree"), sets the state duty for the alienation of land plots at one (1) percent of the amount of the corresponding agreement and, in any case, not less than one (1) non-taxable minimum income, which is currently 17 Ukrainian Hryvnia (see sub-point "b" of point 3 of Article 3 of the Decree). At the same time, point 49 of the Instruction on the Procedure for the Calculation and Collection of State Duty, approved by Order No. 15 of the General State Tax Inspection of Ukraine, dated April 22, 1993 (as amended) (the "Instruction") provides that the amount of the state duty be calculated based on "the amount of the agreement, but not less than the normative price of the land plot as set forth by the Law of Ukraine No. 2535-XII "On Payment for Land," dated July 3, 1992 (as amended).

Please note that this provision only concerns land plots turned over to Ukrainian citizens on a gratuitous basis for so-called ancillary individual farming, construction and maintenance of individual residential houses and commercial buildings, gardening, country cottage and garage construction, etc. Notably, at the time of the adoption of the Instruction, no other form of private land ownership was allowed. Therefore, the practitioners "expanded" the interpretation of the rule and applied it to other forms of private land ownership. Upon enactment of the Land Code, however, notaries tend to relate the amount of the agreement to the expert appraisal rather than to the normative one, making references to Article 201 of the Land Code.

Given the above-mentioned, it is most likely that the enactment of the Law will alter the size of the state duty charged for the exchange, gift and inheritance of land plots, which size will become at least one (1) percent of the amount stated by the normative monetary appraisal of the land plot in question. Support of this assumption can be found in Article 5 of the Law, which requires the application of the normative monetary appraisal of land plots for purposes of determining the size of the state duty in cases of exchange, inheritance and gift of the land plots in question.

The Law has also introduced certain changes to the rules governing expert monetary appraisals. Point 4 of Article 201 of the Land Code stipulates that an expert monetary appraisal is applied



in effectuating civil law transactions with respect to land plots. Article 5 of the Law adds a slight clarification by adding that such appraisals are also applied with respect to the rights to land plots as well. In other words, any transaction, including those not involving alienation, will require that an expert appraisal be carried out. Therefore, it is likely that a land lease agreement would not be registered until the interested party carried out (i.e., paid for) an expert appraisal.

In general, one effect of the Law is that the appraisal of land (either normative or expert) would be carried out more often, considering the following:

- a) Article 4 of the Law names the uninterrupted continuity of the process of land appraisal as one of the basic principles of its application;
- b) the legislator expanded the list of cases when a normative appraisal of land is required (i.e., determination of the amount of lease payments for state-owned and communally-owned land plots and the size of state duties);
- c) the legislator expanded the list of cases when an expert monetary appraisal of land is required (including such instances as insurance of state-owned and communally-owned land plots; reorganization, bankruptcy or liquidation of land owning companies in which the state or the community hold shares; and reflecting the value of land plots and/or the right to use land plots in accounting reports); and
- d) the legislator determined the concrete frequency of carrying out land appraisals (see discussion above).

One question arises: who is supposed to finance land appraisal? As mentioned above and according to Article 24 of the Law, "the appraisal of land and land plots may be carried out at the expense of the State Budget of Ukraine, local budgets, landowners and land-users, as well as at the expense of other sources not prohibited by law." It is most likely that the users and owners of land plots will bear the burden of monetary appraisals of their land plots, while the economic and comparative appraisal of administrative units, territories, districts, zones, etc., will most likely be carried out at the expense of the taxpayer (i.e., the budget at the national or local levels). One last important point to remember, however, is that land appraisal is not and presumably will not become an inexpensive procedure.

III. Conclusion

In all, the Law is a positive development. The structured types of land valuation, the defined requirements regarding the documentation related to land appraisal, a rigidly regulated appraisal business and other finalized statutory requirements will facilitate transparency of the land valuation procedures. This should influence the development of the land market. As with many sectors of the economy involving land, one should expect more detailed changes to the existing regulations as land appraisal practice becomes more commonplace.

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REFERENCES

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"We at Sun and I am personally as legal counsel for Sun operation in CIS region, are very pleased with a level of expertise and service which were and are provided to our company in Ukraine by Frishberg & Partners. I would like to particularly mention also a constant effort of F&P lawyers to keep its clients updated on the most recent developments of Ukrainian legal environment and their responsiveness to our needs in that country."

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Jan Huijbregts, Joss Chemicals BV

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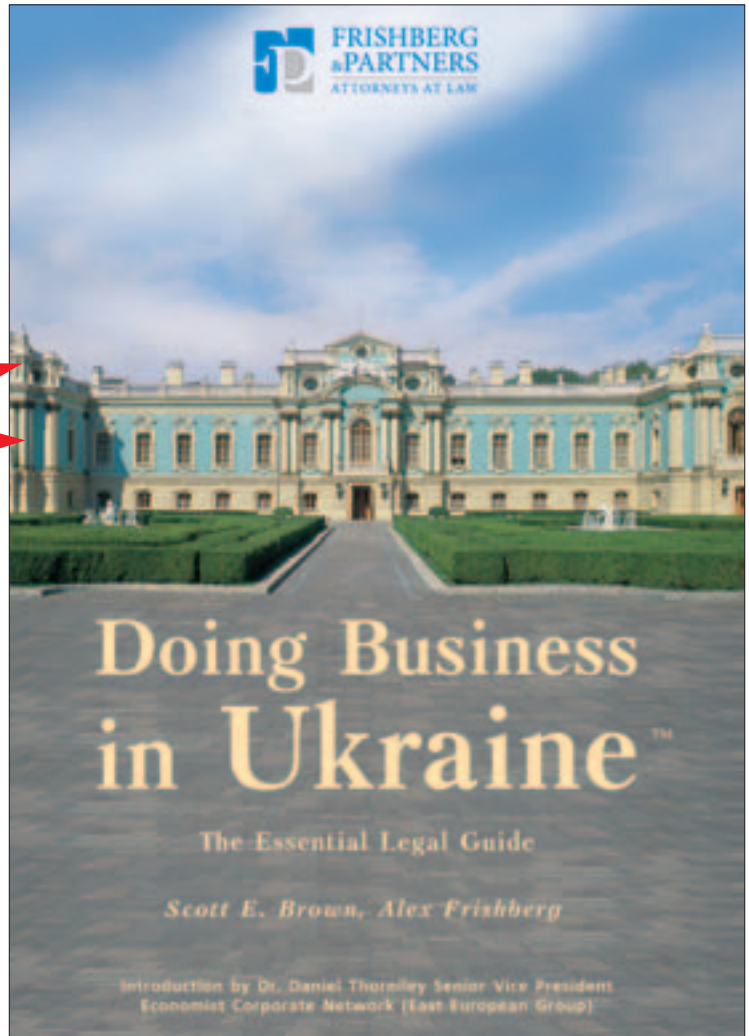
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