Real Estate Law in Ukraine

Executive Summary: Part one of this series of two articles examines the procedures for purchases of buildings, offices and apartments in Ukraine, including by foreign individuals and companies, and due diligence issues such as problems on verifying possible prior mortgages and transfers. Important risks from unregistered title changes and mortgages and the absence of special authorizations for property acquisitions in Ukraine are discussed.

Part two will focus on the purchase and leasing of land under the recently adopted Land Code, the leasing of premises and the enforcement of rights.

This article examines the principal features and problems of Ukrainian real estate law as it applies to the purchase and sale of buildings, offices, apartments and other premises. At the outset, it should be noted that Ukrainian law is still in the process of development, particularly as to acquiring and leasing residential and office space in urban areas. Despite improvements, there remain several significant but little noticed problems, discussed below, that can make confirmation of title to premises difficult, if not impossible, and that have resulted in losses to unsuspecting purchasers. Most significantly, some title transfers and mortgages may not be reflected in the public registries. It is expected that these problems will be resolved in the near future, but for now, they present legal as well as practical problems for many transactions.

During the past nine years, following the adoption of new legislation on real estate aimed at enabling Ukrainians to acquire their own dwellings by privatization, most residential apartments in the cities of Ukraine have been privatized by individuals. This legislation allows buildings, and the apartments and offices in them, to be owned privately by both Ukrainians and foreigners. An active real estate market in premises has resulted from this privatization.

In general, however, most land in urban areas is still owned by the state, although rights may be granted to permit long-term use by the owners of buildings to the land underneath. As discussed in part two of this series, the new Land Code of October 25, 2001, provides that Ukrainians and foreigners may in certain instances purchase land in Ukraine, in particular under buildings and other structures that they own.

• Privatization of Residential Apartments by Ukrainians

Ukrainian urban residents may privatize the apartments they rent from the state by purchasing them for a state-appraised value. This right arises from the June 19, 1992 Law "On Privatization of the State Dwelling Fund." This Law effectively credits each Ukrainian individual with certain assets, so that whether any payment above this amount is in fact due from the occupier depends on a valuation based on the location, type, condition and size of the premises and on the number of family members or other occupiers involved.

For example, in Kyiv, a family of three may ordinarily privatize an apartment of 73 sqm or less for free. For a larger apartment, an additional payment would usually need to be made for the extra space based on a formula. Such an owner might therefore choose to continue to rent the premises rather than pay to privatize them. Once privatized, the owner may deal with the premises as he or she wishes, including selling, leasing, mortgaging or otherwise disposing of them.

• Purchases of Real Estate by Foreigners

Under Soviet law, until 1991 foreigners were prohibited from purchasing any real estate interests in Ukraine. Under the Law "On Property" adopted in 1991, foreigners were permitted to purchase buildings, as well as offices and residential premises in them. However, in order to be valid, purchases of such real estate by foreign companies and other legal entities must apparently be authorized by a permit as required by the Regulation[1] of the Cabinet of Ministers of Ukraine No. 670, of June 28, 1997).

The Regulation is being used to prohibit any purchase or leasing of apartments, offices or other real estate by foreign companies except with the permission of a designated governmental body. Such an interpretation is questionable since the Regulation only obliquely refers to "foreign firms, etc." in its definition of what constitutes a "representation of a foreign organization that is reached by its requirements." (The Regulation otherwise generally focuses on the diplomatic representations of countries and international organizations.)

However, the Ministry of Justice has expressed its opinion to the 1st Kyiv State Notary and several other state notaries[2] in Kyiv that the Regulation applies to all foreign legal entities. In addition, the General Direction for Services to Representative Offices (known by its Ukrainian abbreviation as GDIP), which issues such permissions in Kyiv (elsewhere in Ukraine, the appropriate oblast administrations and the city administration of Sevastopol grant such permissions), has implemented the Regulation, apparently on the instructions of the Ministry of Justice, to require GDIP's approval for all purchases or leases of premises by foreign companies in Kyiv. On this basis, GDIP has refused to permit

1 "On Changes and Amendments to the Resolution on the Procedure for Locating Diplomatic Representations, Consulate Offices of Foreign Countries, and Representations of International and Foreign Organizations."

2 Unlike in the U. S., notaries in Ukraine (as under most other European civil law system) are a type of lawyer with statutory qualifications and powers to handle certain types of transactions, including in particular those involving the sale or mortgaging of real estate. Notarial records are a foundation of many civil law title transfer systems.

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numerous proposed purchases by Western companies. GDIP takes the position that any purchase without its permission is void and subject to legal challenge. This position is, however, contrary to the literal wording of the Regulation, which requires approval only if the premises are being purchased "to locate a representation of a foreign organization," which should exclude purchases of premises for other purposes, for example, for further development with a view to sale or lease.

The requirement for the receipt of such permission is also provided for in the Instruction of the State Construction Committee of June 9, 1998 "On the procedure for the registration of title of legal entities and individuals to immovable property," which states that the Bureau of Technical Inventory (BTI) (the agency for registration of title to real estate other than land) will register agreements for the purchase of real estate by foreign organizations only if the relevant permissions have been obtained. As a matter of practice, however, we understand that the BTI is still registering transfers for companies as well as diplomatic representations even if the permission required by the Regulation has not been granted. (This has caused a problem for one Embassy in Ukraine, which was subsequently obliged to give up premises because of the lack of GDIP's permission.)

- **Procedure to Purchase Offices and Apartments**

To purchase an office or residential premises, the first step for the buyer is to verify the seller's title by reviewing the title documents and checking these with the notary or exchange (auction) house (if one was used) responsible for the conveyance.

Traditionally, state notaries and the BTI would ordinarily only register a transfer of title based on the short-form types of contracts generally used in Ukraine, which in one or two pages (with annexes) documented only the bare conveyance of title with no guarantees or other protections. Typically, such agreements merely state the names of the parties, the address of the premises with a brief description of the floor plan, the price and the current registration number for the premises allocated by the BTI. The agreement will show the signature of the parties, and the signature, seal and number of the notary, if one is used. The authorities have in the past usually resisted the typical Western-style longer form, detailed contract as being unusual and unnecessary.

(a) Full Contract Protections Should be Sought

However, the law of misrepresentation and fraud is not well developed in Ukraine, and thus there is only very limited recourse against sellers under the typical short-form contracts used in Ukraine. For protection under Ukrainian law, it is advisable to have all agreements, guarantees and indemnities as fully documented contractually as possible in the purchase agreement. Fortunately attitudes are changing, and a number of state and private notaries and other state officials now accept contracts that contain covenants similar to those one would expect in the West. Increasingly, more elaborate agreements, like those common in the West, are being used for substantial transactions, especially where foreign buyers and their lawyers are involved and the Ukrainian seller has substantial assets and can be held accountable. Agreements guaranteeing, for example, absolute and unconditional title, the good physical condition of premises, and the absence of any knowledge of adverse claims and defects may often be obtained by negotiation.

The purchase contract that is registered with the BTI must contain a Ukrainian version, but the contract can be made in two or more languages.

(b) Documents Required of the Seller

Turning to the title documents that should initially be presented by the seller, ordinarily this includes (1) a certificate of privatization, a purchase contract (which will usually be notarized showing the number and bearing the seal of the notary before whom it was executed), or evidence of inheritance or gift, (2) a certificate from the appropriate office of the BTI stating that the seller is the owner and citing the BTI registration number, and (3) a certificate from the Unified Register of Prohibitions on Disposal of Immovable Property on the absence of mortgages, arrest or other encumbrances (however, for the reasons discussed below, such a document will not necessarily provide conclusive proof that the property is in fact owned free of adverse claims). An individual should also show his or her passport.

In addition, investigation should be made into any propiskas-the residency permits for individuals stating in which locality and where they live (the propiska is a Soviet era requirement that the Ukrainian government has announced will be abolished in the near future). In particular, a buyer should confirm that all individuals who could have residential rights to the premises (including children through their representatives) have relinquished their rights. Therefore, a certificate from the local state dwelling management enterprise (known as ZHEK, discussed below) should also be obtained to confirm who is listed as residing at the premises as well as the status of payments for utilities.

A corporate seller will need to prove that it is a validly existing and registered entity and that its representatives are properly authorized to enter into the sale transaction, which is usually accomplished for a foreign company by providing a fully notarized and legalized (including by a Ukrainian consulate abroad) set of the following documents with certified translations into Ukrainian: (1) resolutions on the appointment of the company's officials who have signatory authority or other documents that confirm the authority of the company's representatives; (2) a copy of the certificate of incorporation of the company; (3) a copy of the foundation documents (charter, memorandum and articles of association or similar document) of the company or extracts thereof confirming the authority of the company to sell, real property; and (4) a power of attorney from the company's officials authorizing any individual representing it to sign on its behalf, if applicable.

(c) Documents Required of the Buyer

On the buyer's side, an individual needs to show his or her passport. A corporate buyer will need to prove that it is validly existing and registered and that its representatives are authorised to enter into the purchase transaction,

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which is usually done with documents paralleling those indicated above for a corporate seller. In addition, a foreign company should have the permission (discussed above) for the purchase from GDIP, for Kyiv, or of the relevant oblast or Sevastopol City administration, as applicable. The notary should also require the submission of receipts confirming that the state duty and pension fee (each constituting 1 percent of the amount of the transaction) have been paid.

(d) Due Diligence for Purchases

Before a purchaser completes any acquisition of real property in Ukraine, for many reasons (including those discussed further below on title and mortgage verification), a complete due diligence of title, starting with the original transfer from state ownership (if applicable), should be conducted. If a building or other construction was built by the owner, the necessary construction documentation (permission for construction, project approval documentation including the Governmental Act (discussed below), etc.) should also be verified, since the absence of any of the required documents may lead subsequently to a prohibition of any use of the structure that was improperly constructed.

The importance of exhaustive due diligence for title transfers in Ukraine can not be over-emphasized, especially for substantial transactions. The seller should not rely merely on the BTI and notarial documents of the seller, although typically Ukrainian sellers will not initially volunteer more documents than these, based on traditional practice. In addition to verifying the title legally, certain practical verifications should be made as to the complete chain of title.

These practical verifications should include a physical site inspection and enquiries into past residents. For example, if a building was built initially, or was entirely rebuilt, without a right of land use first being obtained from the local Council (beyond the right that automatically arises for owners of existing buildings, which would not apply for a rebuilding where the original building was destroyed, as discussed in part two of this series on land use rights), the purported owner would have illegally constructed premises on the state's land. The state could require that the premises be moved or destroyed, or possibly have them confiscated. Likewise, approvals must be granted for most modifications to premises, for example to subdivide a room or remove a dividing wall. A sale of premises with unapproved modifications is subject to fines, and this could be a basis for voiding the prior sale. Cases like these have actually occurred, although as a practical matter, usually such problems can be cured if timely and effectively handled with the relevant authorities.

The technical description of the property being purchased should correspond exactly to all official records, including the BTI certificate (in addition, the purchaser should inspect the technical passport for the property, a description of the property with drawings prepared by the BTI for each property). For a corporate party to a sale, it is also important to verify that the company's actions were properly authorized. In connection with this, its charter and foundation agreement (or equivalent documents), and documents on appointment of the person signing for such party, should be reviewed. (In Ukraine, however, the charter and foundation agreement are not available for public inspection and verification, although as a practical matter, some comfort is usually possible in this regard.)

(e) Lease-Purchase Option Agreement to Protect the Purchaser Pending Completion

In the meantime, while due diligence proceeds, in order to protect the purchaser's right to acquire the property on the agreed terms, a long-term lease with a purchase option might be signed. Such a lease-purchase option document could give the purchaser the right to hold in escrow the prior purchase contract or other evidence of title, which could make a transfer to others more difficult, if for example a third party offers the seller a higher price before completion. While not required, it would be preferable to have this lease-option document executed before the notary (if one was used) who was responsible for the previous sale of the property, and who holds one of the original copies of the prior purchase contract.

A seller will often require a down payment before parting with its original copy of the prior purchase contract, usually in the amount of 1 percent to 5 percent of the purchase price. Ordinarily, such contracts provide that if the seller sells to a third party in violation of the down payment terms, then the seller suffers a penalty, such as being obliged to pay double the amount of the down payment to the purchaser under the lease-purchase option.

(f) Completion of the Purchase

Once good title has been verified as much as possible through the due diligence process, and the price and other sale terms agreed, the purchase contract (usually called in Ukraine a "purchase-sale agreement") is ordinarily executed before a notary, and the transaction is listed in the notary's register of notarial acts. Usually two original copies of the purchase contract are prepared, with one copy for the buyer and one for the notarial records, and a notarized copy is provided to the seller.

The buyer should then apply for the transfer of the property to be registered at the appropriate BTI office and obtain a registration number and an appropriate certificate or stamp on the purchase contract. Once a BTI certificate and registration number exist, the documentation formalities are completed, although in fact under current law the moment when title actually passes is established by the contract of purchase.

Risk from Possible Prior Transfers by Companies Without Notarization or Registration

Unfortunately, there are some loopholes to the notarization and registration process described above. For example, as currently provided in provisions of the Ukrainian Civil Code adopted in 1963, as amended, it is literally possible for a company validly to sell premises to another company without using a notary and without further registration. Article 227 of the Civil Code of Ukraine provides that notarization of a purchase agreement for premises is only required if one party to the agreement is an individual, so there is no direct obligation for notarization of an agreement on the sale of premises between companies. While there is a legal obligation to register such sale at the BTI, there is no time limit for the completion of the registration and no penalties for failure to register. The lack of a registration does not affect

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title to premises, and a delay in registration does not alter the date as of which title passes under the purchase contract.

Presumably, companies were not required to use notaries when the 1963 Civil Code was adopted because they were all state owned, so there was thought to be no risk of fraud. The situation is now quite different since most companies are privately owned. As a matter of practice this exception is not widely known, and to comply with the BTI's expectations for its registration and provide the best evidence of execution, most purchase contracts between companies are notarized.

However, presently title to premises can still be secretly transferred between companies without there being any public record. This creates a risk of fraud from sellers selling the same premises twice as well as from back-dated documents, for example where a former general director signs a contract to sell his former company's property, with the contract back-dated earlier to when he had authority to sign, thereby undermining any sale subsequent to the date of such contract unless the fraud can be proved.

Defect in Title Affects All Subsequent Buyers

Such risks are usually dealt with, as a practical matter, by an exhaustive examination of every transaction and document and every person and entity involved in the chain of title. Such a thorough examination is required for the complete title chain since, if there was for any reason a fraudulent conveyance earlier, then the present owner cannot convey good title because a seller cannot sell more than the seller previously received.

For example, in a recent case over a multi-million dollar development in Kyiv, it was proved that a director of the company that originally privatized the building in question had forged the signatures of most of the shareholders to authorize the privatization transaction. As a consequence, the Western developer, who was the third private owner of the building, lost its title in a litigation brought by shareholders of the original private owner, even though the Western purchaser had paid fair value to acquire it without knowledge of the earlier problems with the privatization and had spent millions of U.S. dollars to renovate it. The court found that the Western developer failed to conduct sufficient due diligence prior to its purchase and that, as the initial private sale was void, good title could not be passed on to the developer.

It is expected that most of these types of issues will be addressed by changes in the new Civil and Housing Codes presently under consideration. The changes in law needed to require all titles to be registered, and for priorities in title to depend upon the date of registration, are relatively minor. On this basis, with corresponding law revisions to require registration of all mortgages (discussed below) and the addition of few other minor amendments, clean title opinions could be issued in Ukraine in all circumstances as in Western jurisdictions.

Mortgages and the Risk from Prior Unregistered Mortgages

Ukrainian legislation permits mortgages (hypothecas), but presently they may be of limited value because they do not need to be publicly registered. This results in a risk of undisclosed prior mortgages, which can be a problem for both subsequent title transfers as well as later mortgages.

In order to create a mortgage, a mortgage document must be executed between the owner (mortgagor) and the creditor (mortgagee) before a notary. Once mortgaged, the owner can not sell the property, except with the creditor's consent, until the mortgage is released.

Information on such mortgages may be officially reflected in the Unified Register of the Prohibitions on the Disposal of Immovable Property (Register), administered by the State Enterprise "Information Center" of the Ministry of Justice of Ukraine. However, there is an inconsistency among Ukrainian laws as to whether a mortgage of a building or other premises is presently required under Ukrainian law to be so registered, unless the terms of the mortgage itself so require. Probably, mortgages that do not provide for registration do not need to be registered. As a matter of practice, mortgages are often validly executed before notaries without being listed in the Register.

Although all mortgages must be notarized, and in theory all state notarial records could therefore be individually checked within the applicable administrative area to identify whether a property has been mortgaged, checking notarial records is in practice too difficult and time-consuming to be effective. For example, there are over 100 public and private notaries scattered throughout the city of Kyiv. To contact them all (which could not be reliably done by telephone) would take considerable time, and many, if not most, notaries will probably not be co-operative with the conduct of such an unusual search.

However, other ways exist as a practical matter to try to limit such risks. For example, ordinarily for a mortgage to be granted, the notary involved will require a BTI reference document on the property that was issued for purpose of establishing the mortgage. It can usually, as a practical matter, be ascertained whether the BTI has ever issued such a document for a mortgage as well as to whom the document was issued (although the BTI is not presently required to provide any such information).

There are also currently ambiguities concerning the enforcement of mortgages. If the debtor defaults, then in principle the creditor has a right to possess the property. However, the law does not provide for any procedure for the disposal of property taken over through a real estate mortgage by foreclosure.

Since the mortgage instrument was introduced by the Law "On Pledge," and the separate presidential decree "On Mortgage" was voted down by the Parliament, it is arguable that the procedure for the disposal of pledged property should be applied to the disposal of property foreclosed under a real estate mortgage. Such procedure permits a creditor, in the event of a default, to bring a lawsuit in order to have the property sold at a public auction, if no other disposition is provided for in the pledge agreement. Following a sale in such an auction, the creditor receives what it is owed after the services of the auctioneer are paid for, and any balance remaining is paid to the debtor.

Special Considerations for the Acquisition of Buildings-ZHEK and Project Approvals

Where a building is to be acquired, either by outright purchase or by pur-

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chasing all of the apartments, special considerations apply. For formerly state-owned buildings, the state typically retains ownership of the non-privatized apartments and the common parts, with title usually held by the Executive Committee of the appropriate local Council, which in turn delegates management to the appropriate local state dwelling management enterprise (known by its Ukrainian abbreviation ZHEK). The owners of all the apartments are then required to enter into maintenance agreements with the ZHEK. Each apartment owner under such agreements will be obliged to pay ZHEK for its maintenance role, regardless of whether any services are actually provided, at rates that vary depending on the size of the apartment, the number of occupants and whether the apartment is for business or residential use.

It is, however, possible for the owners of all of the apartments and other premises in a building, following their complete acquisition by privatization, to form an association of owners (a condominium) to take over the ownership of the common parts and the responsibility for their maintenance. The condominium can then either retain ZHEK or independently contract for its building maintenance.

However, where one or more private owners take over ownership of all of the common parts as well as the apartments and other premises of a building, they will be required to obtain a right of use (likely to only be granted on a temporary basis) and then to pay either land tax or, if they enter into a lease under a temporary use, rent. Where the common parts of an apartment building remain owned by the state, there is no charge under current law to any private owners of the apartments in the building for the land use for the building.

If the whole building is acquired by this condominium process, or is otherwise acquired outright (including by "greenfield" new construction), then another consideration is to document the rights to the land under the building (or the construction site). In the past, for foreign purchasers, this meant that the rights to use of land by temporary use allocation or lease or permanent use allocation had to be confirmed or established. Based on the new Land Code, foreign purchaser soon be able to obtain ownership rights to land under buildings (either by purchasing land from the seller of the building, or if the seller only has land use rights, by having these rights relinquished and then purchasing the land from the State). The procedures for such transfers of land should be developed in the near future based on the recently adopted Land Code, as will be discussed in part two of this series.

In addition, a Governmental Act on acceptance of the building into operation should be executed by the appropriate governmental commission to permit the use of most buildings and other constructions (especially if the premises were formerly part of an industrial enterprise or complex) as part of the project approval process. The governmental commissions that provide such Governmental Acts are normally supposed to be made up of specialists and governmental officials competent in a number of fields relevant to the proposed activities at the structure as well as in other areas that may be potentially affected by the contemplated use, such as the authorities responsible for health and safety, fire and labor protection.

One of the principal legal acts on such governmental commissions is the Instruction "On the Acceptance into Operation of the Completed Objects of Construction," adopted by the Cabinet of Ministers of the USSR on January 23, 1983 (Instruction), which remains in force (Soviet laws remain in effect in Ukraine to the extent not inconsistent with or replaced by Ukrainian law). The Instruction creates a general procedure for the establishment of such commissions as well as the project approval process that must be followed for a commission to authorize the entry into operation of facilities or other constructions.

The Instruction prohibits the start up of operations of any facility or construction without the execution of the Governmental Act by each of the representatives of the "State supervision authorities" (clause 8, para. 3). This is interpreted as referring to the state health and safety, fire, labor protection and all other authorities on a commission. Most of the sanctions that may be imposed by these governmental authorities for non-compliance mirror each other. Thus, if health and safety, fire or labor protection authority approval is lacking, the owner of the building or other facility in question may be liable for penalties or the authority may close down the building or facility, either temporarily, until compliance with the order of the authority, or indefinitely.

Surprisingly, a significant number of buildings and facilities in Ukraine, including those of some major Ukrainian enterprises, have been found to lack the appropriate Governmental Act, especially those buildings that were built or renovated in the aftermath of the Second World War. Usually these sorts of problems can be readily corrected, especially if they arise while the building or facility is still owned by a state enterprise. However, difficulties can ensue, particularly if such issues are not appropriately handled before completion of a transaction. In general, requirements like these underline the need for thorough due diligence before a purchase is made.

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