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Legal security of investors in the process of financing housing construction in Ukraine and some European countries

Правове забезпечення безпеки інвесторів в процесі фінансування будівництва житла в Україні та деяких країнах ЄС

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Abstract

The purpose of the article is to find mechanisms that would guarantee the protection of investors' rights in the process of housing construction. Methodology. In the process of conducting the research, the following methods were used: theoretical generalization, grouping method, methods of dynamic, statistical and comparative analysis, comparative method, method of structural and logical analysis, calculation and analytical method. Research results. The works of scientists who studied the problem of risks associated with investing in construction were analyzed. A comparative study of investor security in France and Germany was conducted. The legislation of Ukraine on this issue was examined. Practical implementation. It was determined that in order to prevent the misuse of funds in housing construction in foreign countries, there is a mechanism for attracting funds by opening escrow accounts and transferring funds from them to the developer. Value/originality. It was proven that the use of

Анотація

Метою статті є пошук механізмів, які б гарантували захист прав інвесторів в процесі будівництва житла. Методологія. У процесі проведення дослідження були використані такі методи: теоретичного узагальнення, метод групування, методи динамічного, статистичного та порівняльного аналізу, порівняльно-правовий метод, метод структурно-логічного аналізу, розрахунково-аналітичний метод. Результати дослідження. Проаналізовано роботи науковців, які вивчали проблему ризиків, пов'язаних із інвестуванням у будівництво. Проведено порівняльне дослідження забезпечення безпеки інвесторів у Франції та Німеччині. Розглянуто законодавство України з цього питання. Практичне значення. Визначено, що для попередження нецільового використання коштів в будівництві житла в зарубіжних країнах діє механізм залучення коштів за допомогою відкриття ескроу рахунків та перерахування коштів з них забудовнику.

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escrow accounts in house-building can become an effective mechanism for protecting the rights of investors in Ukraine.

Keywords: construction, escrow accounts, housing, investor, riskiness.

Introduction

Investment activity is one of the key factors of economic growth. However, the current level of investment activity of both business entities and the population is low in Ukraine. Among the reasons for this phenomenon, along with the lack of necessary financial resources, is the significant risk of investing in most areas of the domestic economy. This is due to the negative perception of increased risk from investors, and the lack of adequate competence in investment risk management, in particular, in the field of housing construction.

Despite the fact that the demand for housing in Ukraine is still far from being fully satisfied, and some potential investors have sufficient financial resources, domestic housing construction still remains inadequate. Cases of inefficient investment in this sphere in the past and a large number of potentially accompanying risk events make housing projects appear to be unsafe and, accordingly, cause the transition of investments from this area to other less risky investment objects.

Financing housing construction remains a challenge in Ukraine. The problem is primarily related to insufficient legal protection of investors. The issue of finding and implementing mechanisms that would reliably guarantee the protection of investors' rights in the process of housing construction remains open.

Methodology

The Article uses general scientific and special methods of research, namely:

The method of theoretical generalization is applied to clarify the essence of the investment system in housing construction and the risks related to this activity.

The grouping method is used for the identification of stages of contractual mechanisms for real estate purchase, formation of a consolidated model of investment mechanisms in housing construction, allocation of risks inherent in the subjects of investment in

Цінність/оригінальність. Доведено, що використання ескроу рахунків в будівництві житла може стати дієвим механізмом захисту прав інвесторів в Україні.

Ключові слова: будівництво, ескроу-рахунки житло, інвестор, ризиковість.

housing construction, analysis of the legislative framework for investing in housing construction in Ukraine.

The methods of dynamic, statistical and comparative analysis make it possible to analyze of international and domestic investment experience in housing construction.

Comparative method helps to equate the legal instruments of Ukraine and some European countries governing the problematic issue.

The method of structural and logical analysis is applied for the development of tools for investor and developer risk regulation under various investment mechanisms.

Calculation and analytical method is useful for the development of methodical recommendations for protecting the interests of investors in financing housing construction.

Literature Review

In general, the purchase of residential premises should be considered as a certain investment project. Consequently, modern science and business practice offer effective tools for project analysis and management (Flyvbjerg, 2006). Chan et al., (2004) state that the use of such tools makes it possible to increase the success of implementation of investment projects. This is achieved, in particular, due to the fact that all the main factors of such success are taken into account and the processes of evaluating the characteristics of projects are formalized.

One of the most important characteristics of projects is their riskiness, that is, the threat of failure to receive the expected results from the implementation of projects. Taking this into account Jaafari (2001) stresses on the need to estimate the level of risk of projects by using special indicators and methods. Ho and Pike (1991), in their turn, note that the specifics of projects, in particular, housing investment projects, should be taken into account.

Doloi (2009) proves that the risk of such investment is determined by a number of factors, in particular, its considerable duration, the complexity of the mutual relations of the participants among the participants of the investment process, etc.

As for the clarification of the mechanism of the emergence and implementation of investment risk, it is worth noting the presence of a certain hierarchy of uncertainties causing it. At the same time, at the top level of such a hierarchy will be the ambiguity of the generalizing indicators for evaluating the effectiveness and feasibility of project implementation (above all, the net present value of the project's cash flow, its internal rate of return, etc.). Accordingly, the vagueness of the values of such indicators is caused by the uncertainty of lower level indicators. In turn, the listed indexes of investment projects, which determine the value of generalizing traces of effectiveness and feasibility of their implementation, are influenced by many factors that directly or indirectly determine their level. In this regard, the uncertainty of indicators of investment projects, among others, can be caused by three reasons:

1. Vagueness caused by the lack of necessary information on all factors that influence project performance (Lian & Zhao, 2017).
2. Indeterminacy due to the deficiency of complete data regarding the forecast values of those types of indicators that describe the impact factors;
3. Indefinites because of the shortage of necessary content concerning the quantitative relationships between the impact factors and indicators of investment projects (Jaafari, 2001).

Specific features are characteristic of the construction industry and as well, in particular, housing construction.

As we can see, the risk factor of residential construction investment has been considered in a number of scientific works. However, the issue of search and implementing mechanisms that would reliably guarantee the protection of investors' rights in the process of housing construction is not finally resolved and requires further research.

Results and Discussion

According to French law, any natural person of age 18 and with full legal capacity can be a buyer of real estate development. No special

requirements apply to such purchaser; as for foreign buyers, there are no restrictions, except for the need to carry out an anti-money laundering check. In practice, the developers of real estate are property companies that manage and obtain financing for the construction project. The developer engages builders, architects, designers and other contractors to perform the construction.

There are no special requirements for real estate developers at the construction stage. However, they should meet the general requirements for property developers. For example, they must obtain a building permit or preliminary declaration, if necessary, for a new construction project. A building permit is issued either by the mayor or the prefect. It is valid for three years; during this period the developer must start construction. However, the relevant authorities may extend this term; once started, construction work cannot be suspended for a period beyond one year.

If a developer begins construction without permission, it may be subject to certain sanctions, including prohibitions requiring the cessation of work or the demolition of the constructed structure, a ban on obtaining new building permits, etc.

Local authorities, such as the prefect, mayor and officials authorized by the Minister of Construction and Urban Development, are empowered to monitor the safety of ongoing construction projects (including construction work in progress) and may request all technical documents related to the implementation of the project.

Upon completion of construction, the developer should provide the relevant mayor with a certificate of completion, signed by the architect, stating that the project complies with the preliminary declaration or building permit, depending on circumstances (Kramer & Frankel, 2019).

Legislation provides that a buyer can purchase real estate under construction only by contractual mechanisms. This procedure includes two stages:

- the first one – the conclusion of a preliminary (reserve) contract between the buyer and the developer ("preliminary contract");
- the second one – conclusion of definitive purchase agreement ("VEFA contract").

According to the terms of the previous contract, the developer undertakes to reserve the premises for the purchaser in case of completion of construction. This contract is not binding on the parties and does not obligate the developer to sell the property to the buyer. Therefore, the purpose of the pre-contract is only to ensure that the developer reserves the agreed property for a particular buyer and will not actively sell it to other potential buyers for some period of time.

There are no legislative requirements regarding the mandatory provisions of the preliminary contract. As practice indicates, it usually includes details of the approximate location of the premises, detailed plans of the proposed development, the number of main rooms and the list of maintenance rooms, extensions, permits, indicative price of the reserved accommodation, etc. There is also no legal requirement for notarization of the Preliminary Agreement.

If the parties enter into a Preliminary Contract, the buyer has a ten-day time period to decide whether to proceed with the final sales contract. The consideration period begins after the buyer has received a copy of the annex to the previous contract, which includes technical description of the property (plans, sections, information on the coverage of each room, etc.), materials used for construction and a description of common equipment (elevator, basement, collective heating, etc.) and other technical information.

During this period of discussion, the buyer may withdraw from the contract and receive a full refund of the deposit paid to the developer. If the buyer renounces the contract after the reflection period, he/she will lose the deposit, unless such withdrawal is due to special reasons provided by law, for example, the inability of the developer to perform the actions according to the Preliminary Contract (Aimvesting, 2019)

For sale and purchase of real estate at the development stage the parties should conclude a VEFA Contract. Before signing it, should provide the buyer with a set of rules that will apply to the property built, for example, the use of communal property, economic use of the property, service charges, etc.

Current French legislation establishes requirements for mandatory provisions of the VEFA Contract. In particular, it should contain the following items:

- a detailed description of real estate under construction and its location in the building;

- purchase price, payment terms and terms of revision of construction in progress;
- completion date;
- guarantee of completion or reimbursement.

The VEFA may also contain certain conditions precedent, i.e. the terms that the parties should fulfill by a certain date in order to proceed with the sale and purchase of the property. In practice, such requirements often include the buyer's obtaining a mortgage to pay the purchase value of the property, under construction, or the developer's taking a bank loan to finance the construction (since the initial purchase price payments received from the buyers may not be sufficient for such financing, and developers, as a rule, do not invest their own funds). If the parties do not fulfill their previous conditions, the VEFA Contract is terminated and the developer returns the deposit and / or the amount of the purchase price actually paid by the buyer at the time of such termination.

The VEFA Contract may provide a fixed or preliminary purchase price. However, in most cases it is a fixed price. If this is a preliminary price, the VEFA Contract shall include the basis on which such price may be revised and therefore the final price is set. In any case, the final price cannot increase by more than 70% of the increase in the construction price index.

Buyer has to pay the purchase price in several parts. The amount of each contribution is calculated as a percentage of the total purchase price, depends on the stage of construction and the type of housing (apartment or house) and cannot exceed the maximum established by law. For example, the purchaser's payment to the developer is no more than 20% of the total amount at the stage of building the foundation of the house. The deposit is also included in the installment payments (in particular, it is part of the last payment). The buyer pays for each stage after the developer has received a written certificate from the supervising architect confirming the completion of the relevant stage of construction. Thus, the buyer is protected from any abuse by the developer and can influence its behavior.

At the same time, the contract may also provide for a penalty of up to 1% of the outstanding amount per month to be paid by the buyer in case of late payment of the purchase price. If the buyer is unable to pay the relevant installment within a month or longer, the developer may terminate the VEFA Contract and file a claim for compensation (FrenchEntrée, 2007).

According to the legislation of the Federal Republic of Germany, any person of age 18 and fully capable can be a buyer of real estate under construction. No special requirements apply to such buyers, and there are no restrictions on foreign buyers, except, as in France, the prohibition of financing with illegally obtained funds.

Unfinished construction is usually sold by real estate agencies that are only responsible for marketing the property or directly by developers who are also in charge for construction management and financing the construction project. The developer engages builders, architects, designers and other contractors to carry out the construction.

There are no special requirements for developers of construction under development. However, they should meet the general requirements for property developers. For example, before starting construction works, they should obtain a building permit. Moreover, depending on the type of project, other administrative permits may be required, such as environmental permits or health safety certificates (Terrafinanz Wohnbau, 2013).

Failure to comply with the conditions of any building or other permits may result in the imposition of sanctions on the developer, including the project closing or even the demolition of the construction work.

In order to purchase unfinished real estate, the parties must enter into a purchase and sale agreement ("SPA"). In contrast to French practice, the purchase of unfinished property in Germany does not require the conclusion of a preliminary contract.

Current legislation establishes requirements for the mandatory provisions of the sales contract. In particular, sales contract should include the following provisions:

- a detailed description of the building;
- construction plans;
- terms of payment;
- property rules and any easements.

A sales contract may also contain certain conditions precedent, meaning conditions that the parties should perform by a certain date in order to proceed with the sale and purchase of the property. In practice, such pre-conditions often include the buyer obtaining a mortgage loan to pay the purchase price of the unfinished property and the developer receiving a bank loan to

finance construction (since the initial contributions to the purchase price received from buyers may not be sufficient for such financing) or acquisition by the developer of household land for construction purposes. If the parties do not fulfill their previous conditions, the contract of sale is terminated, and the developer returns the deposit and/or the amount of the purchase price actually paid by the buyer at the time of such termination.

The developer can receive payments from the buyer (customer) only after signing the SPA (sales agreement). The developer must keep the money obtained in a bank account separate from the developer's assets.

The parties may agree on the amount and schedule of payment of the purchase price in the SPA at their own discretion, but in any case subject to the following legal requirements:

- if the purchase price is paid in installments, the current legislation allows up to seven payments, provided that the construction stages are completed;
- each payment is made only after completion of the relevant stage of construction;
- the initial payment must be equal to 30% of the purchase price and can be paid after the commencement of the land works or the excavation of the basement.

The following payments are made in such manner:

- 40% of the purchase price can be paid for the completion of construction works (framework, concrete shell, etc.);
- 8% of the purchase price may be paid for the installation of roofs and gutters;
- 3% of the purchase price may be paid for the initial installation of sanitary premises;
- 3% of the purchase price may be paid for the initial installation of heating systems;
- 3% of the purchase price may be paid for the installation of electrical systems;
- 10% of the purchase price may be paid for installation of windows, including glazing;
- 6% of the purchase price can be paid for internal plastering, except for decorating;
- 3% of the purchase price can be paid for screed (main floor, usually poured concrete);
- 4% of the purchase price can be paid for tiles in sanitary facilities;
- 12% of the purchase price can be paid after the date of readiness for occupation of the premises and step by step before transfer;

- 3% of the purchase price can be paid for facade works;
- 5% of the purchase price may be paid upon completion.

However, since current legislation only allows for up to seven partial payments, one partial payment generally corresponds to the completion of several construction phases together. Thus, German law regulates in detail the terms of the contract of sale of real estate at the stage of its construction and, in the same way as French law, protects the rights of buyers (customers) from possible financial abuses by construction companies (Chance, 2019).

As for Ukraine, it should be noted that in accordance with the Law of Ukraine “On Investment Activities” (Law of Ukraine No. 1560-XII, 1991), investment and financing of the construction of residential construction objects using non-state funds, attracted from individuals and legal entities, including management, can be carried out exclusively through construction financing funds, real estate transaction funds, joint investment institutes, as well as through the issuance of special purpose bonds of enterprises, the fulfilment of obligations for which is carried out through transferring the object (part of the object) of residential construction. Other methods of financing the construction of such objects are determined exclusively by laws.

The functioning of construction financing funds is provided for by the Law of Ukraine No. 978-IV (2003), according to the provisions of which funds are raised from individuals for housing construction by the manager, which is a financial institution.

The manager, having attracted funds, has the right to enter into an agreement on the financing of housing construction with the developer. In accordance with the terms of the concluded contract, the manager transfers the funds to the developer for their use in the construction of housing. It should be noted that the current legislation does not provide for the amount and conditions of the transfer of funds by the manager to the developer. This aspect is the prerogative of the parties and is determined exclusively by the contract concluded between them. As a result of the non-regulation of this issue in the legislation, in practice, there are frequent violations by the developer of commitments made, for example, the use of funds not for the intended purpose. This, in turn, puts not only the possibility of timely completion

of housing construction at risk, but its finalization in general.

To prevent misuse of funds in housing construction in foreign countries, there is a mechanism for attracting funds by opening escrow accounts and transferring funds from them to the developer.

At the same time, the legislation, and not just the contract, determines the percentage of installment to the developer. The condition for the transfer of each subsequent tranche is the completion by the developer of a certain stage of housing construction work (laying the foundation, erecting the walls of the house, etc.) with the presentation of relevant documents confirming the completion of these works. Such a mechanism allows to effectively control the activities of the developer and the use of funds for construction, while reducing the risks of their loss by investors.

The current legislation of Ukraine provides for the possibility of opening escrow accounts. However, unfortunately, this mechanism currently remains on the sidelines in matters of attracting funds for housing construction. In October 2020, Draft Law of Ukraine No. 4247 (2020) was submitted to the Verkhovna Rada of Ukraine, which proposes to implement a mechanism for attracting funds for housing construction using escrow accounts to ensure the protection of investors' rights at the legislative level. It should be noted that the author of this bill paid attention only to housing construction financing and real estate transaction funds.

At the same time, the draft law not only does it not enhance investor protection, but also exposes additional risks both to investors and banks that service the accounts of Construction Financing Funds / Real Estate Operations Funds and/or are managers of such accounts and entrusts banking institutions with non-specific functions of examination of the state of construction works.

In particular, with regard to the requirement provided for in the draft law to ensure actual control over the progress of construction by a bank, in which the manager has opened an escrow account (transfer of funds to the developer only after bank is convinced that the relevant stage of construction has been completed), it should be noted that banking institutions are not experts in such kind of works and are not authorized to evaluate the level of their actual implementation. Determining the scale of completion of construction works at each

of the nine stages provided for by the draft law requires the participation of third-party expert organizations authorized to carry out such estimation.

Entrusting the bank with an additional control mechanism through the gradual release of funds from the escrow account only on the condition that the developer completes the previous stages of work, actually removes the developer from responsibility to investors and exposes the bank, which serves the escrow account, to claims from investors in the case of construction failure.

Besides, this mechanism creates a risk for investors to obtain insurance compensation, as it gives the developer and the insurance company grounds to deny the fault of the developer, thus removing him from civil liability, which, in turn, makes insurance indemnification of such liability impossible.

However, the mechanisms of attracting funds for housing construction are rarely used by developers in practice. Investors are usually offered other ways, in particular, concluding preliminary contracts, according to which the investor must pay a significant part of the funds for housing construction. Despite the fact money paid are generally a means of ensuring compliance with the obligation to conclude the main contract in the future on the part of the investor, and not the developer himself. Therefore, such a mechanism is even more risky for investors, since under the terms of the previous contract, the developer is in no way obliged to transfer the real estate object to the investor, but only to conclude a contract for the sale of the real estate object in the future. However, even if the developer does not enter into a basic contract with the investor in the future, the developer does not bear any particular financial risks.

Conclusion

Summing up, it is worth concluding that the use of escrow accounts in housing construction can become an effective mechanism for protecting the rights of investors. The legislator has to secure the interests of those who invests in the development of property by means of gradual (staged) financing of building using escrow accounts, provision of additional control, including by the bank, over the course of erection, introduction of mandatory insurance civil liability of the developer in favor of investors.

For this purpose, the introduction of a mechanism for opening escrow accounts in banks for the accumulation of investors' funds and the subsequent phased financing of the construction of a specific object according to the degree of its preparedness can be a promising and effective measure for the storage and targeted use of investors' money.

In fact, the analogue of escrow accounts in terms of the gradual financing of housing construction in France and Germany is the legally established opportunity for investors to pay for housing construction depending on the completed stage of construction. Thus, it allows investors to be financially protected from possible risks from construction companies. Therefore, the use of foreign experience in financing housing construction should be extended to all possible ways of attracting funds through the adoption of a corresponding draft law in Ukraine.

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