



Serbia: Forced Conversion of Land Use Rights into Ownership Rights May Give Rise to Investment Treaty Claims by Foreign Investors

IN SHORT:

The Situation: Serbia's Land Conversion Law regulates the procedure by which companies convert their land use rights into ownership rights. Although land use rights were previously adequate for companies to obtain construction permits, this is no longer the case under the new legislation. Companies, including those, which were acquired through privatization, must pay substantial consideration to affect this conversion.

The Result: If a company wishes to develop its land, it must possess ownership rights. Companies holding land use rights must therefore instigate the lengthy and expensive conversion process. Companies are effectively required to re-purchase rights they acquired at the time of their initial investment. These legislative changes could diminish the value of investors' acquired companies in Serbia.

Looking Ahead: Affected companies may have a cause of action against Serbia under either Serbian laws or a Bilateral Investment Treaty, as a result of expropriation or diminution in value of their assets and the violation of their legitimate expectations at the time of investment.

A. Brief Introduction

Following the end of the WW2, then Yugoslavia enacted the Law on Nationalization of Rental Buildings and Construction Land (the “**Law on Nationalization**”), which introduced a significant novelty that will have enormous impact on today’s entire industry in Serbia – *land use right*.

Namely, under the Law on Nationalization all rental buildings (whether commercial or residential) as well as entire construction land within boundaries of cities were nationalized and have become so-called social ownership. From that moment on, individuals and companies were able to have only a land use right on city construction land, which right was not *per se* transferable.

Generally, holders of the land use right were able to obtain construction permits based on this right and subsequently to develop the land.

Starting from 2009 (and the enactment of the 2009 Law on Planning and Construction) Serbia has introduced the so called “*land conversion process*” with the aim of converting the land use right in the ownership right on the land. Due to various reasons political decision was made that in case of entities / companies that were acquired through privatization and their legal successors the land conversion process must be carried out against (considerable) fee. The basic logic behind this idea was that acquirers of companies in the privatization procedure were buying “enterprises and not their assets” and hence if they want to build / develop the land they have to (re-)purchase it first.

Yet, until 28 July 2016, with certain time gaps (of almost two years in total), the land use right continued to entitle its holders to obtain construction permits for further development of the land. Under the 2015 Law on Conversion of Land Use Right into Ownership Right on Construction Land (the “**Land Conversion Law**”), **starting from 28 July 2016**, the land use right ceased to be adequate title for obtaining construction permits – i.e. addressees of the Land Conversion Law lost their right to develop the land based on their land use right. Instead, they now have to complete the land conversion process and obtain the ownership title on the land in order to be able to obtain construction permits for further development of the land.

B. Consequences of the Land Conversion Law

- **Subject Matter**

The Land Conversion Law regulates conditions for conversion of the land use right into the ownership right on the construction land against payment of consideration (the “**Consideration**”), which is determined in accordance with guidelines provided in that law. Subject of conversion is one or more cadastral lots of developed or undeveloped construction land.

- **Applicability**

This law applies inter alia to:

- Companies and other legal entities that were subject of privatization under provisions of laws regulating enforcement procedure, insolvency procedure and privatization, and their legal successors;
- Persons that had acquired the land use right on undeveloped construction land for the purpose of its development according to applicable regulations until 13 May 2003 or based on decision of competent public body;
- Entities regulated under the statutes on sports and associations, etc.

- **Calculation of the Consideration**

The Consideration, to be paid by holder of land use right for the conversion, generally represents fair market value of the respective construction land at the time of filing the conversion application, subject to certain deductions and reductions (e.g. based on the location of the land in undeveloped parts of Serbia,

and/or on account of the land serving for the regular use of the existing objects). Although the Law provides detailed parameters to determine the Consideration, ultimately, the amount is determined by the relevant local state body.

- Manner of Payment

The Consideration may be paid in two manners:

- At once (“bullet payment”) – where the payor is entitled to 30% discount, or
- In 60 monthly instalments – where the payor is obliged to provide adequate means of security.

- Exceptions – Lease of the Land

As an exception from the obligation to complete the land conversion process in order to be able to develop the respective land, the Land Conversion Law provides a possibility of lease of the construction land until completion of the conversion process. In such a case, the lease agreement is concluded with the owner of the land in question (i.e. the state or the local unit of self-government) and for a period of 99 years with payment of the rent. The amount of the rent is determined in a manner that the fair market value of the construction land (without deductions and decreases) is divided with 99, and so derived amount represents the amount of annual rent. The lease agreement must include provisions for adjustment of the rent with the rate of inflation in Serbia, as well as a means of security for the payment of rent (e.g. a bank guarantee, mortgage etc.), which usually makes the lease arrangement unattractive and burdensome for the affected entities. Such concluded lease agreement provides adequate title on the construction land for the purposes its development (i.e. for obtaining of the construction permit). Upon construction and registration of the object in land registries, the lessee may carry out the land conversion process with the decrease of the Consideration based on the criteria relating to the land necessary for regular use of such constructed object. Upon such completion of the land conversion process, the lease agreement ceases to apply.

C. Effects on Foreign Investors’ Acquired Rights

- Grounds for Protection

Republic of Serbia has concluded 49 bilateral investment protection treaties (the “*BITs*”), including with countries where vast majority of foreign investors in Serbia are domiciled. BITs will often provide broad ranging substantive protections such as protection against illegal expropriation and discrimination, and the fair and equitable treatment standard, which includes the protection of an investor’s legitimate expectations. For example, foreign investors in Serbia may have invested with the expectation that land use rights were a surrogate for ownership rights and would be sufficient to obtain a construction permit. The Land Conversion Law violated such expectations and could destroy or substantially decrease the value of investors’ investments, making such investors potentially eligible to bring an investor-state arbitration against Serbia.

In addition, protection of foreign investments in Serbia is also guaranteed by domestic legislation, which like BITs provide standard corpus of guarantees such as guarantee of legal certainty, protection from nationalization, expropriation and measures of equivalent effect.

- Violation of Foreign Investors’ Acquired Rights

Foreign investors that acquired real property in Serbia (directly or indirectly through privatization of legal entities that were holders of land use right on respective land) were entitled, as holders of land use right, to develop respective land (i.e. land use right was adequate title for obtaining construction permits on that land). Furthermore, in the moment of acquisition of respective land, holders of land use right were not obliged to carry out the process of conversion in order to be able to obtain construction permit.

However, starting from 28 July 2016, the land use right ceased to be adequate title for obtaining construction permits. For the vast majority of domestic companies that were subject of privatization, this practically means that if they want to develop the construction land, they must first undergo the conversion process and pay significant Consideration – practically repurchasing the land they had already acquired through acquisition of the respective local entity / company in Serbia. This process is usually complicated, non-transparent and long-lasting with uncertain outcome.

Given that in the moment of their investment foreign investors were entitled to obtain construction permits based on the land use right, it seems apparent that acquired rights of foreign investors in Serbia were expropriated by this kind of conduct by the state.

D. Legal Remedies

- Causes of Action

As outlined above, the Land Conversion Law dictates that land use rights are no longer adequate for companies to obtain construction permits. This forces companies wishing to develop their land to instigate the conversion process, which can be complex, expensive, lacking transparency, unpredictable and slow. Furthermore, the majority of investors would likely have acquired the companies and/or entities on the premise that the land use rights were sufficient to obtain construction permits and equivalent to ownership rights, and certainly with no obligation to pay further compensation. The Serbian State's actions could be therefore tantamount to expropriation. Furthermore, the diminution in the value of the investors' investment, in the form of the companies or entities possessing the land use rights, could in itself give rise to both domestic or international claims.

Foreign investors impacted by provisions of the Land Conversion Law may seek protection of their acquired rights in two main procedures:

- Administrative Procedure

In the conversion process, which is executed in accordance with rules applicable on the administrative procedure, affected foreign investor may request from the competent authority to enact respective decision on conversion, determining that the Consideration to be paid by respective foreign investor shall amount to nil – by invoking protections afforded to foreign investors in Serbia based on both national Serbian legislation and BITs. Notably, currently there is no practice in Serbia in this regard.

- Investment Dispute – International Arbitration

Investor-state arbitration provides an attractive option for aggrieved foreign investors, as it not only provides a specialized forum, in which to bring a dispute against the relevant state (in this case Serbia) but also generally does not require the investor to exhaust local remedies or instigate domestic litigation ahead of bringing an investor-state arbitration.

A foreign investor could bring the arbitration under a BIT between Serbia as the host state, and the state of incorporation of the investment company. At present Serbia has 49 BITs in force, most notably with capital-exporting states such as the Netherlands, Austria, Germany, France, the UK, and the Belgium-Luxembourg Economic Union. Such BITs are designed to protect an investor's investments from unlawful action of the states who are party to the relevant treaty. The majority of BITs broadly define an investment and as a result, such treaties will normally apply to all kinds of assets such as property rights, shares, contracts and other assets having financial value.

The applicability of such BITs will depend on an investor's nationality in a signatory state. A company's nationality is primarily determined by its country of incorporation and/or the claimant's place of citizenship. Many BITs permit investors to make claims for directly or indirectly held investments as well as minority shareholdings. Thus, parent companies or individual shareholders are often able to assert rights relating to an investment held through a subsidiary company.

There are many advantages to investor–state arbitration. Successful claimants are typically awarded monetary compensation, which in some cases not only includes the amount invested (plus interest, costs, and expenses) but also lost future profits. Arbitral awards are binding on the parties and create an obligation to comply with them. Most states comply with international arbitration awards voluntarily. In the event a party fails to comply with an award, one of the major advantages of arbitration (as opposed to litigation) is the international enforceability of arbitral awards as compared with foreign court judgments.

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KEY TAKEAWAYS:

1. Companies in Serbia are no longer able to obtain construction permits unless they possess land ownership rights. Companies acquired through privatization must pay substantial consideration to complete this conversion.
2. Foreign investors having to pay consideration to affect the conversion process may have recourse against Serbia through one of the 49 BITs currently in place as a result of Serbia's breach of the investors' legitimate expectations and the diminution in value of investors' investment.

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