

COMMERCIAL LAW & MICROECONOMIC REFORM

A Practical Guide to Program Implementation

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TABLE OF CONTENTS

Contents	
Introduction	1
Company Law and Corporate Governance	5
Contract Law and Enforcement.....	25
Real Property	37
Secured Transactions.....	53
Bankruptcy	65
Competition Law and Policy	75
Commercial Dispute Resolution.....	83
Foreign Direct Investment.....	97
International Trade.....	107
Appendix A: Cross-Cutting Themes in CLIR, 2005-2010.....	121
Appendix B: Glossary of Key Terms and Concepts.....	137
Appendix C: List of Major Institutions Referenced in this Guide.....	143
Appendix D: Case Studies	145
Appendix E: Commercial Law and Microeconomic Reform Legal Subject Area	
Summaries.....	155
Pillar I: Real Property (Including Mortgage Law).....	157
Pillar Law II: Contract Law	159
Pillar III: Company Law (Including Business Registration and Corporate Governance).....	161
Pillar IV: Commercial Dispute Resolution (CDR)	163
A. Bankruptcy Law (Also called “Insolvency Law”)	165
B. Competition Law and Policy.....	167
C. Foreign Direct Investment (FDI)	169
D. International Trade Law.....	171
E. Secured Transactions Law (Also known as “Collateral Law” or “Law on Pledges”).....	173

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This guide is intended to be a living document which will be updated with success stories, case studies, and other areas as they are developed. We thank all future contributors.

Introduction

As development practitioners, we face a difficult challenge: how to translate the macro-level insight that “good” laws and institutions are critical to sustained poverty reduction into specific approaches that will deliver measurable and lasting development impact. This insight has been supported by a growing body of scholarship

prosperity over time. Similarly, the World Bank’s Doing Business surveys provide a cross-country comparative ranking of various economic conditions that constrain or enable economic activity at the firm level.³ The result of this work suggests that poorer countries tend to have faulty commercial law systems. With this work in mind, this guide seeks to contribute toward meeting the challenge of forming specific programs that will help USAID achieve its core operational goal of promoting transformational development in the countries it serves so that the country may ultimately thrive without foreign aid.⁴

“Transformational’ development is development that does more than raise living standards and reduce poverty. It transforms countries, through far-reaching, fundamental changes in institutions of governance, human capacity, and economic structure that enable a country to sustain further economic and social progress without depending on foreign aid. The primary determinant of progress in transformational development is political will and commitment to rule justly, promote economic freedom, and make sound investments in people.”

USAID White Paper, U.S. Foreign Aid: Meeting the Challenges of the Twenty-first Century (January 2004).

and analysis. In his article *Innovation, Information and the Poverty of Nations*, Robert Cooter persuasively argues that defective legal institutions cause national poverty.¹ Michael Porter makes a similar point in *Building the Microeconomic Foundations of Prosperity: Findings from the Business Competitiveness Index*², where he draws empirical correlations between macro-level indicators of competitive potential (e.g., “Efficiency of the Legal Framework,” “Effectiveness of Bankruptcy Law”) and micro-economic outcomes – rising

One of USAID’s tools to achieve this goal is the Commercial Law and Institutional Reform Diagnostic Methodology (CLIR Methodology). It is a practical tool that analyzes the impact of a country’s legal system on business. In 1998, the USAID Bureau for Europe and Eurasia commissioned this tool to help development professionals better understand and respond to the complexities of modernizing a nation’s laws and institutions that support, facilitate, and sustain a modern market economy.

This guide is intended to assist development professionals – with or without formal legal training – in understanding the complexities

of commercial law reform. Further, this guide is intended to help development practitioners apply the CLIR Methodology as a practical tool for: 1) identifying development needs, 2) establishing relative priority among competing requirements, 3) building a development assistance program with a higher probability of achieving the desired result, 4) creating a set of recommended next-steps for commercial law and institutional reform, and 5) evaluating the impact of development assistance programs. The CLIR Methodology serves as a tool to help capture and distribute information useful for informed development assistance.

The CLIR Methodology has been applied successfully in all 20 countries worldwide. Successful application of the CLIR Methodology has resulted in varied projects designed to address problems identified during assessments, ranging from a financial crimes enforcement program to a court modernization project, as well as various commercial law reform projects. The CLIR Methodology has also been applied as a tool to identify the status of the commercial law environment across an entire region, most recently throughout Central America and Southeast Asia.

WHY ENCOURAGE COMMERCIAL LAW REFORMS?

Land Ownership and Access to Credit

A sound commercial law and institutional environment is critical to sustained economic development. In most fragile states, the right to own land typically is either non-existent or not enforced due to systems that fail to protect, document and enforce ownership rights. As highlighted by Peruvian economist Hernando de Soto's groundbreaking work, people who hold land or homes without a state-sanctioned deed or title cannot use this property to build upon what they have. Specifically, these land holders cannot tap into their property's value to use as collateral for additional capital that could be used to enhance existing businesses, or for business startup.⁵ Even in more stable, transitioning economies, sound commercial

laws governing processes of accessing capital to launch a business, registering a company or a loan secured against collateral, or seeking enforcement of contracts and debt, are regularly defeated by illogical and ineffective bureaucracy, crushing costs, or corruption. When institutions and professionals that have the potential to support economic activity – including courts, judges, registries, lawyers, the private sector, non-government organizations, and even the media – are ineffectual and lack independence from political interests, broad-based economic development may be sacrificed to serve the economic gain of a powerful elite. Moreover, foreign investors face considerable levels of risk where legal systems lack transparency, predictability, and security, and as a result will often avoid high-risk environments.

Encouraging the Formal Sector to Reap Benefits for All

One troublesome consequence of a weak system of commercial law and institutions is the rate at which entrepreneurs elect to bypass the formal sector. Rather than registering with a state-operated registry, a new business – seeking to avoid minimum capital requirements, cumbersome bureaucratic licensing procedures, or taxes – will often choose to remain informal. Where businesses remain informal, the negative impact on an economy is multi-layered. For example, they remain relatively small because they are unable to formally access bank loans, certain donor assistance, and other benefits that would allow them to grow. National treasuries fail to receive the taxes they need to support the country's infrastructure – the very roads, ports, electrical lines, and other resources that support a vibrant economy. Products remain unregulated and often companies are run inefficiently and even dangerously.⁶ Workers are generally deprived of access to health benefits, pensions, social security, and protection from abuse. Internationally sanctioned principles of corporate governance are disregarded, thereby weakening opportunities for attracting outside investment. Finally, the absence of enterprises from the formal legal system means that their operators often remain similarly estranged from the political system, thereby

undermining a country's access to the benefits of stability and democratic participation.⁷

Commercial Law is an Underpinning Framework for Other initiatives

There are many components of economic development in fragile states and transitioning economies, all of which are distinct disciplines and are related to one another. Through its Bureau of Economic Growth, Agriculture, and Trade (EGAT), USAID serves many of these components, including: privatization; enterprise development; financial markets; access to reliable, environmentally sound energy sources in rural and urban settings; economic policy; information technology; social safety nets; and trade and investment. These programs have significant commonalities with other USAID initiatives, both within EGAT and in other Bureaus. These include programs that support democracy and governance, sound management of the environment, increased agricultural output, and, even more fundamentally, education and health.

One key lesson learned over the past several decades of development assistance is that there is no single recipe for success that can be transplanted from one country to another. Topics such as land reform, insolvency, foreign investment, and international trade require states to confront complex issues and engage in candid and often painful reassessment of history, politics, culture, and other national values. These questions will be unique and nuanced in each country where they arise. Thus, it is up to the development professional to take the tools provided in this guide and insights gained through application of the CLIR Methodology and balance discrete national and regional policy concerns with important CLIR principles, priorities and opportunities to help achieve sustainable economic growth.

ENDNOTES

¹ Robert Cooter, *Information, Innovation, and the Poverty of Nations* (2005).

² Michael Porter, *Building the Microeconomic Foundations of Prosperity: Findings from the Business*

Competitiveness Index, in *The Global Competitiveness Report 2003 – 2004* (2003).

³ The World Bank *Doing Business* reports are available at <http://www.doingbusiness.org/>

⁴ USAID White Paper, "U.S. Foreign Aid: Meeting the Challenges of the Twenty-first Century" (January 2004).

⁵ Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (2000).

⁶ World Bank, *Doing Business 2004: Understanding Regulation* at xv.

⁷ See World Press Review, Interview: Peruvian Economist Hernando de Soto (October 15, 2003).

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Company Law and Corporate Governance

KEY CONCEPTS

Definition: For purposes of this overview, a set of laws that: (1) sets forth requirements for incorporating a company (i.e., business registration), (2) defines and regulates ownership interests of company shareholders, (3) establishes basic principles or rules of corporate governance, (4) sets limits on the liability of company shareholders, and (5) establishes legal personality for the firm created, providing the legal basis for entering into contracts and accessing finance.

What is a company? A company is a legal entity formed for the purpose of carrying on a legitimate business. A company may own property and enter into contracts in its own name rather than in the name of the owners. A key benefit of operating through a company is the principle of “**limited liability**.” When the owners of a company formally register their business under the laws of their country, they are then shielded (in most instances) from personal liability for the company’s debts, and thus their liability is generally limited to the amount of their investment. Company Law thus plays a critical role in market economies by reducing the personal risk involved with starting a business and by providing a sound legal environment for the formation and operation of business entities.

Company Law creates the framework for how companies are formed and must operate. Company Law sets forth requirements for forming a company, including requirements as to the minimum capital needed for formation and the procedures for registering a company. Company Law also sets forth basic principles or rules of Corporate Governance – that is, the rules that outline the division of roles and

responsibilities between company management, boards of directors and supervisory boards, investors or shareholders, employees, and outside stakeholders. In addition, Company Law establishes “disclosure” or “transparency” requirements regarding the type of information that companies must report to their investors and, in many cases, to the public. Finally, as mentioned above, Company Law generally aims to encourage entrepreneurship by setting limits on the liability of investors. Specifically, shareholders or owners are often only liable to the extent that they have invested in a company, rather than having their personal assets used to satisfy the debts of the business.

The existence of a sound Company Law is not an end in itself. Even the strongest law can be rendered ineffective by an overly restrictive licensing or regulatory regime, corrupt practices of state officials, or failure to enforce restrictions against self-dealing by controlling shareholders. **But a sound legal framework is a prerequisite for sustained private enterprise growth and development.**

A robust Company Law framework should permit the formation of various types of business associations.

An enterprise benefits from the existence of varying legal

structures, depending on the nature of its business, its financial underpinnings, and its size. **Public companies** or **joint-stock companies** are financed through the public equity investment of shareholders – including individual, institutional, controlling, and minority shareholders – and have shares that can be publicly traded on stock exchanges. Other companies take such forms as **closely held companies**, **partnerships**, or **limited liability companies**, and are typically owned by a small group of owners or investors. The shares of these companies – generally small or medium-sized enterprises (SMEs) – are not traded on a stock exchange.

Corporate Governance is the system by which companies are directed and controlled. Company Law typically requires businesses to establish a system that delineates the rights and responsibilities of its different participants – including its board(s), managers, shareholders, and other stakeholders – and to spell out the rules and procedures for making decisions on company affairs. This delineation of roles, or system of *Corporate Governance*, establishes the structure through which company objectives are set, the means of attaining those objectives, and how performance will be monitored. Corporate Governance rules are also meant to foster efficient decisions that benefit the company’s investors while discouraging insiders, such as majority shareholders and managers, from expropriating the assets of the firm or acting contrary to the interests of the shareholders.

“Corporate Governance . . . provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good Corporate Governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the property functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.”

Preamble, Principles of Corporate Governance, OECD (2004)

Corporate Governance became a prominent focus of the development agenda among international financial institutions and donor-funded entities in the wake of the Asian financial crisis. The privatization and liberalization of financial markets throughout the world in the mid 1990s also resulted in a greater emphasis on Corporate Governance. A number of high-profile corporate failures and accounting scandals in 2001-2002 brought a renewed emphasis on the importance of sound Corporate Governance for companies in emerging markets and thriving market economies alike. Company Law reform now focuses extensively on the Corporate Governance principles embedded within Company Laws and regulations.

Do Company Law and Corporate Governance matter for economic development? Assessments of Corporate Governance have focused on the relationship between governance and efficient use of capital.¹ This literature has also generated a number of applied research projects and strong policy statements relating to the relationship between corporate governance and investor confidence (both domestic and foreign) and national economic performance. Although a clear “causal link” between systems of Corporate Governance and traditional measures of economic improvement is difficult to show, practitioners generally agree that strengthening domestic investor confidence in a country’s own companies and capital markets may contribute to business competitiveness and to the overall growth

of a national economy. In addition, the principles of fairness, transparency, and accountability may reduce a company’s vulnerability to financial crisis and broaden and deepen access to capital.

Sound Corporate Governance is part of a larger international emphasis on increased transparency, integrity and the rule of law. The challenge for legal reformers is to apply the principles and standards of

“Studies using what are considered to be best practice econometric techniques indicate that Corporate Governance is an important determinant of [economic] performance. Establishing an empirical relationship between Corporate Governance and performance is exceedingly difficult since there is a considerable leeway in specifying measures of performance and indicators of Corporate Governance are very restricted. It is not possible at present to use a widely accepted index of overall Corporate Governance. As with all regression work, the question of “causality” will never be resolved fully to everybody’s satisfaction, in part because of the poor measurement, and the implications for practical policy are sometimes difficult to interpret. Nevertheless, best practices have emerged that address many of the issues and usually involve examining a panel of companies over time, using quite specific aspects or features of governance.”

OECD, Survey of Corporate Governance Developments in OECD Countries 15-17 (December 2003)

Corporate Governance across a wide variety of legal, economic, ownership, political, and cultural systems.

MAJOR GUIDELINES

Legal framework

There are various models upon which new Company Laws are based, including the German model, the U.S. model (often derived from the state of Delaware’s Company Law), and the Japanese model. Within a given region, moreover, a certain framework may serve as a model for neighboring countries. Russia’s Company Law, for example, influenced the reform process in neighboring countries such as Kazakhstan and Uzbekistan. A useful source of guidance with respect to the development of a new Company Law is found at General Principles of Company Law for Transition Economies, a document prepared by an international group of experts in 1999 on behalf of the OECD’s Centre for Co-operation with Non-Member Economies.²

Persons who wish to set up a business in a given jurisdiction must be familiar with the laws that address the way companies are formed, operated and closed down. Where the laws and regulations related

to the establishment of companies are clear, easily accessible, and not unduly burdensome, business formation has a greater chance of taking place than where the law is confusing, unduly complex, or where it creates unnecessary hurdles.

The framework legislation governing companies may be found in discrete statutes dealing with companies or in provisions included within a broader civil or commercial code. In addition, since public companies have shares that are traded on stock exchanges, a country’s laws concerning its securities or capital markets are often considered framework laws. A country’s Law on

Securities (which may also be referred to as a “Law on Securities and Stock Exchanges” or “Law on Securities Market Regulation”) typically mandates the type of reports that must be maintained by public companies, and the type of information that must be disseminated to the public.

Formation and mechanics. In theory, capital requirements and requirements regarding company charters and bylaws should be kept to a minimum to provide for a company’s ease of entry into a market. Furthermore, the actual process of registering a company (via the courts, a specific company registrar, or other state agency) should be easy, fast and also unbiased – that is, free from corruption or favoritism – and based on published standards and guidelines.

Countries differ significantly in the ways in which they regulate the entry of new businesses. In some countries, the process is straightforward and affordable. In others, the procedures are so burdensome that entrepreneurs must choose between bribing officials to speed up the process and running their business informally. As extensively documented by the World Bank,³ businesses in poor countries face much larger regulatory burdens generally than

A Company Law typically contains provisions related to the:

- Formation or incorporation of companies, including costs and procedures for registration
- Requirements for articles of incorporation and memorandums of association
- Duties of directors, management and company auditors
- Procedures and requirements for holding meetings within the company, especially meetings of shareholders
- Relationship between directors and shareholders in terms of voting rights
- Rights of minority shareholders
- Regulation of takeovers and mergers
- Procedures for dissolution and winding-up

typically spell out the types of company actions that require shareholder approval, and the nature of the majority vote required to achieve approval. Especially significant corporate decisions (such as whether to dissolve a company) require a super-majority approval of the shareholders, thus ensuring that management cannot make significant economic decisions without input from shareholders.

Another concept that may be addressed within a Company Law is the right of

those in rich countries, and the **registration of new businesses is one area in which the streamlining of procedures results in improved economic activity and, in turn, economic growth.** The World Bank specifically proposes removing the registration of businesses from the courts, asserting in its report, *Doing Business in 2006*, that “company registration is an administrative process” and that, through the elimination of the company registration process from the courts, judges are “freed to focus on commercial disputes.”⁴

Shareholder rights. Shareholder rights refer to the extent to which a Company Law or other relevant law provides explicit rights for shareholders when dealing with corporate decision-making and changes to the economic situation within a company. Shareholders are typically able to exercise their rights through voting and participation in an annual general meeting of the company. Shareholders are also able to participate in elections of the board of directors and/or supervisory board of a company.

For example, a Company Law should allow shareholders to easily sell or transfer their shares without undue encumbrances. Other examples of shareholder rights relate to the nature of the majority vote needed to approve various types of corporate actions, such as the sale of assets, mergers, acquisitions, and so forth. A framework law should

shareholders to introduce corporate resolutions at annual shareholder meetings and to vote by proxy, either via paper ballot or by assigning their vote to another shareholder. In addition, rules concerning minority shareholders are meant to protect smaller investors from possible unfair treatment by larger shareholders within a company.

Creditor rights. Creditor rights relate to the ability of creditors to seek relief in the event of company default, as well as in the event of fraud or collusion by company directors. The laws of Secured Transactions and Bankruptcy specifically address the ability of creditors to be compensated where there is default or insolvency. For their part, Company Laws should outline the extent to which officers and directors may be held personally liable for certain types of malfeasance or negligence. In drafting or refining a Company Law, specific penalties should be stated and provisions for redress should not contradict related statutes, such as the country’s civil, criminal or commercial code.

Officers, directors and governance. Company Law also defines the roles and duties of senior management and the board of directors (and/or supervisory board) and whether any breach of their duties gives rise to personal liability. In addition,

Negative Implications of High Entry Costs

Scholars at the World Bank have shown a correlation between countries that have greater start-up regulations and higher levels of corruption. This leads to larger unofficial economies without a corresponding increase in the quality of goods or services. The study suggests that greater burdens on market entry tend to favor rent-seeking officials, without adding significant quality to the services or goods provided.

See Simeon Djankov, et al.,
The Regulation of Entry (The World Bank, 2001)

Courts and judges often have responsibility for reviewing or approving the licensing and formation of companies, sometimes in cooperation with the registrar. Alternatively, as previously discussed, the court may have the primary role of registering companies. In addition, courts are the primary site for resolution of lawsuits against companies, including suits by shareholders, creditors, and individuals.

director-liabilities may be described more broadly in a country's civil, criminal or commercial code.

Dispute resolution. There currently is no consensus regarding whether and to what extent Company Law should contain provisions for dispute resolution beyond traditional judicial mechanisms. The OECD has emphasized the need for arbitration – the process through which parties in a dispute agree to let a neutral third party other than a traditional court hear evidence and make a decision that will end the dispute – as a means of resolving disputes involving foreign investors in emerging markets. The question remains, however, whether such a model is useful for resolving domestic disputes under the Company Law. Regardless of the formal incorporation of ADR into the law, local businesses may develop alternative mechanisms for dealing with disputes, such as through Chamber of Commerce arbitration panels or independent mediation services. This topic is further developed in this Guide's chapter on Contract Law and Commercial Dispute Resolution.

Implementing Institutions

Several state institutions may be involved in the implementation and enforcement of Company Law. One principal implementing institution is the **company registrar** (or the functional equivalent), which registers and records the establishment of public companies and limited liability companies as well as the amendment of corporate documents. The relevant registering entity may be the courts rather than a separate registrar. As a secondary function, the registrar maintains public records and information on company formation.

Government ministries such as a ministry for trade and economic development or a competition authority (or another type of administrative agency) may also have a primary responsibility for dealing with companies. Ministries often are vested with responsibility for approving the formation of companies and for approving mergers or acquisitions of companies.

A national securities commission may have a role with respect to minority shareholder protections or enforcement actions against certain publicly traded companies. Securities regulators also ensure timely and accurate disclosure of company information.

Supporting Institutions

Supporting Institutions include both governmental and non-governmental actors. Their respective capacities will ultimately affect the strength of a country's system of Corporate Governance.

Lawyers play an important support role by assisting with the formation of companies, by representing them in litigation and also during significant economic changes such as mergers or acquisitions, dissolution, or public offerings. Lawyers are involved in advising companies, shareholders and creditors. They also can play an important role in Company Law reform by regularly encouraging legislative changes.

Accountants are involved in auditing company books and records and in preparing and certifying annual financial statements. One important issue,

detailed later in this chapter, is whether accountants are required to use international accounting standards or some other form or generally accepted accounting principles when auditing the financial statements of companies.

In the process of company registration, **notaries** are often called upon to verify certain assertions, such as whether the minimum required capital has been supplied. Whether and to what extent the notaries' services add value to the process is subject to considerable debate. As stated in *Doing Business in 2006*, this function might just as easily (and less expensively) be handled by a municipal official or court clerk.⁵

In fact, *Doing Business* survey respondents throughout Central and Southeastern Europe have reported that notaries “add no value to the [company formation] process.”⁶ On the other hand, the traditional role that notaries play in certain societies – chiefly as a low-cost alternative to attorneys – must be evaluated prior to any initiative to eliminate them from the registration process.

Private professional services. The private sector often provides auxiliary services that enhance the operation of public companies in a market economy. For example, banks, lawyers and other entities may offer company registration services. The private sector may also publish relevant books and periodicals related to Company Law and corporate finance.

Stock exchange and professional securities broker-dealers, investment advisors and securities registrars/depositories also contribute to a well functioning public market for securities. In the absence of a functioning securities market, even a well structured law pertaining to joint-stock companies can be of limited impact. Investors will invest in public companies to the extent that their

The World Bank Doing Business Reports contain a treasure trove of policy recommendations. With respect to business registration, *Doing Business* recommends:

- Creating a one-stop shop for registering a business, with an automatic approval system (“silent consent”) in order to sharply limit the discretion of government officials
- Eliminating the involvement of judges and notaries from the registration process
- Easing filing requirements, including zero or next-to-zero capital base requirements, elimination of newspaper publication requirements, and introducing the use of standardized forms
- Introducing temporary business licenses and eliminating the renewal of licenses
- Consolidating the numbers and types of taxes with which business must comply, and keeping company rates moderate
- Reducing special exemptions and privileges

The World Bank Doing Business Reports (2004-2006)

shares will maintain a reasonable rate of return through trading on a well functioning stock market.

Bankers associations, chambers of commerce, foreign investor associations, and the media are also important supporting institutions in the effective implementation of a Company Law regime. Such actors can monitor and share information about Company Law developments, educate the public, and work for effective reform in Company Law.

ADDITIONAL GUIDANCE, TOOLS AND RESOURCES

In the context of developing CLIR initiatives, certain areas of legal reform that impact Company Law and Corporate Governance bear consideration for incorporation into project plans. These areas include the following:

Emphasizing other forms of business entities.

In the past, CLIR efforts often focused on public companies with equity investors (often called joint-stock companies). Yet the legal underpinnings of other types of businesses entities, including limited liability companies, partnerships, and cooperatives,

**Institutional Snapshots:
Company Registries in Three Countries**

Guatemala. “There is one central Registry in Guatemala City and another one in Quetzaltenango. In some rural areas, information about real property is recorded with a municipal office rather than with the main Real Property Registry. Thus, to determine the real owner of a property in rural areas it is not sufficient to only check the national Registry. Extensive research needs to be conducted or a legal action to grant a supplementary property deed needs to be filed . . . A past attempt to automate the [Registries] failed badly, due to poor technical devices, leaving many properties in limbo. Information about properties is stored partially in written records and partly in electronic records. Transactions on properties whose data is in written records are put on hold indefinitely.”

Trade and Commercial Law Assessment– Guatemala
(December 2004).

Indonesia. “The company is registered with the Corporate Registry, which is located within the Ministry of Industry and Trade. Registration follows a checklist of requirements. The checklist includes documents such as the certificate of incorporation; approval from the Ministry of Justice; any related licenses from responsible ministries; proof of domicile; a tax file number that must be obtained before registration from the Tax Office; and identification numbers of the company owners, directors, and officers . . . Records at the Corporate Registry [in Jakarta] are created manually. Only three computer terminals are in use for data entry, and the cost for computerizing the records must be met from the Registry’s regular budget. Full computerization of records will be complex and time-consuming.”

CLIR Assessment Report for the Republic of Indonesia
(September 2003).

Croatia. “[T]he registration process . . . takes a considerable amount of time (usually about one month, but even more in some cases) and is far from being transparent and reliable. [Notwithstanding recommendations to] locate the system outside the courts (within the Chamber of Commerce or with the local administration) and to make the procedure as simple as possible . . . in the end the traditional approach prevailed. As a result, the courts are burdened with a large amount of administrative work, the system is inefficient and not fully operational several years after it has been introduced . . .”

CLIR Assessment Report for the Republic of Croatia
(May 2000).

warrant significant attention. SMEs in transitioning economies often face disproportionately greater burdens than those faced by large public companies. SMEs are concerned with barriers and impediments to entry into the marketplace, as well as with regulations or requirements that create additional obstacles to carrying out their businesses in a productive fashion. Such regulatory obstacles may include tax laws, permit requirements, and cumbersome registration procedures.

The OECD has convened events focused on the role of SMEs within transitioning economies and how to enhance their global competitiveness.⁷ The United Nations Economic Commission for Europe also has developed useful resources focused on fostering SME growth, including detailed information about SME-related policies, services, and programs.⁸ **Further discussion of SMEs is set forth in Appendix A of this Guide.**

Enhanced protections for minority shareholders. The prevalence of closely controlled businesses in transitioning economies places minority shareholders at risk of exploitation and expropriation. This occurs when controlling shareholders and managers strip assets from the company through self-dealing, pay themselves excessive compensation, engage in insider trading, or otherwise act in their own interests to the detriment of the company.

Legal reforms thus are increasingly focused on ways to improve minority shareholder participation. Some of the mechanisms that may prove beneficial include greater use of independent directors; improvements in required disclosure of related-party transactions; mandatory direct shareholder approval for related-party transactions; expanded appraisal rights; and pre-emptive rights with respect to capital increases. Some countries are experimenting with the use of shareholder class action or derivative lawsuits as a way of providing minority shareholders with a new redress mechanism.⁹

Improved bank governance. The continuing need for equity capital often drives sound practices in Corporate Governance, since a company's track record with equity investors greatly determines its ability to raise additional public equity. Where "soft" bank lending practices are in place – that is, practices that lack consistency or rigorous requirements for genuine accountability – companies have less reason to care about their governance. Effective monitoring by lenders can help prevent or catch borrower problems or abuses that might otherwise go undetected by the borrower's shareholders.

Audit and accounting standards and practices. As mentioned previously, accounting and auditing standards and practices are being reformed throughout the world to take into account international norms, including auditor independence, quality assurance, codes of ethics, and continuing professional education. Adoption of International Accounting Standards is the decision of national authorities or, where relevant, self-regulatory organizations. Some stock exchanges require financial statements in accordance with IAS as a condition for listing.

As part of its Reports on the Observance of Standards and Codes (ROSC) initiative,¹⁰ the World Bank has established a program to assist member countries with implementing IAS. The objectives of this program are two-fold, namely:

- To analyze comparability of national accounting and auditing standards with international standards, determine the degree to which

applicable accounting and auditing standards are employed, and assess strengths and weaknesses of the institutional framework in supporting high-quality financial reporting

- To assist the country in developing and implementing a country action plan for improving institutional capacity, with a view toward strengthening the country's corporate financial reporting regime.

Using a detailed diagnostic tool, the World Bank conducts reviews of accounting and auditing within the ROSC initiative at the invitation of a country. During the past several years, many transitioning states have shifted to IAS and away from national accounting standards. However, more can be done at the local level to reach full compliance, including the creation of a stronger auditing and accounting profession within many countries.

Self-regulatory organizations and intermediaries. Both accounting and auditing are of central importance to the proper functioning of capital markets and the governance of enterprises. Although the state may have a strong interest in ensuring the credibility of financial markets, the responsibility for regulating the accounting profession – including the training, certification and licensing of accountants, and the monitoring of the profession – tends to be delegated to professional associations that function as self-regulatory bodies. Thus, CLIR initiatives might focus on increased training of accounting and auditing professionals and include efforts to create more robust and professional self-regulatory organizations (SROs) within various countries.

Similarly, new legal reform efforts may support the development of the SROs of financial market intermediaries such as securities broker-dealers and investment managers-advisers. The goal would be to create technically and financially self-sustaining professional organizations.

Moreover, intermediaries (as opposed to companies) may become a new subject of regulation and supervision. State regulators by themselves are often ill-equipped to monitor all companies' compliance

with disclosure and reporting requirements, as well as other rules. Thus, a securities commission could regulate intermediaries, such as brokers and investment advisors, who would in turn attempt to assure compliance with regulatory requirements by listed companies. The regulator's authority over intermediaries comes from its power to issue and revoke licenses, and to assess regulatory penalties.

A number of countries, including Germany and Poland, have introduced private intermediaries into the enforcement of securities regulations. Their success suggests that smarter regulations, particularly in countries with relatively weak legal systems, can improve the protection of investors.

Codes of Conduct. Colombia, Mexico, and Russia have established commissions formed by members of the private sector in partnership with public officials to review corporate practices and investor protection in the country. In each of these countries, a committee within the commission produced a "Code of Best Practices," detailing rules of good Corporate Governance. These codes are primarily concerned with the organization of boards and special committees.

Such codes are meant to foster a culture of investor protection. Investors can identify firms that do have effective Corporate Governance mechanisms in place; firms that offer better investor protection may also be rewarded with higher valuation-multiples or lower costs of capital. The adoption of the principles of a Code of Conduct or Code of Best Practices is usually voluntary, but the disclosure is compulsory for all firms.

Alternative Dispute Resolution. Because enforcement of Company Law and Corporate Governance remains weak in many countries, the OECD and other international institutions are increasing their focus on the applicability of ADR for Company Law disputes. For example, the OECD has instituted a formal work program in the Arbitration of Company Law Disputes. The OECD program statement notes that "poor regulatory enforcement [is] a significant impediment to shareholder protection and foreign investment."¹¹

Accordingly, in emerging markets such as Russia and China, the use of arbitration has become a preferred method of dispute resolution for equity investors.

The OECD program is meant to:

- (i) Disseminate knowledge of effective practices from developed markets to emerging markets
- (ii) Deal thoughtfully with difficulties involved in "transplanting" practices from one jurisdiction to another.
- (iii) Use constructive peer pressure to promote ADR and good-faith application of international treaties concerning arbitration.

ADR, including arbitration and mediation, is a topic that is being explored in many other aspects of CLIR, particularly with respect to the resolution of contract disputes. Because of its potentially broad applicability and wide-scale interest among donors, ADR is one area in particular that warrants close coordination with and integration of other donor projects and initiatives.

Accessing Key Resources

Certain international organizations have taken the initiative to develop key principles and guidelines meant to foster stronger governance. The institutions discussed below are among those playing a key role in setting priorities and developing models for reform.

The **European Commission of the European Union** maintains that "harmonisation of the rules relating to Company Law and Corporate Governance, as well as to accounting and auditing, is essential for creating a Single Market for Financial Services and Products."¹² In this regard, the EU engages in projects aimed at, among other goals, providing equivalent protection for shareholders and other parties concerned with companies; ensuring freedom of establishment for companies throughout the EU; fostering efficiency and competitiveness of business; promoting cross-border cooperation between companies in different Member States; and stimulating discussions between Member States on the modernization of Company Law and Corporate Governance.

The modernization of the European regulatory framework for Company Law and Corporate Governance is spurred by the growing trend for European companies to operate across borders in the internal market, the continuing integration of European capital markets, the rapid development of new information and communication technologies, the enlargement of the EU to incorporate new Member States, and the damaging impact of recent financial scandals.

In an effort to create a modern regulatory framework for Company Law in Europe, the Commission tasked a group of high-level experts to address the topic. Based on expert feedback, the Commission drafted an EU Action Plan relating to Company Law and Corporate Governance.¹³ The main objectives of the Action Plan are:

- To strengthen shareholders' rights and protection for employees, creditors, and the other parties with which companies deal, while adapting Company Law and Corporate Governance rules appropriately for different categories of company
- To foster the efficiency and competitiveness of business, with special attention to some specific cross-border issues.

Along with the Action Plan, the Commission has set priorities for improving and harmonizing the quality of statutory audits throughout Member States to ensure that investors and other interested parties can rely on the accuracy of audited accounts and to prevent conflicts of interest.

In 1999, the **OECD** developed a set of Principles for Corporate Governance, representing the first initiative by an international intergovernmental organization to describe the core elements of a good Corporate Governance regime. These principles were updated in 2004¹⁴ through a revision process that incorporated the recent experiences of both member and non-member countries and regions, including Russia, Asia, Southeast Europe, Latin America and Eurasia. The OECD Principles emphasize the core tenets of fairness, transparency, accountability and

responsibility. The OECD Principles focus on five major topics:

- (1) The rights of shareholders
- (2) Equitable treatment of shareholders
- (3) Role of stakeholders
- (4) Disclosure and transparency
- (5) Responsibilities of the board(s).

The OECD Principles further focus on key structures that must be in place and well functioning for development of a sound governance environment. The OECD designed the Principles to be used as a benchmark by governments as they evaluate and improve their laws and regulations. While the emphasis of the Principles is on publicly traded companies, the OECD designed the Principles to serve as a useful tool for privately held and state-owned enterprises as well.

The OECD Principles recognize that there is no single model of good Corporate Governance and thus represent core values that take into account differences in legal systems, institutional frameworks and historical traditions. When the Principles use the term “board,” for example, they embrace the different national models of board structures found throughout OECD countries.

The 2004 Principles set standards even higher in a number of areas than standards found in the original 1999 Principles. First, the 2004 Principles specify that investors should have both the right to nominate company directors and a more forceful role in electing them. Second, they state that shareholders should be able to communicate their views about executive and board compensation policies and submit questions to auditors. Third, they call on institutional investors to disclose their overall voting policies and how they manage material conflicts of interest that may affect the way they exercise key ownership functions, such as voting.

The 2004 Principles also identify the need for effective protection of creditor rights and an efficient system for dealing with corporate insolvency. They call on rating agencies, brokers and other

providers of information that could influence investor decisions to disclose conflicts of interest and how they are being managed. They also call for boards to be more rigorous in disclosing related-party transactions and to protect so-called “whistle blowers” by allowing them confidential access to a contact at board level.

Established in 2002, the **World Bank Group and OECD Corporate Governance Forum**¹⁵ is an initiative that strives to bring together the leading bodies engaged with governance reform worldwide, including multilateral banks active in developing countries and transitioning economies and international organizations, along with professional standards-setting bodies, and the private sector. The Forum has three general functions: to broaden the dialogue on corporate governance; to exchange experience and good practices; and to coordinate activities and identify and fill gaps in the provision of technical assistance. A central mission of the Forum is to assist countries identify priority areas for reform and help implement reforms in a consistent and sustained basis through leverage of resources and expertise.

In 2000, the **European Bank for Reconstruction and Development** developed a “Corporate Governance Checklist” that builds upon the five OECD Principles in practical, implementation-oriented terms.¹⁶ The purpose of the Checklist is to help the EBRD’s own experts, including lawyers and bankers, “assess whether a particular company, in a particular jurisdiction, in which the [EBRD] is contemplating an equity investment, has adopted . . . good or satisfactory principles of Corporate Governance.”¹⁷ Under each of the five OECD principles, the EBRD identifies specific examples of adherence. This Checklist may prove to be a succinct yet effective resource for evaluating the state of Corporate Governance in many transitioning economies, even those beyond the EBRD’s mandate to help build market economies and democracies in 27 countries from central Europe to central Asia.

The **Asian Corporate Governance Association (ACGA)** also offers a model for reform of Corporate Governance.¹⁸ ACGA is an independent, non-

profit membership organization working on behalf of company investors and other interested parties for the improvement of Corporate Governance in Asia. ACGA is funded by a network of sponsors and corporate members, including many investment funds, financial institutions and intermediaries.

ACGA advocates the competitive benefits of better Corporate Governance and works with institutional investors, regulators and companies to achieve concrete improvements. ACGA researches Corporate Governance developments around Asia, tracking 11 markets and producing independent analyses of new laws and regulations, investor action and corporate initiatives. ACGA is incorporated under the laws of Hong Kong and is managed by a secretariat based there. Its governing Council includes directors from throughout Asia.

United Nations Economic Commission for Africa and New Partnership for Africa’s Development.

In Africa, the concept of Corporate Governance is often considered tangent to “economic governance,” namely, the accountability and effectiveness of the public financial management systems, monetary and financial systems, and regulatory framework. Concurrent reform of both public and private players in the market system is seen as fundamental to the overall effort of the continent to mobilize increased resources for reducing poverty and achieve higher levels of growth.

Among the important initiatives in this area is the Guidelines for Enhancing Good Economic and Corporate Governance in Africa, disseminated by the U.N. Economic Commission for Africa in May 2002. These Guidelines are intended to provide a framework of policies, processes, instruments, codes, standards, indicators, best practices, and enforcement mechanisms that can be adopted or adapted by African countries to demonstrate their commitment to good economic and Corporate Governance practices.¹⁹ The guidelines were developed in light of:

- (1) The requirements of the New Partnership for Africa’s Development (NEPAD)²⁰ to enhance sound economic and public

European Union Corporate Governance Action Plan

The EU's Corporate Governance Action Plan identifies the following initiatives as the most urgent ones:

- Introduction of an Annual Corporate Governance Statement, requiring listed companies to include in their annual documents a coherent and descriptive statement covering the key elements of their Corporate Governance structures and practices
- Development of a legislative framework that helps shareholders exercise various rights, such as asking questions, tabling resolutions, voting in absentia, and participating in general meetings via electronic means. These opportunities are envisioned to be offered to shareholders across the EU, and specific problems relating to cross-border voting will be addressed
- Adoption of a Recommendation promoting the role of independent non-executive or supervisory directors. Minimum standards on the creation, composition and role of the nomination, remuneration and audit committees would be defined at EU level and enforced by Member States, at least on a "comply or explain" basis
- Adoption of a Recommendation on Directors' Remuneration. Member States would be rapidly invited to put in place an appropriate regulatory regime giving shareholders more transparency and influence, which includes detailed disclosure of individual remuneration
- Creation of a European Corporate Governance Forum to help encourage coordination and convergence of national codes and has the way they are enforced and monitored

financial management, as well as Corporate Governance, as preconditions for overall economic reform in Africa

- (2) The need to further expand on one of the key strategic actions in the UNECA's foundations for the "Compact for African Recovery" – a commitment by African states to "put their houses in order" by moving

toward, and embracing, good governance (including its economic and corporate aspects).

The Guidelines for Africa specifically advise countries embarking upon reform to consider the various codes and standards that have been developed by international institutions for good economic and good Corporate Governance. The various codes and standards include those promulgated by the IMF, OECD, the World Bank, the International Association of Insurance Supervisors, the International Association of Supreme Audit Institutions, the International Accounting Standards Board, the Commonwealth Association for Corporate Governance, and others. The Guidelines caution African states, however, that adoption of the various codes and standards must be prioritized in a way that best lead to "pro-poor development outcomes."

Another important initiative is the African Peer Review Mechanism (APRM). Adopted by NEPAD in 2003, the APRM is a self-monitoring tool for examining the extent to which participating African states conform to NEPAD's central political, economic and Corporate Governance values. The purpose of the APRM is to "foster the adoption of policies, standards and practices that lead to political stability, high economic growth, sustainable development and accelerated sub-regional and continental economic integration through sharing of experiences and reinforcement of successful and best practice, including identifying deficiencies and assessing the needs for capacity building."²¹

Through a multi-stage peer review process, a panel of "eminent persons" from countries throughout Africa will study, collect information about, and visit a participating country and prepare a draft report, to which the country's government is invited to respond. A final report incorporating the official response is then submitted to the APRM's Participating Heads of State and Government Implementation Committee, and, thereafter, in countries where there is "a demonstrable will to rectify the shortcomings," assistance and

support are offered, including efforts to secure international donor engagement. Where “political will is not forthcoming,” additional efforts, such as constructive dialogue or a plan to “proceed with appropriate measures” may follow. Development professionals involved with CLIR projects in Africa should monitor developments pertaining to APRM, and, when possible, incorporate findings, recommendations and lessons learned from this important African development initiative.

The **General Principles of Company Law for Transition Economies** were prepared in 1999 by academics from France, Germany, Russia and the United States.²² Although this document is a bit dated, it is a helpful guide to various approaches. Some of the policies advocated in the document have been refined or abandoned after experiments with such provisions in Russia and other transitioning economies. Nonetheless, this document sets forth proposed principles for legislation on joint-stock companies that are considered to be appropriate for a country making the transition from a centrally planned economy to a market economy. The focus of this exercise is Company Law – that is, legislation that regulates commercial organizations with limited liability and investments represented by shares: corporations in the US; *aktiengesellschaften* in Germany; *societes anonymes* in France, and joint-stock companies in Russia. The discussion of Company Law principles in this document is premised upon companies being formed in a civil law jurisdiction.

The **European Corporate Governance Institute**²³ is a nonprofit membership organization that provides “a forum for debate and dialogue between academics, legislators and practitioners, focusing on major corporate governance issues and thereby promoting best practice.” The ECGI sponsors research on corporate governance and advises various institutions on the formulation of corporate governance policy and development of best practice. The ECGI maintains a database of corporate governance codes that can be searched by country.

The **International Institute for Corporate Governance (IICG) at the Yale School of**

Management²⁴ was established in July 2001. The IICG is a research, teaching, and policy center focused on the institutional framework for Corporate Governance, and the principles and practices of effective corporate governance.

Lessons Learned: The State of Corporate Governance in Transitioning Economies

In January 2004, OECD issued a summary report of 25 regional Corporate Governance roundtables that it convened over the preceding four years in cooperation with the World Bank Group.²⁵ The Roundtables took place in 18 countries located in five regions – Asia, Russia, Latin America, Eurasia and South East Europe. The OECD’s major findings prove very instructive with respect to issues of legal framework, institution-building, and, most importantly, implementation and sustainability of reform efforts. Lessons learned from the Roundtables – and further borne out by USAID-CLIR experience to date – include the following:

1. Ownership and control

In transitioning economies throughout the world, there is a high degree of concentrated ownership and control over individual companies or groups of companies. In Asia and Latin America, and increasingly in other regions, certain individuals and families tend to hold a very high degree of controlling interest in one – or often several – companies. In other jurisdictions, the controlling shareholders may be insiders (e.g. former management) who have acquired majority shareholdings during a privatization process.

Although concentrated ownership by individuals or families may have positive aspects, such as careful oversight of a company’s management, the interests of controlling shareholders often conflict with those of minority shareholders and controlling shareholders often extract private benefits from the company.

In countries that experienced mass privatization during the early or mid-nineties, large percentages

of the adult populations became shareholders in companies, resulting in widely dispersed ownership. These companies typically are not traded on or off the stock market, leaving their shareholders “stranded” and with no real rights. Where markets for trading these otherwise valueless shares have been created and supported, such as in Romania and Mongolia, ownership has been consolidated and liquidity has been generated, resulting in companies that are more productive and receptive to effective systems of governance.

States continue to control large companies in all regions, many of which have strategic functions in the economy, such as air travel, telecommunications, banking, electricity, water, and oil. State control is typically maintained for policy-based reasons, such as the interest in continuing state oversight in an incomplete regulatory framework, or, more ominously, the political need to sustain insolvent companies that employ large numbers of workers. In many instances, however, state control results in inefficient management practices and a conflict between a state’s roles as both owner and regulator.

2. Enforcement

Although most emerging markets now have laws and regulations that seem to offer strong protection to shareholders and other stakeholders, a major problem they share is ineffective enforcement. In particular, there is a pronounced need for strengthened judiciaries. This might be achieved through training of judges in general and specific commercial law topics, greater specialization of judges, publication of written court opinions, and anti-corruption initiatives.

Some countries are also developing the use of private actions, such as derivative and class-action lawsuits, to make it easier for shareholders to receive redress for violation of their rights.

Increasing the capabilities of securities regulators is a priority for many countries. The effectiveness of securities regulators is currently undermined by gaps and ambiguities in Securities and Company Law, along with a significant lack of resources. In addition, while securities regulators are charged with

improving the transparency of financial markets, their own transparency and accountability is an issue as well. Regulators should explain and publish their rulings, and new regulations should be created in an open and transparent manner.

Market forces – chiefly the existence of genuine competition that challenges companies to act efficiently and in the best interests of their stakeholders – can serve as an effective restraint on corporate malfeasance. Enhancing market discipline through self-enforcing mechanisms, however, requires a real possibility of judicial enforcement.

3. Shareholder Rights and Equitable Treatment

With respect to protecting the rights and equitable treatment of shareholders in transitioning economies, three priorities emerged:

- First, shareholders should have secure rights to hold and transfer their company shares
- Second, shareholders should be able to fully participate in the company’s general meeting
- Third, major and related-party transactions must be carried out in a transparent manner that treats shareholders fairly.

Registration of shares, particularly with respect to privatized companies with highly dispersed ownership, represents a central concern in many countries. Many countries allow restrictions on the transfer of shares of publicly held companies, a restraint with little purpose other than to perpetuate the control of a few narrow interests. Such restrictions are appropriate only with closely held companies, and can otherwise serve to gravely inhibit a company’s competitiveness.

Many countries identified the need to improve annual company or shareholders meetings as a way of promoting sounder corporate governance. Changes that enhance the meeting process include increasing shareholders’ awareness of their rights, improving notice of and access to meetings, and strengthening administrative procedures to support the smooth and accurate execution of meetings.

Corrupt insiders (whether they are controlling shareholders or management) affect businesses throughout fragile states and transitioning economies. Insiders may undermine or even bankrupt a company through such means as acting on privileged information, selling company assets on very favorable terms to a related party, acquiring additional shares on unduly favorable terms, changing control of the company for the purpose of assuming private benefits, and other creative ways of extracting resources from the company. In addition, there remain common problems associated with so-called “soft” private benefits, such as employing a relative for excessively high wages or making investment decisions based on personal interests rather than objective considerations.

Additional factors concerning shareholder rights include the following:

- The availability and effectiveness of proxy voting
- The rights of foreign shareholders
- The quality of the approval processes for major company transactions and related-party transactions
- The presence of appraisal rights and dissenters’ rights
- Procedures relating to changes in control and delisting
- Prohibitions against insider trading
- Effective involvement of the various types of shareholders, including controlling shareholders, institutional investors, the state, foreign investors and individual shareholders.

4. The Role of Company Boards

Company Laws throughout the world provide for varying board structures. Some countries use unitary boards of directors, while others have boards of directors that work in concert with supervisory boards. Some boards function with complementary structures such as statutory auditors. Regardless of structure, company boards have a “functional convergence”; that is, all boards should be capable

of acting in the interests of the company as a whole, rather than on behalf of a few narrow interests.

In transitioning countries, most company boards fall into one of two patterns. The board may be entirely passive and serve merely to rubber-stamp the actions of management – this dilemma of passivity may be attributable to cultural or past political inclinations toward deference to the board’s chair or another powerful figure. Or the board may be essentially a “family” operation that engages close relatives to serve in powerful executive positions, who work chiefly to serve the interests of the controlling shareholders rather than good of the company as a whole.

A lack of board independence might be remedied through changes to a Company Law that: (i) make greater use of independent board members; (ii) require that a certain portion of a board be selected directly by minority shareholders; (iii) strengthen the duties of loyalty and care; or (iv) enhance the role of board committees, such as audit committees. In addition, Company Laws should be evaluated as to what extent they permit meaningful shareholder actions to discourage self-dealing.

Mechanisms for strengthening boards include training of board members to improve their understanding of their duties and potential liabilities; basic accounting principles; the essentials of Company Law; and other central issues. The core concepts of director independence and professionalism also represent important facets of a board training program.

Codes of conduct represent another approach toward strengthening the performance of boards. Such codes may be voluntary, mandatory or a combination of mandatory or voluntary.

Additional factors contributing to an overall assessment of whether a company’s Corporate Governance processes provide incentives to directors to act in the best interests of the company include:

- Civil and criminal liability of board members
- Presence of “political” board members

- Procedures for nomination and voting for board members, including the issue of cumulative voting
- Remuneration of board members
- Ability of shareholders to remove board members
- Board size
- Nature of a board's role in major and related-party transactions
- Presence of board tiers and committees
- Availability of information and support.

5. The Role of Stakeholders

In pursuing their operations, companies must be mindful of a variety of stakeholders, including employees, customers, suppliers, creditors, governments, the local community, and others.

With respect to employees, certain issues arise in the context of Corporate Governance. They include:

- The extent to which agreements, laws and standards designed to protect employees are observed by the company
- Employee participation in the governance of joint-stock companies
- The role of employees as shareholders
- Employee ownership through pension funds
- Treatment of whistle-blowers
- Performance-enhancing compensation.

Creditors are major stakeholders. In transitioning economies, creditors have, at times, been adversely impacted by such activities as management concealment or removal of corporate assets (often referred to as “asset-stripping”). This can lead a company to default on its debts. These abuses come at the cost of reduced willingness by creditors to lend to companies, in turn limiting company development and, ultimately, economic growth.

Strengthening the position of creditors may be achieved through one or more of the following approaches:

- Improved systems for the enforcement of contracts, including enforcement of claims to collateral
- Improved legal methods of blocking company transactions that undermine creditors
- Greater use of “work out” methods in response to default
- Improved judicial capacity with respect to understanding and dealing with the rights of creditors
- Improved enforcement of insolvency (bankruptcy) legislation.

Reform of financial services, including banks, capital markets and insurance, may have a strong bearing on creditor rights. Banks in transitioning economies frequently have ownership structures that may create conflict of interest and undermine their own governance. In many such countries, banks engage in related-party lending – that is, they make loans on favorable terms to a related party, often disregarding the party's lack of credit-worthiness. The problem of creditor rights should be approached through studying the weaknesses of both sides of the lending equation.

6. Information and Disclosure

The “resounding opinion” expressed at the OECD Roundtables was that, “with few exceptions, companies and financial markets in developing and emerging market economies are opaque.” Opacity results in a range of negative effects, including unlawful related-party transactions, obscured corporate performance, and serious barriers against informed decision-making by investors.

“Three pillars” of an effective system for transparency and disclosure were identified through the OECD Roundtables:

- A sound legal and regulatory environment, including “quasi-regulation” such as listing requirements, codes of conduct, and general expectations for Corporate Governance

- Accounting and auditing professions with technical capabilities, self-regulating mechanisms, and independence
- Effective internal control and external disclosure mechanisms within individual companies.

Improved standards for financial and non-financial reporting – in particular the global effort in support of International Accounting Standards (IAS) drafted by the International Accounting Standards Board – have constituted a central priority over the past ten years. Adoption of new standards has “raced ahead of implementation,” however, leading to a pronounced gap between the aspirations of a legal and institutional framework and actual, sustainable reform. Moreover, the degree of harmonization with IAS varies from country to country, and the relationship between newly adopted accounting standards and tax collection represents an area in particular need of assessment and action.

Disclosure of company information is a significant issue requiring review and reform. The following disclosure categories were identified as ones in need of greater emphasis:

- Consolidation, accounts payable and receivable, and other liabilities including guarantees
- Ownership and control
- Related-party transactions
- Material events, such as planned transactions and other events that may have significant impact on shareholders and the company
- Executive and board-member remuneration
- Company policies and objectives; and
- Board-member profiles.

ENDNOTES

¹ See, e.g., Rafael La Porta *et al.*, *Law and Finance Working Paper 5661*, National Bureau for Economic Research, Cambridge (July 1996). This paper was one of the first to analyze relationships between legal rules and rates of external finance. It documents the legal basis for the protection of shareholders and creditors in

49 countries, the historical origins of these legal rules, and how well they are enforced. In addition, a 2002 McKinsey Global Investment Survey concluded that Corporate Governance is a significant factor in foreign investment decisions. See McKinsey & Co., *Global Investor Opinion Survey 2002 – Summary of Key Findings*.

² See Gainan Avivlov *et al.*, *General Principles of Company Law for Transition Economies*, Stanford Law School, John M. Olin Program in Law and Economics, Working Paper No. 165 (1999), located at www.olin.stanford.edu/workingpapers/WP165GAVILOV.pdf.

³ Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *The Regulation of Entry*, Quarterly Journal of Economics, 117, 1-37 (Feb. 2002), located at www.econ.worldbank.org/files/2379_wps2661.pdf (“Economies differ significantly in the way in which they regulate the entry of new businesses. In some economies the process is straightforward and affordable. In others, the procedures are so burdensome that entrepreneurs have to bribe officials to speed up the process or they would rather run their business informally.”) See also World Bank, *Doing Business in 2006: Removing Obstacles to Growth 3* (2005) (*hereinafter* *Doing Business in 2006*).

⁵ *Doing Business in 2006*, *supra* note 4, at 22.

⁶ *Id.*

⁷ *Id.*

⁸ See, e.g., OECD, *The Competitiveness of SMEs in the Global Economy: Strategies and Policies Workshop for Enhancing the Competitiveness of SMEs in Transition Economies* (June 2000).

⁹ See UN-ECE Index of SME Development, located at www.unece.org/indust/sme/ece-sme.htm.

¹⁰ For a brief discussion of increased shareholder activism in Brazil, Russia and Korea, see Anne Simpson, *The Shareholder Activist Role in Emerging Markets*, talk presented at International Corporate Governance Network Annual Conference (June 2000), located at www.gcgf.org/library/speeches/Simpson714.doc.

¹¹ See www.worldbank.org/ifa/rosc_aa.html.

¹² OECD Programme Statement for Corporate Governance and Arbitration of Company-Law

Disputes (“ACLD”), located at www.oecd.org/dataoecd/22/40/7348435.pdf.

¹³ See generally the website of the European Union, www.europa.eu.int, and specifically its sections devoted to Company Law and Corporate Governance.

¹⁴ See Communication of 21 May 2003 from the Commission to the Council and the European Parliament, *Modernisation of Company Law and Enhancement of Corporate Governance in the European Union - A Plan to Move Forward*, located at www.europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0284en01.pdf.

¹⁵ OECD Programme Statement, *supra* note 12.

¹⁶ More information about the Forum can be found at www.gcgf.org.

¹⁷ See EBRD, *Principles of Corporate Governance and Corporate Governance Checklist* (in-house reference tool), located at www.ebrd.com/country/sector/law/corpgov/assess/checklst.pdf.

¹⁸ *Id.* at 2.

¹⁸ See www.ACGA-Asia.org.

¹⁹ U.N. Economic Commission for Africa, *Guidelines for Enhancing Good Economic and Corporate Governance in Africa* (May 2002), located at www.unpan1.un.org/intradoc/groups/public/documents/UNECA/UNPAN009243.pdf.

²⁰ More information about NEPAD can be found at www.NEPAD.org.

²¹ New Partnership for Africa’s Development, *The African Peer Review Mechanism*, at paragraph 3, located at www.iss.co.za/AF/RegOrg/nepad. As of August 2004, 24 African States had acceded to the APRM: Algeria, Angola, Benin, Burkina Faso, Cameroon, Congo (Brazzaville), Egypt, Ethiopia, Gabon, Ghana, Kenya, Lesotho, Malawi, Mali, Mauritius, Mozambique, Nigeria, Rwanda, Senegal, Sierra Leone, South Africa, Tanzania, Uganda, and Zambia. NEPAD maintains a list of countries that have acceded to the APRM, located at www.iss.co.za/AF/RegOrg/nepad/aprmaccede.htm.

²² Stanford Law School, John M. Olin Program in Law and Economics, *Working Paper No. 165*, located at <http://olin.stanford.edu/workingpapers/WP165GAVILOV.pdf>.

²³ More information about ECGI, including its database, can be found at www.ecgi.org.

²⁴ More information about the IICG can be found at www.iicg.som.yale.edu.

²⁵ OECD, Experiences from the Regional Corporate Governance Roundtables (January 2004), located at <http://www.oecd.org/dataoecd/19/26/23742340.pdf>.

Contract Law and Enforcement

KEY CONCEPTS

Definition: A system of creating, interpreting, and enforcing commercial obligations between parties. (Often referred to as the “Commercial Law” or “Law on Obligations” in Civil Code legal systems.)

What is a contract?
Contracts are legally binding agreements between two or more parties that are enforceable in a court of law. Contract Law establishes rules for determining whether an agreement or exchange of promises between parties is enforceable.

Contract Law provides legal remedies for the breach of any of

the promises or duties outlined in a contract. The central remedy of contract law is compensatory damages, that is, payment for actual injury or economic loss. Remedies may also include an order of specific performance of the obligation, or payment of additional penalties (such as attorneys fees) contemplated by the contract itself. In Civil Law jurisdictions, Contract Law is often referred to as the “Law of Obligations.”

Fundamentally, for a contract to be valid and subject to enforcement, the following conditions must be met:

- All parties to the contract must indicate that they agree to its terms, as demonstrated through an offer and an acceptance. (Where the terms of the acceptance vary from that of the offer, that “acceptance” generally constitutes a counteroffer, which does not, in the absence of acceptance by the party making the original offer, amount to an enforceable contract)
- The contract does not serve an illegal purpose, or a purpose that plainly interferes with public policy
- Neither party has entered into the contract through illegal coercion, such as duress or fraud
- In common law countries, with limited exceptions, promises made in a contract must be made in exchange for consideration, that is, a payment, or some action, or another promise
- The contract may be made only by parties with the capacity to reach an understanding, thus excluding such groups as the mentally incompetent and, in many cases, minors
- In most instances concerning business affairs, particularly in Civil Law countries, the contract must be in writing. In Common Law countries, although certain oral contracts can be legal and enforceable, contracts for the sale of goods and property, contracts that establish obligations lasting longer than one year, and contracts to assume the obligations of another must generally be in writing to be enforceable

The ability to enforce contracts is generally considered a prerequisite condition for economic growth. Contract rights constitute a key ingredient for economic growth in transitioning economies.¹ There is a vital correlation between the quality of contract enforcement and the quality of the business and investment environment.² Specifically, it is not enough for a party to win a judgment in court – the party must be able to collect upon that judgment. Slow, unpredictable enforcement of judgments leads to higher interest rates, lower availability of credit, lower investment, higher prices for goods and services, higher rates of business default and bankruptcy, and lower rates of successful bankruptcy reorganizations.

Where there is a legitimate expectation of meaningful

enforcement, Contract Law can transform a market based solely on barter trade, personal relationships, or instantaneous transactions into one in which people may project value forward in time – that is, they may make promises now for some future action. Business entities and entrepreneurs, as well as individual citizens, may be more likely to enter into agreements relating to economic activity if they know that (i) the agreement they have created is valid; and (ii) if a dispute about the terms of the contract or about someone’s performance under the contract arises, they have a strong chance of enforcing the contract in a court or through Alternative Dispute Resolution (ADR). Contract Law also operates as a device for apportioning risk and setting price in response to articulated possible future events. The very existence of an apparatus for resolving disputes that is relatively available, reliable, inexpensive, and predictable gives individuals and businesses the confidence to take action and make plans based on promises made in a contract by someone else. In the absence of a viable legal and institutional framework that provides for meaningful enforcement of contracts, economic development will falter.

The effectiveness of Contract Law turns on far more than the substance of the law itself: the commitment of implementing and supporting institutions is key. Even if the written rules governing Contract Law are sound, courts and other institutions must be willing and able to enforce the law and help prevailing parties secure their remedies. Specifically, courts and judges must be capable of accurately interpreting contracts, impartially judging the performance rendered, and reliably implementing the appropriate remedies.³ Other legal institutions, such as law schools and professional organizations, must be capable of training and overseeing lawyers who are competent at drafting contracts that satisfy legal requirements.

Thus, a reform program dedicated to improving the enforcement of contracts must necessarily assess and take steps to improve the organizational effectiveness of courts, the capacities of judges, the quality and effectiveness of lawyers, and the

supporting institutions of the private sector, among other groups. Where implementing or supporting institutions prove hostile to change, careful effort must be placed into diagnosing interest structures and power relationships that are at the root of the recalcitrance. In many instances, resistance may be based in simple fear of being exposed – perhaps for the eminently forgivable failing of not understanding the new laws, or for the greater problems of incompetence or even corruption. Or the hostility may be directed at outsiders to who presume to “reform” their system, however broken it may be. The process of unraveling webs of institutional intractability and engendering trust is slow and often painful, but also necessary to fully understand and act upon an impediment to reform.

To improve the overall environment for Contract Law and Enforcement, a reform program must embrace not only public and semi-public institutions, but also the private sector as a source of influence and change. Much of the emphasis on Contract Law to date has focused first on revising or updating existing formal laws governing contracts, and second, on strengthening public or semi-public institutions that support or enforce Contract Law. Reform programs should also include the private sector in a broad-based program to improve expectations for enforcement of commercial obligations. The problem of contract enforcement involves the entire payment cycle, and most of this cycle is entirely within the hands of the business community. As detailed below, self-help that may be encouraged includes standardization of contracts, improved credit-check and collection practices, and greater engagement of alternative dispute resolution.

Various economic or policy considerations justify the regulation of certain contracts. A term that holds great significance in market-oriented economies, “freedom of contract”, refers to a person’s ability to enter into many types of contracts freely and easily without regulation or state interference. In the commercial sphere, this means that parties can enter into contracts without requiring government approval and intervention. The law simply specifies the rules that apply if a dispute arises and the parties

Key Components of Contract Law Legal Framework

- Contract formation (the requirements for creating a legally enforceable contract)
- Enforcement (how one can seek redress in a court or through alternative dispute resolution)
- Remedies available upon breach of a contract (i.e., what sort of redress or relief a court may grant in the event a party fails to perform or performs in a way that does not conform to the contract)

seek the involvement of the court as a third-party arbiter of the dispute.

Although a party's ability to enter into a contract in an efficient and free manner is important, states often intervene and regulate specific types of contracts for a variety of reasons. Employment agreements, for example, are often governed by specialized rules relating to labor laws and regulations. Similarly, insurance contracts are typically regulated by special rules.

Consumer contracts may also be regulated. For example, a law might require that a consumer have a three-day right to cancel a residential mortgage agreement. This is due to the relatively complicated nature of mortgage contracts – they can be lengthy, and borrowers may not have the time to read all of the documents while closing the loan.

In addition, certain types of contracts are illegal or unenforceable as a matter of public policy. For example, courts may refuse to enforce an agreement that charges a party an excessive rate of interest or that would violate fundamental human and civil rights protections.

MAJOR GUIDELINES

Legal Framework

Although there may be a number of laws dealing with some aspect or subset of contracts, there is often one principle law or code that sets forth general contract rules for commercial contracts.

In Common Law jurisdictions, principles of Contract Law are often embodied in case law and further summarized in treatises that try to set forth the basic formal rules or principles. In addition, Common Law jurisdictions typically have numerous laws and regulations specific to particular contracts, often geared toward consumer protection or balancing perceived inequities in bargaining strength. For example, laws may be enacted to control certain terms of insurance contracts, franchise contracts, labor agreements, and competition-related contracts.

In Civil Law jurisdictions, the framework legislation for contracts may include a civil code or Law on Obligations, the commercial code, and any relevant legislation that deals with specific types of contracts (e.g., concessions laws, lending, or mortgage laws). Contract Law in Civil Law jurisdictions tends to separately regulate particular kinds of contracts: sales contracts, credit contracts, transportation contracts, agency contracts, and so on.⁴ Moreover, in Civil Law jurisdictions, many types of contract are subject to special requirements, such as notarization. Such requirements should be expressly stated in the law. In some countries, notarization is simply a matter of evidence. Having a notary validate a contract proves the identity of parties to a contract. In other countries, the contract is not legal or enforceable unless it is notarized.

Implementing Institutions

The institutions charged with implementing and enforcing Contract Law will typically be **government entities**, including **ministries**, **courts**, and **administrative agencies**. With respect to those entities tasked with implementation and enforcement of commercial law, it is important to assess whether they: (a) have a clear and well defined mandate to implement and enforce a particular type of commercial law; (b) have the resources and staff to carry out their mandate; and (c) are effective in carrying out their mandate. To the extent that no institution has been clearly vested with authority to implement and enforce the law, or that there are overlapping or contradictory mandates, legal reform will likely be hindered.

Courts and Judges. The main implementing institutions for the enforcement of contracts are the courts and the judiciary. Where judges lack security, independence, training, case management skills, or accountability, their ability to consistently enforce contracts is compromised, and all the potential benefits of Contract Law are undermined. Similarly, where courts are inefficient, slow, non-transparent or corrupt, the business community's need for prompt action is foiled. Specific resources and guidance pertaining to the improvement of judicial and court capacity is set forth in the Commercial Dispute Resolution chapter of this Guide.

Administrative Tribunals for Government

Contracts. If a state entity contracts with a private party, contract disputes may be referred to special administrative tribunals or bodies. For example, contract disputes relating to government concessions or procurement may be resolved through

administrative proceedings rather than through the courts.

Registries. A system for registration of collateral⁵ improves Contract Enforcement – and thus the cost and availability of credit – by bringing other parties into the culture and system of enforcement. If a debtor attempts to defraud a creditor by selling assets pledged as collateral, the creditor can repossess the property from the buyer and seek penalties against the debtor for fraud. Buyers learn to protect themselves by making sure that assets are not subject to creditor claims, and thus become part of a larger “team” that encourages repayment of debts.

Notaries. In countries with a Civil Law tradition, the law often requires that various forms of agreements be witnessed or certified by a notary (who are in many cases also lawyers), in order for the documents to be legally enforceable. Notaries

Notaries in Costa Rica: an Implementing Institution

“[In Costa Rica,] contracts do not need to be registered to be valid. Some contracts need to be notarized. Those are known as ‘public’ contracts. They are primarily the powers of attorney and contracts for sale of goods and real property.

“Notaries in this context are more than support institutions. The notary is in charge of drafting the document, confirming the identity of the parties, and certifying the authenticity of the signatures. Likewise, the notary is responsible for whatever the document states. If additional formalities are required, such as registration, the notary would do those. Failure to comply with his duties and collusion to commit fraud make them liable. Many businesspeople commented that from a practical standpoint involvement of the notaries in many of the contract-making steps such as document drafting and presentation at the registry is not necessary and could be diminished. That would reduce the contractual transaction costs.

“Notaries are regulated by special law and supervised by a special agency. Their fees are set by a special decree. However, notaries complain that there is unfair competition, that the requirements to become a notary are flexible and that fees are too low. They also complain that judges do not know notary law.

“On the other hand, it is commonly perceived that notaries are expensive. Some foreigners feel the notary is unnecessary and increases the transaction cost. Likewise, some foreigners have complained that a document notarized abroad, such as a power of attorney, is not valid in Costa Rica without passing through the lengthy procedure of legalization and even after that it needs to be locally notarized. Costa Rica is part of the Inter-American Convention on Legal Regime of Powers to be used abroad. However, notaries, judges and lawyers said that a power of attorney granted in a signatory country would not be valid if it is not notarized by a Costa Rican notary.”

Trade and Commercial Law Assessment – Costa Rica (January 2005).

The World Bank **Doing Business Reports** recommend the use of standardized forms as a way of reforming Contract Laws. Many global and regional organizations, both public and private, have developed standardized forms for international contracts. The Reports also provide a number of recommendations concerning Contract Enforcement, more fully described at the Commercial Dispute Resolution section herein.

The World Bank
Doing Business Reports (2005-2006)

are regulated quite differently from jurisdiction to jurisdiction. It is important to understand how the notaries are professionalized within a country and whether there are any qualifications for becoming a notary, whether training or examination is required, and so forth. In addition, the CLIR professional might challenge a legal community to take a critical eye to the role and effectiveness of notaries. What is their purpose and their historical place in a country's legal structure? What value do they add to (or subtract from) transactions? How much time does the notaries' input add to the transaction process, and, again, what is the ultimate benefit of that time spent?

Bailiffs are often required or needed to execute court judgments. Sometimes the bailiffs operate under the direction of the courts and judiciary; in other instances, they may be a branch of the Ministry of Justice. Without a functioning bailiff or state-sanctioned private enforcement system, courts may be rendered ineffective.

In some countries, for example, practitioners have complained that they are unable to arrange for appropriate officials to seize or sequester movable property after execution has been ordered because the bailiff simply does not have adequate transportation.

A bailiff's office may also lack sufficient staff or properly compensated staff. Lack of resources often results in lack of productivity. This can be addressed through hiring and training. Problems with state-sponsored enforcement can also be

addressed through delegation of execution functions to licensed private service providers. This is done in various jurisdictions throughout Europe and North America. In either case, it is useful to create incentives for success, such as a 3-5% collection fee as is commonly used elsewhere.

Supporting Institutions

Legal reform focused on supporting institutions often involves drafting framework legislation that creates the institution – for example, preparing a draft Law on Alternative Dispute Resolution. Such legislation or regulations may require professional qualifications for members of the institution or profession. In addition, reform efforts often focus on training and education of various stake-holding groups – lawyers, business people, notaries, etc. – to alert them to changes in contract and commercial law and to encourage their active role in legal reform efforts in this area.

Alternative Dispute Resolution (ADR). If courts are unable to effectively resolve private disputes, parties may turn to other methods for resolving their disputes. ADR allows legal disputes, including contractual disputes, to be resolved privately and through means other than litigation in the courts. This usually takes place in the forms of **arbitration** and **mediation (conciliation)**.

Arbitration is a process through which parties in a dispute agree to let a neutral third party hear evidence and make a decision that will end the dispute. In most cases, once the arbitrator (or panel of arbitrators) reviews the evidence, he or she hands down a *binding* decision. An alternative to binding arbitration, *non-binding arbitration*, allows the disputing parties to put their case before an impartial third party who renders an opinion or recommendation, which the parties may choose to accept or reject. The presence of arbitration clauses in many international contracts – referring disputes to an international tribunal – allows international investors to avoid weak or biased domestic courts.⁶

For arbitration to function effectively, there must be framework legislation that allows parties to resolve

contractual disputes using arbitrators. In addition, domestic legislation must enable courts to recognize and enforce international arbitral awards. Arbitration services may exist through local chambers of commerce or other professional organizations, which, in addition to providing the service, may play a role in training arbitrators and publicizing the advantages of arbitration as an alternative to litigation.

In *mediation* (also known in certain countries as *conciliation*), a neutral third party, the mediator, assists two or more parties in evaluating the strengths and weaknesses of their respective positions and achieving a negotiated agreement, with concrete effects, on a matter of common interest. Mediation techniques can be specially tailored to the idiosyncratic needs of the parties. For example, depending on the nature of their relationship, the parties may meet together with the mediator, or they may never face each other, instead allowing the mediator to be the “go-between.” A formal mediation agreement may take the form of a contract, which may be enforceable through traditional legal mechanisms. Mediation can be a public or private service, delivered through the traditional court system or through independent organizations. Mediation is an area in which the business community can be encouraged to take the initiative to speed up and improve the quality of dispute resolution. Any initiative to develop mediation services will likely include components in training, public education, establishment for rules of mediation, and development of codes of conduct for mediators.

The advantages of ADR are speed and cost: it typically (though not always) costs less and is quicker than court litigation. ADR forums are also private. A perceived disadvantage of ADR is that it often involves a level of compromise that persons engaged in litigation do not wish to make.

Many legal reform projects are now focusing on creating the institutional capacity for ADR processes including arbitration, mediation, and, for consumer contracts, small claims procedures or courts.⁷ The sequencing of ADR initiatives vis a vis traditional

court reform activities is a matter of some debate. On the one hand, ADR represents an important alternative for businesses that cannot wait for long-term changes to take place in a court system’s efficiency, competency and overall integrity. On the other hand, the ultimate strength of an economy is deeply affected by whether a country’s legal system is a source of public confidence and judicial independence. Thus, reform on both fronts is generally necessary, and usually at the same time.

The private sector. As mentioned above, the business community itself should be engaged to improve the environment for contract performance and enforcement.

Areas in which the private sector can contribute to an improvement in the overall Contract Law environment include the following:

- *Develop standardized contracts.* To be readily enforceable, the terms and obligations of a contract must be clearly stated, with performance, amounts, deadlines, and penalties spelled out in reasonable detail. A contract granting credit for goods or services should be clear about payment requirements. For example, it might include a statement that a client will be responsible for all costs of collection, including fees of collection agencies and lawyers, if the client is delinquent with payment.

Many industries in wealthier countries have developed standardized contracts through their business and bar associations. The terms of these standardized contracts are commonly understood and do not need extensive review by parties and counsel beforehand. By working together with legal professionals (including judges and notaries), business communities can create and use more effective, enforceable contracts, thereby clarifying expectations and reducing surprises in the process of contract fulfillment.

- *Establish common, predictable systems of collection.* Collecting debts is an integral part of a client relationship and customer service process. Well-designed collection policies help maintain

ongoing customer relations and also set standards for when to eliminate customers who simply do not pay, and when to seek recourse in courts. There are various measures businesses can take to increase compliance with existing contracts. CLIR programs can help establish industry-wide practices and train businesses in these practices. For example, credit management systems allow businesses to be aware of the status of accounts at all times. Receivables management begins with tracking deadlines and payments. Whether receivables are tracked on paper or by computer, they must be tracked. Early intervention is the single most important practice for increasing likelihood of timely payments. It has been shown that companies in the same business who are more aggressive in managing receivables have a lower rate of default.

Businesses should consider a lawsuit as a last resort rather than a first response to non-compliance. CLIR programs can help businesses think proactively about common systems that may be established before entry into the court system.

- *Explore mediation as an efficient alternative to litigation as a means of resolving business disputes.* Litigation is a high-cost, risky process that takes control out of the hands of the disputing parties and places it in the hands of the court. Success depends on the skills of the lawyers and the judge, who may not have expertise in the particular area of the dispute. Moreover, judges often have limited remedies they can apply to the case that may not meet the real business needs involved. Resulting judgments must still be enforced, which can lead to additional costs, investments, and delays. Even a strong case is no guaranty of satisfactory litigation.

Mediation allows businesses to retain control over the process and its outcome. It gives them an opportunity to explore a wide range of possible solutions that are more flexible, effective and better suited to their situation than traditional damage awards. As a result mediation can be a reflection of good business judgment rather

than a perception of weakness. Furthermore, it demonstrates to the opposing party willingness, determination and commitment to resolve the problem immediately.

The private sector can take several specific steps to increase the use of mediation as a pre-litigation method of collecting unpaid debts and resolving other disputes. It can, for example, include mediation clauses in standard business contracts; require business lawyers to request mediation before commencing lawsuits; train in-house counsel or client managers in mediation techniques to ensure better negotiation and problem-solving skills; create an in-house mediation capacity for internal disputes; and work through professional associations and donor projects to start mediation programs for common business entities.

- *Establish mechanisms for identifying and prioritizing enforcement needs based on the impact of the courts on business and the economy.* The business community and their lawyers are well suited to identify gaps in judicial capacity pertaining to Contract Law and Enforcement. Businesses deal with the courts on a routine basis and make their decisions to invest, disinvest, or even declare bankruptcy based in great part on the ability of the courts to enforce the relevant legal framework. An agenda for judicial reform or training that does not take this into account may not effectively address the most pressing needs of the business sector. Thus, business and legal communities should each establish a mechanism for identifying priorities for training in the judiciary. Bar Associations and other professional organizations can survey their members to identify a number of areas where training and knowledge of judges are inconsistent or insufficient.
- *Encourage the development and use of credit bureaus or other reputational rating agencies.* Credit rating agencies, which monitor the ability of businesses (and individual debtors) to repay debts, also provide useful services. By providing greater information about contracting parties, registries and intermediaries allow contracting parties to

assess the risk of another party's non-performance or breach of a contract. Many countries have a well established system of credit agencies that can provide credit information – and even analysis – for a reasonable fee.

Law faculties and law professors/academicians.

To play an effective role in implementing Contract Law, lawyers must understand the substantive law. Law school curriculums that emphasize abstract legal theory relevant under socialism rather than commercial contract law courses produce lawyers who are not yet capable of functioning in an environment that is favorable to economic development. Moreover, law professors are often involved with legislative drafting and publication of contract treatises, regardless of their true understanding of market principles. Donors providing CLIR assistance would be wise to integrate law schools into their agendas for reform, and even to reach out to law students who may benefit from time spent as interns or trainees with the CLIR project.

Trade, business and professional associations.

Organizations of businesses and individuals who share common concerns in the arena of Contract Law and Enforcement include chambers of commerce, sector-specific organizations (including bankers associations, retailers associations, or groups of smaller merchants), and professional groups such as bar associations or professional notary associations. These associations are vital resources with respect to proposing standardized contracts or lobbying for change in Contract Law and procedure. These organizations may also be encouraged to offer their own type of dispute resolution services for members, such as a mediation service or some type of industry-wide arbitration. In many jurisdictions, for example, brokers or the stock exchange offers dispute resolution for securities disputes.

ADDITIONAL GUIDANCE, TOOLS AND RESOURCES

Many transitioning economies have recently revised or adopted new commercial or civil codes.

Thus, future legal reform projects may focus on the additional dimensions of Contract Law that may further enhance the ability of parties (including foreign investors) to enter into specialized commercial contracts within a given country.

Franchise Agreements. Franchising is a business process that enables a company to expand and distribute goods or services while giving individuals the opportunity to operate their own business under a recognized brand or trademark. A franchise is created when a business, the franchisor, licenses its trade name, brand and business methods to an individual, the franchisee.

A franchisee agrees to operate the business in accordance with a franchise agreement, another form of specialized commercial contract, with the franchisor's support. In return the franchisee pays a franchise fee as well as on-going royalties. There are two basic types of franchise:

- **A Product Distribution Franchise** is a simple licensing agreement that refers only to the brand. Typically a franchisee will sell a product that has been manufactured by the franchisor and which features the franchisor's trademark or logo. The franchisor will not usually supply a business operating system to the franchisee.
- **A Business Format Franchise** is an extension of a Product Distribution Franchise. The franchisee is no longer just taking a license for the trademark or logo. He is taking a complete business for the delivery of the product or service.

Franchising is increasingly present in various emerging markets/transitioning economies.⁸ As such, there may be a corresponding need for legal reform in this area.

In September 2002, Unidroit issued a Model Franchise Disclosure Law.⁹ The model law was the work of a study group on franchising, convened in 1999.

Consumer Protection. Retail consumer contracts are important to the development of a market-based economy. As such, consumer protection

The UN Consumer Guidelines are a useful tool in national policy development and in the design and implementation of consumer protection legislation. The objectives of the UN Guidelines for Consumer Protection are:

- To assist in achieving or maintaining adequate protection for their population as consumers
- To facilitate production and distribution patterns responsive to the needs and desires of consumers
- To encourage high levels of ethical conduct for those engaged in the production and distribution of goods and services to consumers
- To assist countries in curbing abusive business practices by all enterprises at the national and international levels which adversely effect consumers
- To facilitate the development of independent consumer groups
- To further international co-operation in the field of consumer protection
- To encourage the development of market conditions which provide consumers with greater choice at lower prices
- To promote sustainable consumption

Section I(1), U.N. Guidelines for Consumer Protection

legislation can promote consumer contracts by providing consumers (end users) with certain rights and remedies in the event that a merchant engages in fraudulent, deceptive or harmful behavior with respect to the sale of goods and services. Consumer protection legislation typically occurs well after revisions to basic framework legislation for commercial contracts. Consumer Protection is often considered one aspect of Competition Law.

In 1985, the United Nations General Assembly adopted the United Nations Guidelines for Consumer Protection.¹⁰ Expanded in 1999, the Guidelines represent an international framework for Governments, particularly those of less-developed countries, to use in formulating and strengthening consumer protection policies and legislation. The Guidelines were adopted “recognising that consumers often face imbalances in economic terms, education levels, and bargaining power, and bearing in mind that consumer should have the right of access to non-hazardous products, as well as the importance of promoting just, equitable, and sustainable economic and social development.”¹¹

Financial Leasing Agreements. Financial leasing is a contractual arrangement that allows one party (the lessee) to use an asset owned by the leasing

company (the lessor) in exchange for specified periodic payments. Legal ownership (retained by the leasing company) is separated from economic use of the asset (held by the lessee). The leasing company focuses on the lessee’s ability to generate cash flow to service the lease payments, rather than relying on its credit history, assets or capital base. This arrangement particularly suits new, small or medium enterprises that often lack a credit history. The asset itself provides security for the transaction.

One-eighth of the world’s private investment is financed through leasing.¹² The proportion is as high as one-third in some OECD economies. In 1994, over US \$350 billion of new vehicles, machinery, and equipment were financed through leasing. The first modern independent leasing company was formed in the United States in the 1950s, and the industry extended to Europe and Japan in the 1960s. Since the mid-1970s, the industry has been spreading rapidly through less-developed countries.¹³ Leasing enables a firm or individual to use assets — such as vehicles or equipment — owned by a leasing company in return for regular payments.

Various sources of guidance are emerging in the area of leasing. The International Finance Corporation and other international financial institutions have

been involved with leasing and leasing reform in emerging markets. The World Bank has articulated “critical provisions” for a model financial leasing law. Unidroit is also developing a new model law on leasing. Unidroit aims to formulate a coherent response to the requirements of those less-developed countries and countries in economic transition currently engaged upon the reform of their domestic leasing laws with the assistance of both regional and universal development banks. Unidroit already has created an International Financial Leasing Convention.

Accessing Key Resources

There are certain key institutions that have been developed to facilitate the harmonization of international Contract Law. Such frameworks may provide a useful basis for revisions to commercial Contract Law in transitioning economies.

Unidroit Principles of International Commercial Contracts. The Principles of International Commercial Contracts were promulgated in 1994 by the International Institute for the Unification of Private Law (Unidroit).¹⁴ The principles are the product of many years of comparative legal research. They were drafted by a special working group comprised of representatives of all the major legal systems of the world, and exist fully translated in sixteen languages. The Principles are intended to “serve as a model to national and international law-makers for the drafting of legislation in the field of general Contract Law or with respect to special types of transactions.” The Principles are directed particularly to those countries which lack a developed body of legal rules relating to contracts and which intend to update their law, at least with respect to foreign economic relationships, to current international standards. The Principles are also of particular use to emerging markets that, “after the recent dramatic changes in their socio-political structure, have an urgent need to rewrite their laws, in particular those relating to economic and business activities.”

The Unidroit Principles are composed of a Preamble and 119 articles divided into seven chapters: General

Provisions; Formation; Validity; Interpretation; Content; Performance; and Non-Performance. The provisions (also referred to as “black-letter rules”) are accompanied by detailed comments, including illustrations, which form an integral part of the Principles.

Principles of European Contract Law, Commission on Enforcement of European Contracts. The Principles of European Contract Law¹⁵ (“PECL”) represent an attempt to rationalize common principles of Contract Law within the European Union. The PECL were drafted by an independent body of experts from each Member State of the European Union under a project supported by the European Commission. In the EU, there is interest in developing a common European civil and commercial law. The European Parliament has twice called for the creation of a European Civil Code. The PECL constitute one step toward this goal.

The PECL consist of a set of articles with a detailed commentary explaining the purpose and operation of each article. In the comments there are illustrations (short cases) which show how the rules are to operate in practice. Each article also has comparative notes surveying the national laws and other international provisions on the topic.

Parts I and II of the PECL cover the core rules of contract: formation, authority of agents, validity, interpretation, contents, performance, non-performance (breach) and remedies. The Principles previously published in Part I (1995) are included in a revised and re-ordered form. Part III, published in 2003, covers plurality (multiplicity) of contracting parties, assignment of claims, substitution of new debt, transfer of contract, set-off, prescription, illegality, conditions and capitalization of interest.

The PECL are considered “soft law”, which means that they are non-binding. Their main purpose is to serve as a first draft of a part of a European Civil Code. In drafting the PECL, the special Commission reviewed the Contract Law of the EU Member States. The Commission also considered rules of legal systems outside of the

EU, including the U.S. Common Law of contracts and existing international conventions, such as the United Nations Convention on Contracts for the International Sales of Goods (CISG, discussed below). Some of the PECL reflect ideas that have not yet materialized in the laws of any European state. Thus, the Commission has tried to develop principles that it believed to be best under the existing economic and social conditions in Europe.

United Nations Convention on the International Sale of Goods. The United Nations Convention on Contracts for the International Sale of Goods (also referred to as the “Vienna Convention”)¹⁶ provides a uniform text of law for international sales of goods. The Convention was prepared by the United Nations Commission on International Trade Law (UNCITRAL) and adopted by a diplomatic conference in April 1980.

The Vienna Convention is divided into four parts. Part One deals with the scope of application of the Convention. Part Two contains the rules governing the formation of contracts. Part Three deals with the substantive rights and obligations of buyer and seller arising from the contract. Part Four contains the final clauses of the Convention concerning such matters as how and when it comes into force.

The Vienna Convention establishes a set of rules governing certain aspects of the making and performance of “plain vanilla” commercial contracts between sellers and buyers who have their places of business in different countries. By adopting it, a nation represents to the other nations that have adopted it that it will treat the Convention’s rules as part of its law.

The purpose of the Vienna Convention is to make it easier and more economical to buy and sell raw materials, commodities and manufactured goods in international commerce. Without the Convention, there is greater room for uncertainty and disputes. The sales law of one country often differs from that of another. In international transactions, there is often doubt about which nation’s law controls. Where there is doubt about the rules that apply, the parties cannot be sure of their rights and obligations.

The Vienna Convention does not deprive sellers and buyers of the freedom to mold their contracts to their specifications, however. Business parties are free to modify the rules established by the Convention or to agree that the Convention does not apply at all.

ENDNOTES

¹ Douglass C. North, *Institutions, Institutional Change and Economic Performance* at 54 (Cambridge, Cambridge University Press) (1991).

² See Eric Jensen, *The Context for Judicial Independence Programs: Improving Diagnostics, Developing Enabling Environments, and Building Economic Constituencies*, published in USAID Office of Democracy and Governance, *Guidance for Promoting Judicial Independence and Impartiality* (Technical Publication Series, January 2002, Rev.Ed.) at 183-84 (discussing interest of SMEs in particular in transparent court systems and judicial independence).

³ Gillian K. Hadfield, *Contract Law is Not Enough: The Many Legal Institutions that Support Contractual Commitments*, USC Law and Economics Working Paper Series (Paper 3, 2004) (hereinafter Hadfield).

⁴ *Id.* at 36.

⁵ As detailed in this Guide’s chapter on Secured Transactions, a contract can include the creation of security over one party’s assets, such as real estate (including land or buildings), personal property (including so-called “movables,” such as equipment, inventory or motor vehicles), or intangible property (for example, a farmer’s harvest due the following year, or intellectual property rights). In each case, the property itself is the collateral and the security interest is the right that a person has to claim the collateral – that is, to seize and sell it in case of default by the debtor.

⁶ In 1985, the United Nations Commission on International Trade Law (UNCITRAL) developed a model law on international commercial arbitration. This model law has often served as the basis for a framework law governing international arbitration in transition economies (i.e., disputes between foreign investors and domestic companies, for example).

⁷ Small claims courts are among the approaches discussed in the Commercial Dispute Resolution chapter of this Guide.

⁸ A.M. Han, Legal Aspects of Franchising in China, in I. Alon and D.H.B. Welsh (eds.) *International Franchising in Emerging Markets: China, India and Other Parts of Asia* (CCH: Riverwoods, IL); P.J. Kauffman and H. Leinbentein, *International Business Format Franchising and Retail Entrepreneurship: A Possible Source of Retail Know-How for Less-Developed Countries*, 18 *Journal of Development Planning*, 165-179 (1988).

⁹ Unidroit's Model Franchise Disclosure Law can be found at www.unidroit.org/english/franchising/modellaw/modellaw-e.pdf.

¹⁰ More information about the [United Nations Guidelines for Consumer Protection](http://www.un.org/esa/sustdev/sdissues/consumption/english.pdf) can be found at www.un.org/esa/sustdev/sdissues/consumption/english.pdf.

¹¹ *Id.* at Section I(1).

¹² Laurence W. Carter, Teresa Barger, and Irving Kuczynski, *Leasing in Emerging Markets* (1996).

¹³ *Id.*

¹⁴ See www.unidroit.org.

¹⁵ Commission on European Contract Law, *Principles of European Contract Law*, located at http://frontpage.cbs.dk/law/commission_on_european_contract_law/.

¹⁶ See generally www.uncitral.org. In addition, Pace University maintains an extensive database containing information about the U.N. Convention on the International Sale of Goods, located at www.cisg.law.pace.edu.

Real Property

KEY CONCEPTS

Definition: A system of laws and regulations that: (1) creates and protects recognized rights in real property (generally land and buildings), (2) taps the asset value of real property through secured lending, and (3) preserves land use rights and tenant rights.

What is Real Property?
Real property— also commonly referred to as “immovable” property – means land or buildings. Real Property Law concerns the ownership and use rights that attach to these, including forms of ownership, assignment of rights through contracts, and institutions that record, authenticate, and enforce such rights. Ownership rights include the right to exclusively and continuously use and enjoy property (subject to legal regulation) and the right to transfer all or part of such ownership rights through sale, gift, exchange or inheritance. They also include the right to access the value of the property through formally sanctioned mechanisms,

such as leaseholds or mortgages. Ownership-like rights include long or continuing leases that do not convey full ownership of the property but in practice carry most of the benefits of ownership.

Through Real Property Law, people other than owners may also have rights that attach to property. These include rights to reside on land or in a dwelling; rights to travel over land; rights to harvest crops or naturally occurring produce; and rights to pasture livestock, cut timber or draw water from land. Clarifying and stabilizing non-ownership rights in relation to land is critically important in settings in which local communities historically have not had ownership, or

Forms of real property include:

- Land for residential or commercial purposes
- Residential buildings (individual homes and apartment blocks)
- Commercial buildings
- Agricultural land (owned privately, collectively, or by the state)
- Forest
- Conservation land (parks and reserves)
- Bodies of water and contiguous land
- Unoccupied state land
- State-owned pastureland that may also be governed by customary law
- Garden plots
- Land for state or religious purposes

Property Rights in Rural Colombia

According to a draft report for the World Bank, most medium and large size farms in rural Colombia enjoy clean titles, but most farmers with small holdings have no formal titles, and those that do have formal titles have not registered their titles.

“Farmers without title or security tend to invest less in farm equipment and land improvements, use fewer inputs, and obtain less output per unit of land than those with title. Further, farmers with properly registered titles have greater access to formal sources of credit.”

Diana Gruszczynski and C. Felipe Jaramillo, Integrating Land Issues into the Broader Development Agenda: Case Study Colombia (The World Bank, 2002).

in post-conflict settings where ownership systems have been ruptured.

In most Common Law countries, land and structures on the land (usually buildings) are treated together as the “property.” In most Civil Law countries, property in land and in structures on the land is divided, so that it is possible for the ownership of a parcel of land and the buildings on it to be held by different people.

Stable Property Ownership Rights. The fundamental goal of Real Property Law reform in the CLIR context is to stabilize property ownership rights or ownership-like rights to support the reduction of poverty and economic growth. Real Property Law that clarifies and stabilizes land tenure rights is a fundamental building block in social stability and economy activity. Development specialists have identified a clear relationship between land tenure (property ownership or ownership-like rights) and the reduction of poverty. At a fundamental level, about 45% of the world’s population still depends on agriculture for its income, security and status. Of those people, about 500 million are tenant farmers or agricultural laborers, who lack ownership or ownership-like rights in the land they cultivate. This group also includes squatters and traditional owners of land whose customary ownership is not recognized by the formal legal system. They predominate in the agricultural populations of Bangladesh, Brazil, Colombia, Guatemala, Honduras, India, Indonesia,

Pakistan, the Philippines and South Africa and are a significant group in many other countries, including Egypt, Nepal, Venezuela and Zimbabwe. In effect, these agricultural workers have few prospects for escaping severe poverty.

Development agencies, donors, and international financial institutions generally accept that clear property rights and enforceable contracts

are fundamental preconditions for market-based economic activity. This is not an absolute equation – countries such as China (and Indonesia prior to the 1997 financial crisis) have evidenced spectacular economic growth without a system of secure, transparent, and enforceable land tenure. As a general principle, however, the grant of ownership or ownership-like rights in property to rural or urban residents makes it possible to access the value of the real property, both in its primary role (housing, infrastructure for business, garden plots, crop cultivation, or pasturing) and its secondary role as collateral for consumer or commercial credit.

This latter benefit of Real Property Law is directly analogous to the purpose of a Secured Transactions Law, which concerns “movable” or personal property, and is discussed in the following chapter. Under both Real Property Law and the Law of Secured Transactions, borrowers may use their property as collateral to secure loans, thereby accessing capital while giving lenders greater confidence that the loan will be repaid, or that the lenders will be paid back from the sale of the secured asset. **The ability to use real property and personal property as security for loans thus supports increased economic activity in general.**

In a broader context, land tenure issues demand an interdisciplinary approach that cuts across different sectoral interests within agencies such as USAID. Democracy and governance, economic growth, agriculture, environment, and post-conflict peace-

“Land is a strategic socio-economic asset, particularly in poor countries’ societies where wealth and survival are measured by control of, and access, to land.”

USAID Office of Conflict Management and Mitigation,
Land and Conflict: A Toolkit for Intervention (2004)

building projects may all require interventions that impact land tenure. Real property reform objectives can vary from country to country and region to region. In some countries, Real Property Law reform may be motivated by a desire to promote foreign direct investment. In other countries it represents a way to boost rural incomes, inculcate an ownership stake in the political system, and provide a source of credit to the poor. Land, for many of those who own and use it, or from whom it has been taken, represents employment, wealth, power, identity, community, political entitlement, gender (in)equity, environmental stewardship, and sacred space. Historically, lawyers have framed land and land tenure questions more narrowly. Although property rights have been dramatically re-conceptualized in law in recent years, the classic definitions of land tenure are still the basis of most legal regulation of land and structures on the land today.

Real Property Law reform is a fundamental building block for commercial law reform in fragile states or transitioning economies. If major questions exist about the ownership and value of real property, it is very difficult to set up and implement commercial lending transactions with real property as the collateral. Real Property Law establishes systems for managing competing claims and uses for land between the state and individuals or communities, among communities, and between investors or commercial actors and citizens. If property

cannot be bought and sold with the confidence that the authorities will uphold the transaction, the market itself will fail to generate dynamic growth. Individuals and businesses which might otherwise use their real property as collateral will be more inclined to remain in the informal sector, which means that they will stay small, fail to benefit from other commercial law regimes (such as Company Law, Contract Law, and Bankruptcy Law), refrain from accessing legal institutions such as courts and registries, and not pay taxes. Further, owners of land are less likely to invest in the upkeep and improvement of their property if their rights as owners are insecure.

Current initiatives in land reform emerge from several generations of land reform. First-generation land reforms took place during the mid-20th century, often as a result of decolonization or post World War II democratization. The result in rural areas was that land reform beneficiaries received ownership or ownership-like rights in individual family farms, including places such as Finland, Poland, Yugoslavia, Mexico, Bolivia, Japan, Taiwan, South Korea, and the Kerala and West Bengal States in India.

The World Bank Doing Business Reports suggest that efficient courts coupled with strong supporting legislation defining the rights of citizens and businesses to their property are the backbone of real property rights. The reports conclude that inexpensive and quick, cheap registry systems are effective means for securing title to property, even when Commercial Dispute Resolution and enforcement mechanisms are weak. Other recommendations include:

- linking and unifying the agencies involved in registering property;
- providing easy and convenient access to the registry; and
- Protecting the legal rights of creditors

Doing Business cautions that automation and technology are not a panacea. In many countries, particularly poor ones, electronic registration is probably not sustainable yet. If paper records are inaccurate, putting them in a computer will not help. Hence, the focus in such situations should be to focus on improving the efficiency of current services and coverage and accuracy of the registry.

The World Bank **Doing Business** Reports (2004-2006)

Gender Equality in Land Reform

“In Africa, custom rather than religious practice excludes women from ownership; property is held in a man’s name and passed patrilineally within the group. A widow’s right to remain on the land is not secure. In Latin America, discrimination results more from limited status under the law. Women, for example, may reach majority age at 21, but still be required to be represented by their husbands in all legal capacities.”

“Land reform, legislative reform and the forces of modernization have had a mixed effect. Agrarian reform or resettlement programmes use the ‘head of family’ concept, usually a male, as the basis of land reallocation. Few have significant numbers of female beneficiaries or even pay attention to gender as a beneficiary category. New legislation on equality for women is more applicable to the urban-employed class than rural persons; agricultural land is even excluded in some new inheritance schemes. Statutory reform of customary law is confusing and open to interpretation; when customary, religious or statutory systems coexist, the law least favourable to women is often selected. Traditional or customary systems that might have protected a woman’s access to land during her lifetime are breaking down under population, economic and environmental pressures. Growing male rural-to-urban migration is leaving women as de facto heads of households without management authority over land resources. Even under resettlement schemes in irrigated areas, women de facto heads of households rarely benefit.”

“FAO Focus: Women and Food Security: Women and Tenure,” found at <http://www.fao.org/FOCUS/E/Women/tenure-e.htm>

A second wave of reforms in the socialist world in the 1990s led to the “decollectivization” of large, state-managed farm enterprises, including in the countries of the former Soviet Union, most Eastern European countries, Ethiopia, China, and Vietnam.

The paradigm example of “second-generation” land reforms is the land reform and privatization of property ownership that has occurred in the Eastern Europe and Eurasia following the collapse of the Soviet Union in 1989 and the emergence of independent countries embarking on fundamental remaking of their legal systems during the 1990s. In China and Vietnam, too, land reform constitutes an element in the shift to a market-oriented economy. The pace and intensity of these second-generation reforms, many of them assisted by USAID funding, have now outstripped the land reform process for tenant and laborer families in less developed countries. Nevertheless, even after a decade of land reform and privatization in Eastern Europe and Eurasia, outcomes remain very uneven. Beyond those regions, land reform in transitioning and less developed countries remains unfinished business that can hamper commercial legal and institutional reforms.

In the current “third generation” reforms, the agenda is complex. It includes:

- Re-visiting unfinished or unrealized land reform initiatives from the previous periods
- An understanding of the broader aspects of property rights, beyond simply identifying, transferring and registering ownership of land parcels
- An understanding of the link between inadequate legal, institutional and customary protection of land tenure and the potential for social conflict and violence
- The negative impact of natural disasters, environmental disasters, war and mass migration on land tenure and the strains that this imposes on systems of regulating access to land
- The gender dimensions of land tenure and how women can be systemically disadvantaged by new or formal regulation of land rights.

At the same time, regional initiatives have also emerged, notably the Land Net Americas project,¹ which arose from a joint USAID/Organization of American States initiative. This project seeks to share

best practices, build a knowledge and resource base, and coordinate policy reforms relating to property across national boundaries.

Benefits of land reform. The benefits of creating and stabilizing land tenure for people include the following:

Economic growth. A secure interest in land justifies long-term investments and improves income from land ownership. This in turn allows owners to participate in a market economy, ultimately stimulating demand for consumer goods and for non-farm employment.

Increased crop production. Small landholdings out-produce collective farms and large landholdings and owners invest more heavily in and are better stewards of land than laborers.

Improved nutrition for poor households. Ownership of a portion of crops improves nutrition outcomes for poor families.

Stronger communities, facilitating democracy and reducing conflict. Secure rights over real property allow owners to participate in the political process and reduce grievances and violence caused by lack of land ownership or dramatic inequalities of ownership. Land reform also provides owners with a stake in their community.

Improved environmental results. Owners tend to be better stewards and to engage in sustainable farming practices. Ownership of cultivated land reduces the likelihood of landless people encroaching on forest or uncultivated land.

Decreased pressure on urbanization. Land reform may create a stake in village society and reduce pressure for migration to urban areas.

Transformation of the asset. Real property rights that have a predictable market value can be used as collateral, sold for non-agriculture investment, or passed on as wealth to the next generation.

Impediments to land reform. Despite the obvious benefits of land reform, there remain many fragile states and transitioning economies in which the

process has stalled or is only partially complete. Reasons for land reform remaining “unfinished business” in many economies include:

Relative invisibility of the problem. Land, its cultivation, buildings and their occupancy are all visible social issues, but the network of ownership and use rights is invisible until it crystallizes in a problem.

Entrenched opposition from local elites. Land is always controversial. In less developed economies, major landowners and the politicians they support would oppose any redistribution of privately owned land. Reforms involving redistribution of state-owned land are relatively less controversial, but still involve settling claims from former owners whose property was expropriated.

Tendencies to respond to short-term issues, such as violent clashes between the state and squatters or between landless and landowners, rather than engage in systematic planning and reform.

Corruption. Many privatization experiences have involved the non-transparent transfers of key state-owned assets into the hands of well connected insiders, while the vast majority of the population has no access to the benefits of land reform.

Supporting land reform. Political obstacles to effective land reform are common to both less developed and transitioning economies. Nevertheless, reform has been possible, notwithstanding resistance from local elites. Successful elements in land law reform programs to date include:

Effective grassroots support for land reform, through promotion by local stakeholders.

Government buy-in. Historically, central authoritative figures were crucial to land reform programs and continue to be in countries that are authoritarian. Large-scale land reform based on redistribution of vast amounts of privately owned land is no longer feasible in the 21st century, so government support for redistribution of state-owned land or for market-oriented reforms is crucial.

Micro-plots. Particularly in densely-populated, less developed economies, the allocation of micro-plots or house and garden plots may be more feasible than aiming for redistribution of full-sized farms.

Compensation. Incentives for land reform are likely to be more successful than imposed mandates. Credible compensation for the taking of privately owned land has helped to legitimate land reform and reduce landowner opposition. This formula is limited in practice, however, because in many situations, land values have been inflated by population pressure and there are finite financial resources for acquiring land. Many situations may indicate a need for “market-assisted land reform” or “negotiated land reform” in which funding is provided for needy families to acquire private land offered for sale voluntarily, but this, too, is resource-dependent solution.

Ideology. In the former Soviet Union and Eastern Europe, post-communist governments have been able to implement land reform by linking decollectivization to a program of democratic political reform.

Public education. Developing an understanding of land and property issues among all sectors of society is likely to become even more important in future, particularly in pluralist democratic settings.

Institutional support for land markets. Establishing, implementing and maintaining the institutions that support a land market will be vital for ensuring that land reforms ‘stick’. Such institutions include cadastral surveys and registers, land rights registers, dispute resolution facilities, legal and banking support for mortgages, land valuers and auctioneers, and agencies charged with land maintenance and environmental protection.

Technical assistance and financial assistance. Foreign support played an important historical role in land reform in post-World War II reforms in Japan, Taiwan and South Korea. Foreign support continues to be important in Eastern Europe, in the form of signals from the IMF and World Bank, in donor

funds, and in prospects for EU accession. Donor assistance has proved useful in:

- Mobilizing grassroots support among NGOs, labor movements and local communities for land reform
- Advising government policy makers about program design, particularly given that land reform tends to be an infrequent and erratic occurrence
- Assisting with public education programs
- Providing resources for compensation schemes, both identified in advance and then provided as progress payments once land is actually and verifiably redistributed.

MAJOR GUIDELINES

Legal Framework

Sequencing of reforms. In legal systems that allow for private ownership of property, the right to own property is often enshrined in the Constitution. This is true for post-Soviet transitioning economies, which typically amended their constitutions in the early 1990s to include provisions making ownership of property inviolable and allowing expropriation of property for public needs only where carried out following procedures prescribed in law and where just compensation has been provided.

In other economies, private rights in property are typically set out in the Civil Code and the Code is supplemented with special laws that apply to different kinds of property and property transactions, such as, a Basic Land Law, an Agrarian Law, a Law on House Leases and/or Land Leases, and a procedural law dealing with Real Property Registration. As the legislative framework reaches its limits for enabling transactions, new laws are developed (often with the help of foreign donors) and are grafted onto the basic Code/Special Laws framework. Examples may include a Mortgage Law or a Condominium Law.

In transitioning states, the process of privatizing formerly state-owned land has resulted in a tidal wave of enabling legislation, in some cases up to 100 or more separate legislative acts. For the development of a well functioning legal system that allows for full utilization of ownership and ownership-like rights, the sequence differs from economy to economy, but an indicative list would include:

- Constitutional reform to recognize private property ownership and procedures
- Civil Code reform to recognize and define new property rights (for example, the right to be recognized as an owner after openly using the property for a prescribed period of time)
- Law on Restoration of Citizen's Ownership Rights in Real Property
- Law on Land Reform
- Law on Land Leasing
- Law on Leasing State-owned Forests and Pastureland
- Land Law
- Law on Privatization of Agricultural Land
- Law on Privatization of Non-agricultural Land
- Law on Transfer of Property
- Law on Privatization of state and Municipal assets
- Law on Real Property Register
- Law on Pricing and Methods of Sale of Real Property
- Law on Auctioning Real Estate
- Law on Condominiums or Co-Ownership
- Law on Foreign Investment (stipulating ownership rights and procedures for non-citizen individuals and legal entities)
- Law on Migration (stipulating ownership rights for non-citizens living permanently in the country)

- Law on Land Tax (may cover ownership of land and/or buildings, and leases).

In addition, reforms to ancillary laws such as the banking law may be required in order to facilitate a market in mortgages for newly created or acquired real property. Such legislation alone is insufficient. There are many countries in both Europe and Africa where banks and other credit institutions remain unwilling to lend against property as collateral at interest rates that SMEs and individuals can afford. In other places, the static nature of the property market makes it difficult to value land for lending purposes and this stymies a mortgage market. Accordingly, a much smaller number of property owners who have accumulated existing capital or who can raise capital through non-bank means use this in order to acquire or improve property.

Privatization. For the purposes of this Guide, “privatization” is used in its broadest sense – divestment by the state of ownership (or ownership-like) rights and the transfer of real property to individuals, households, legal persons and/or foreign investors. This transfer of ownership could take place either at no cost, for compensation, according to a state-devised formula, or through a competitive bidding process.

In the case of redistribution of privately owned land, compulsory acquisition for just compensation has proven more successful over time than entrenching protections for lessees or creating ‘land banks’ to fund purchases. As summarized by the Rural Land Institute, failure to pay reasonable compensation “virtually guarantees that landlords will evade the law, cause the law to be rescinded, or violently resist the enforcement of the law.”² Thus, the challenge to donors with respect to a scheme of private-land redistribution is to assist the government at issue in identifying the necessary costs involved, possible methods for securing funds to compensate land owners, and proper management and accounting for these funds.

Where land reform and privatization programs deal only with formerly state-owned land, the reallocation of property can be achieved through mass issuance

of titles, free of charge; through a voucher system granting people “credits” that can be exchanged for land; or through state or foreign-donor subsidized programs providing funds for purchasers to buy property at nominal rates. In the experience of many transitioning economies, business enterprises lacked the financial capacity to buy land attached to the enterprise and so purchase of the land had to be effectively subsidized. In many cases, those with sufficient capital or political connections acquired the land without competition. These non-transparent transfers of state-owned property – as in Russian and Bosnia, for example – changed promising seeds of legal and economic reform into a process rife with self-dealing and mismanagement with significant negative consequences.³

Identifying and allocating real property, identifying and recording the new owner(s), and dealing with conflicts of ownership and claims for restitution by former private owners marked the first phase of privatization in most countries. The extent, pace, and results of privatization of property in Eastern Europe and Eurasia have proven erratic and dramatically different from country to country. Variables of this process include the number of privatized properties; the level of employment by sector; the unemployment rate; average monthly earnings; levels of direct foreign investment; population density; quality and development of infrastructure; and system of property credits (allowing purchase or grant of property from the state).

Additional legal and political issues that arise in the privatization process are discussed later in this chapter.

Transfer of property. Once private ownership or ownership-like rights are secured through the Constitution and/or legislation, new legal or regulatory procedures are often necessary to make private land transfers work. For example, transfers of real property should typically be made in writing in a prescribed form. In addition, government approval for some transfers may be required. In Civil Law countries, the transfer usually needs to be notarized and in most transitioning economies the transfer

will also need to be registered before it can become legally effective. In addition, reform or redesign of law is often required to recognize and enable legal persons – companies, other registered associations, trusts, or cooperatives – to acquire and manage property.

For a functional property market to emerge – one in which real property can be bought and sold with relative efficiency and security – different areas of law have to be coordinated. Major barriers to effective property markets include: (1) property taxation schemes that produce less income for national or local government than rent on state-owned property; (2) barriers to entry for foreign investors; (3) limitations on property ownership by legal persons (where there is no clear policy reason, such displacement of individual owners or potential owners from the market); and (4) withdrawal or “exemption” of state property from privatization where no coherent policy reason exists.

Registration. A necessary element of any Real Property Law reform program is the evaluation and strengthening of existing land registries or the creation of new ones, covering both cadastral issues (the dimensions and qualities of the property) and ownership rights. Information contained in state-operated registers should include:

- **Details of the land parcel**, including the name and code of registration zone; the parcel number; the land parcel area; the land parcel address; and tenure status
- **Details of ownership**, including an entry number; an application registration number and date; certification of ownership; name and address of the owner(s); and a registration notice
- **List of encumbrances and easements**, including easements, rights to build, rights to access, use rights, etc.
- **List of registrable interests**, including mortgages and leases.

Many countries still do not have an effective property registry. Many transitioning economies

have established land registries, but the information they contain is inaccurate, incomplete, and/or contradictory with other registration information; such registries will require consolidation and correction of errors for some decades to come. An intermediate step adopted in some land reform programs is to create a temporary deeds registry, recording the grant of privatized property, without waiting for the establishment of a fully-integrated registry covering both cadastral and ownership registration.

A key issue in land-mapping and registration is the extent to which existing, customary ownership rights are respected and the capacity to resolve disputes arising from multiple claims in relation to the same land, often involving previous owners who now claim a right to restitution in post-socialist states.

Enforcement. A full complement of legislation and a functioning real property register are necessary but insufficient elements in identifying and stabilizing real property rights in an economy. Ultimately the credibility of the system of real property rights depends on the wide-spread belief that rights can and will be enforced in a timely way without unnecessary expense. The range of enforcement mechanisms differs from country to country, but in many fragile states and transitioning economies, the mechanisms can be generalized into the following categories:

Self-help. Where customary rights are ignored or where the system cannot provide adequate redistribution or management of property, the issues become that of occupation of state-owned land (squatting) or cultivation of state or privately owned property. In some urban areas, unofficial property markets sprang up because of the self-help exercised by the property owners; today it is sometimes used to resolve disputes over ownership or co-ownership (for example, apartment swapping or acceptance of property in lieu to settle a restitution claim).

Registration. The goal of a registration system is to be comprehensive, accurate and authoritative. A general principle of the administration of property registers is that the contents should be treated

as authoritative and dispositive of the dispute unless fraud or error can be proven. Courts should treat a registered property interest as final and binding without the need for further litigation. In transitioning systems, however, this is often an unrealized ideal because errors are inevitable and proving ownership claims prior to registration is difficult. In some countries the national and local privatization agencies and the courts have all rendered conflicting decisions regarding the same property.

Administrative dispute settlement. Many countries have built in administrative systems of review and dispute resolution to govern ownership claims and restitution claims at the local level. For such systems to be effective, basic laws on administrative review and administrative procedure need to be in place, understood and capable of implementation.

Judicial review. It should be possible to conduct judicial review of administrative decisions or dispute settlements if the grounds for review are stated clearly in the law and apply in the case. For example, demonstrated error of law, bias by the decision-maker, or demonstrated fraud should provide adequate grounds for judicial review of administrative decisions. This assumes a functioning judiciary trained in both administrative and Real Property Law where the costs of appealing an administrative decision are not prohibitive for an individual citizen. Again, this is the ideal rather than the practice in many fragile states and transitioning economies.

Civil litigation. It should be possible to cancel or revoke a transfer of property according to grounds set out in law, or to resolve conflicting claims of ownership through civil litigation. In practice, however, this has proven particularly difficult in some countries in relation to claims for restitution by former owners. Enforcement through litigation assumes a functioning judiciary trained in Real Property Law where the costs of litigation are not prohibitive for an individual citizen and where there is sufficient documentary evidence to support a claim.

Venue. There is no reason in principle why claims relating to real property need to be heard in a special court setting; the ordinary jurisdiction of a court should suffice. During the 1990s, however, many transitioning economies established specialized commercial courts as part of package of commercial law reforms. The jurisdiction of the commercial court is usually defined by reference to whether one of the parties is a commercial entity (a business person or commercial legal person) or whether the transaction has a commercial purpose. This kind of definition would suggest that disputes involving land for industrial purposes, for example, or claims by a foreign investor would fall within a commercial court jurisdiction.

Execution of judgments. If a claim is brought by a creditor to foreclose on a mortgage, effective enforcement requires that there be a system enabling bailiffs to seize the property, evict residents if permitted by law, and sell the property to recover the proceeds. In practice, in most fragile states and transitioning economies this is very difficult to achieve, particularly in relation to residential property. Common handicaps include: courts' willingness to hear an argument instead of granting an automatic execution; a corrupt or unprofessional bailiff; legal protections of tenants and/or residents; and the lack of a functioning market for distressed property encumbered by tenants or residents.

Land use. After the fundamental steps of Real Property Law described thus far have taken place, it is desirable to have laws governing land use and potential conflicts in use, for example:

- Law on Land Use and Monitoring Land Use
- Law on Mining and/or Mineral Extraction
- Law on Environmental Standards/Controls
- Law on Conservation of Nature Reserves
- Law on Urban Planning
- Law on Public Health requirements for residential and commercial buildings
- Law Recognizing Customary Ownership of Land by Indigenous Peoples or Local Communities.

This checklist is law-centric. However, effective resolution of land distribution, land use and land tenure issues requires much more than a simple technical legal intervention. In many fragile states and transitioning economies, legislation may exist on paper but neither resources nor an empowered agency are created in order to apply it. Moreover, there may be a lack of capacity to understand or a lack of political will to confront social inequity and social costs imposed through stark inequalities of land rights and improper exploitations of land by elites.

Implementing Institutions

As with other areas of CLIR, merely enacting real property legal reforms is meaningless without implementing institutions that support the creation and enforcement of real property. These implementing institutions include:

A highly competent registrar. A competent registrar is necessary for an efficient property law system. The registrar must be free from political influence and have sufficient resources to support the creation and maintenance of reliable, accessible registries of real property. The registry/registries must operate to make transactions easier by being accessible at low cost and reliable enough to convince those with registered interests in real property that they will profit in the future from investments made now. The effectiveness of a register is strongly influenced by the following issues:

- **A single cadastre and ownership register:** Many transitioning economies (with foreign donor support) returned to a pre-war model separating the cadastral mapping agency (responsible for the technical records regarding real property) and the land ownership registry. The optimal situation is a single, unified registry that reduces direct costs and reduces the likelihood of error. Despite the cost of establishing new bifurcated systems, specialists in this area predict a need to re-establish a centralized registry in many transitioning countries. Central registries need to have actual and effective control over regional registries including financial monitoring and data

coordination. Furthermore, the central registry should assist the regional registries by providing technical assistance, a complaints procedure, and archiving and budget support.

- **Unifying registers of agricultural and urban land.** Centrally planned economies result in highly sectoral land use and separate administrations for agricultural and urban land. In many countries where there was a multiplicity of privatization programs, documentation is scattered across diverse government offices. This uncoordinated system causes undue delays in the quieting of title and resolution of disputes. Registries need to be centralized to capture efficiencies, correct errors, and allow adaptive use of land as the economy changes.
- **Correcting errors.** Established registries need to have in place both an administrative system for detecting and correcting inevitable errors and to have recourse to (and be subject to) dispute resolution procedures where there are conflicting claims about the same real property.
- **Computerization.** Some transitioning economies have successfully computerized their real property registration system. Many transitioning economies, such as Egypt and Indonesia, have not. Many less developed countries have barely begun to register property at all. The appeal of a publicly accessible computerized register needs to be weighed against the actual cost of implementation. More importantly, the risk of system failure is significant in countries where complex computer networks, reliable power supplies and budgets for maintenance and expansion are not in place. Exclusive reliance on computerized records is a high-risk strategy.
- **Registry staff.** Registry staff must have a clearly defined mandate, adequate pay and training, and sufficient resources to carry out their work. Mandatory registration carries with it the risk of bureaucratic rent-seeking through corruption. A program supporting a Real Property Law reform should identify ways to support the registrar(s) through such approaches as short and long-

term technical assistance, resident advisors and mentoring, training curriculum development and execution, public information programs, and assistance in reaching out to the comparable registries in other countries.

Responsible government entities and land management. Often, responsibility for land, property registration, privatization and land management are spread throughout a government and legal system without effective coordination or consolidation. Responsible state entities may include:

- National Privatization Agency (where one exists)
- Local Privatization Agency
- Ministry of Agriculture
- Ministry of Land Management (if one exists)
- Ministry of Justice
- State land Survey Institute
- Land Management Departments at province or county level
- State Land Cadastre
- State Land Register

Given the great number of institutions and individuals who may be involved with the registration or transaction of a single piece of real estate, real property is an area in which the potential for fragmented governmental responsibility is high. In privatization schemes, multiple programs of privatization often occur, typically overseen by different government departments or agencies. Technical information about land mapping and the cadastre may belong to different departments or agencies and there may be no incentive to give up traditional jurisdictions and sources of income in order to create a single centralized register. The prospect of capital investment in the form of foreign aid may also entrench disparate approaches to the issues rather than facilitate efficient solutions.

For a land market to operate effectively, the provision of infrastructure (roads, sewer lines, electrical networks, telecommunications networks)

also needs to be coordinated effectively. Different approaches to the problems of public utility reform have been tried worldwide, including channeling provision of services through a single government department; centralizing operations and then privatizing them as a public/private joint-stock company; and creating a new coordinating agency. There is no single solution to the problem.

Judges and court staff must be competent, capable, and impartial. Although judges may have some experience addressing issues that arise from Real Property Law, frequently they do not, because the property market is relatively illiquid and commercial transactions have not advanced to embrace mortgages. At the macro level, Real Property Law, like any other area of law, will be undermined if the state lacks an independent judiciary; if judges have no meaningful training or experience in the application of property law or the principles of real property; or if the judicial system is simply corrupt.

Notaries. Particularly in real property transactions, the role of the notary is important in most Civil Law countries. There, real property transactions are usually required to be in writing in a prescribed form and are frequently also required to be notarized. The notary does work that would be done by a lawyer or a conveyancer in a Common Law system. In practice, the notary is the first checkpoint for establishing that the transaction is legal and is usually the person to register the ownership or transfer of rights. This is also required in most systems before the transaction has legal effect. Notaries typically apply their interpretation of whether a transaction is in compliance with the formal law (or Code). This interpretation may or may not be shared by the drafters, by market participants or by judges. Accordingly, any program of professional education or training in this area needs to include notaries as well as other professional groups.

Supporting Institutions

Real Property Law, like other areas of commercial or consumer law, requires support from the private sector in order to become part of routine, reliable

business transactions. **Banks and non-bank lenders** are central to real property since they are the source of the finance and so their institutional willingness and ability to embrace new forms of real property ownership will be important for the viability of the system. Institutions such as **real estate brokers** provide information to the public about available real estate. **Accountants** and **land valuers or assessors** are needed to establish market values of land. This can be a very difficult task in systems in which there are few transactions. **Land surveyors** are necessary to establish or update a cadastral system showing reliable land boundaries; **Auctioneers** will emerge and will be necessary over time to implement a system of real property. **Lawyers** play an important support role by representing land owners or prospective land owners in litigation.

Land administrators will be required to monitor and enforce land-use requirements and restrictions on particular land parcels. Industrialized countries that have experienced post-industrial pollution and urban sprawl tend to recognize land as a fragile and finite resource. One result is support for land use planning, the tightening of environmental controls, and the emergence of sustainability as a key element in decision making. As transitioning economies mature, there will be a need for professional land use planners and land administrators to formulate policy to help redress some of the problems caused by rapid privatization during the last decade.

Community advocates and local leaders have been used effectively in some places to shepherd rural land tenure claims and transactions through administrative or adjudicative processes (such as Kyrgyzstan) and to conduct legal rights education.

ADDITIONAL GUIDANCE, TOOLS, AND RESOURCES

There are many obstacles in the transition to privatized property. The word “transition” itself may be problematic in describing real property reform because it implies a known end-point. Problems emerge precisely because in many cases the end-

point and purpose of property law reform remain obscure to market participants.

Rights to transfer. In many transitioning countries, private rights of ownership are not comprehensive. Two typical scenarios are:

- (1) Where ex-collective or ex-cooperative land has been “privatized” by assigning former members of the collective (or a household) a lease or a land share that is a lifetime inheritable use right (usufruct) (as in Russia). This situation can be further complicated if some parcels of land are then released for full ownership by individuals or households, creating an erratic pattern of land use within a region.
- (2) Alternatively, an individual or household may have been given ownership rights in real property but without the right to transfer ownership either through a blanket time-limit or moratorium, or through establishing the state’s right to vet or pre-empt a transfer according to the identity of the proposed transferee. Whatever the purpose of such restrictions, they have the effect of defeating the full benefit of ownership.

Unless real property can be transferred, a property market can not emerge and the claimed economic benefits of privatization will not emerge. Property owners will have little incentive to invest in improvements to property and fund those

improvements with credit or in the expectations of being able to sell in the future, without the ability to sell their property, and recapture those improvement investments.

Many transitioning economies will need to create a system whereby property owners can capture the full value of transfer rights in their real property.

Environmental degradation. Typical problems include: (1) disincentives to care for remaining state-owned property; (2) state officials seeking to externalize the costs of private enterprise with no agency responsible for, or adequately funded to, monitor and police environmental degradation; and (3) new private owners seeking to exploit their property for immediate profit, particularly if long-term returns seem clouded by legal or regulatory uncertainty. The results include: deforestation, soil erosion, overgrazing, contamination of surface and ground water and soil, and construction without permits in both urban and agricultural areas.

Social polarization. The transfer of state-owned assets is seldom a perfectly fair process – inevitably there are tensions between the property-rich and the property-poor. In particular privatization programs have resulted in: (1) elites or “insiders” benefiting from disproportionate access to newly-privatized property; (2) schemes favoring one ethnic group over others; and (3) inadequate capital markets favoring those with accumulated wealth as purchasers.

Real Property Reform in Honduras: A Multi-faceted Proposition

“The entry into force in June 2004 of Honduras’ new Ley de Propiedad (“LdP”) represents an important new initiative to rationalize the country’s chaotic property system by recognizing settlers’ rights, resolving title disputes, and modernizing the property registry. The law includes the creation of a new entity in charge of property matters, Instituto de Propiedad, which has authority over both the real property register and the cadastre. The LdP began its reforms by concentrating on real property registries, with an ambitious plan to convert the entire system to electronic entries, coordinated with a national cadastral survey. This effort is supplemented by important administrative reforms underwritten by the World Bank. Currently, perhaps due to the complexity of the issues involved, there is a lack of knowledge regarding the intentions and anticipated benefits of property reform as it pertains to the daily lives of Hondurans. There also are significant challenges to the authority of the new law: its ultimate impact awaits resolution of cases challenging its constitutionality, brought by constituencies who are threatened by its ramifications and currently before the Supreme Court.”

Trade and Commercial Law Assessment – Honduras (January 2005)

Deregulation of urban housing. The privatization of urban housing in Central Europe and Eurasia has been a highly complex process. Prior to the 1990s, state ownership of property in countries in these regions was neither complete nor uniform. Accordingly, while most urban dwellers rented houses, or more usually apartments, from the state, not everyone was affected in the same way by privatization. Typically one dwelling (usually an apartment) was transferred to the private ownership of a family, but this was often insufficient to solve the country's housing shortage or to provide for the future needs of younger family members. Deregulation has meant the phasing out of rent controls, the creation of housing allowances, allowing utility prices to rise, and the dilution of tenants' rights.⁴ Not all state-owned housing has been privatized, but rent has been increased in response to the market reality that state subsidies will be inadequate to cover maintenance and operating expenses. In some countries such as Lithuania, purchase and sale of apartments is now more common than renting;⁵ in other countries, the property market is more immobile.

Mixed economic results from the housing sector. In Eastern Europe and Eurasia, many governments consciously used the privatization of urban housing at nominal or no cost to existing tenants as a form of 'soft landing' during the economic upheavals of the 1990s. One consequence is that governments did not realize the value of most properties and so the housing sector, which already had severe undersupply problems, remained under-funded. Without realistic property prices, clear ownership registration and a dynamic property market, financial institutions remain reluctant to lend against property, with the result that few new "owners" can afford improvements to their properties. This has been linked by some commentators to pressures on the construction industry in many countries. Housing shortages may also thwart labor mobility in many countries, but data on this remains inconclusive.⁶

Differential impact of privatization. In many countries where privatization has occurred, the

grant of property is to the household, sometimes in the name of a nominated "head of household" or head of the farming family. As a practical matter, where multi-generational families occupied the same dwelling or farmed land together, this reform has the virtue of simplicity. It will, however, continue to create problems. In some systems the definition of family is imprecise; the power of a nominal owner to deal with the property without the consent of other family members has led to requirements in many systems that all resident adults provide written consent when a major property transaction is involved; when reforms do not solve problems of housing shortages for young adult children; or when questions of inheritance remain. Although inheritance usually entails use of a formula in the Civil Code, it may be unworkable in systems where little alternative housing exists or where sub-division of farming land would make it unviable.

Restitution and compensation. In most countries where large amounts of property had been systematically expropriated by the state, a scheme for recognizing claims for restitution and making compensation was introduced as part of a privatization program. A key exception is Russia, on the basis that pre-Revolution claims would now be unworkable. Schemes of restitution vary by country. They may include compensation for legitimate claims in the form of the property itself, or other, equivalent property, or bonds or privatization certificates (vouchers) or cash. Restitution has worked best in countries with high levels of property productivity,⁷ plentiful property, and dynamic property markets. It has worked less well in countries with static property markets and incumbent tenants who cannot be evicted.⁸

Common property, condominiums and property owner associations. Where the usual form of urban housing was state-owned apartment blocks, privatization has resulted in shared ownership of common areas of apartment blocks and shared liability for maintenance and improvements. In theory a successful condominium or property owners' association requires mandatory membership, the right of the association to act as a legal entity,

and registration procedures that establish title to the property and allow the association to act in respect of the common property. These elements are not satisfied in most transitioning economies to date, resulting in considerable uncertainty about the rights and obligations of property owners in both fully-privatized and partially-privatized apartment blocks.

Reservation of real property for state use. Typically in less developed or transitioning economies, some types of property are set aside for state use and cannot be acquired or privatized. These include land occupied by state infrastructure such as roads, airports and military units; forests and bodies of water used for state purposes; land for public use such as squares, graveyards and watering-places; land occupied by educational and science institutions; national reserves and parks; the coastal zone; land owned by churches or religious institutions.

Foreign ownership. The acquisition of real property by non-citizens is controversial and politically sensitive in most economies, whether industrialized or in transition. Whether foreign individuals and legal persons (companies or other formally registered associations) can acquire full ownership rights in property is a question that differs from country to country. In some places, non-citizens may acquire residential property as well as buildings or other structures necessary for economic-commercial activity and enterprises and for foreign states to establish a consular presence. In other countries non-citizens are also permitted to purchase full ownership rights in residential property. More often, land laws prohibit foreign individuals or legal persons from acquiring agricultural land and grant only leaseholds of less than 99 years over residential and commercial property.

Issues in Post-Conflict Settings

The last decade has seen a host of countries emerge from armed conflict, only to experience prolonged social conflict and violence provoked by insecurity of land tenure or problems of dispossession. In settings such as Kosovo, East Timor, Iraq or Afghanistan, land titling of itself is not the solution. Systems of title may have been destroyed or may themselves

be the root of conflicting land claims. In many cases, court-annexed ADR procedures or non-court, community-based mediation and arbitration have been used with success, as have specially created property commissions or claims commissions. Often these are interim steps but also necessary prerequisites for creating a legitimate, functional system of land titling and registration.

Accessing Key Resources

Accessible; key resources exist that detail, develop and debate the numerous and complex components of Real Property Law and land reform, as well as provide information about regional and international initiatives to support legal reform in this area. These resources include the following:

USAID (www.USAID.gov) employs numerous specialists in land tenure, rural development, and land policy in its various offices and bureaus, including its regional bureaus and its Bureaus of Economic Growth, Agriculture and Trade; Democracy, Conflict and Humanitarian Assistance; and Policy Planning and Coordination.

Since issuing its groundbreaking report, *Land Policies for Growth and Poverty Reduction* (2003), the **World Bank** has helped generate broad consensus among stakeholders (governments, civil society, donors, etc.) on the principles for real property-related interventions and how to coordinate them so as to maximize synergies. The World Bank has developed a significant resource base in the specific area of Agriculture and Rural Development. (<http://lnweb18.worldbank.org/ESSD/ardext.nsf/11ByDocName/AgricultureRuralDevelopment>). Also, the **World Bank's** Doing Business project (<http://rru.worldbank.org/doingbusiness>) is an important source of baseline information pertaining to registration of property.

Various institutions of the **United Nations** are directly involved with issues of land reform and land policy. They include the UN's **Food and Agricultural Organization** (www.fao.org), which is charged generally with defeating hunger, and in particular focuses special attention on developing

rural areas, home to 70 percent of the world's poor and hungry people. **UN-HABITAT** (www.unchs.org/default.asp), the UN agency for human settlements, is mandated by the UN General Assembly to promote socially and environmentally sustainable towns and cities with the goal of providing adequate shelter for all. In addition, the **UN Economic Commission for Europe** (www.unece.org) has a **Committee on Human Settlements**, which has developed significant resources in the area of land administration.

The **Land Tenure Center** at the University of Wisconsin-Madison, (www.ies.wisc.edu/ltc) serves as a global resource on issues relating to land ownership, land rights, land access, and land use. LTC's focus is on the relationship of land to economic development, socio-political organization, and environmental sustainability. LTC's approach to research and training is multi-disciplinary and stresses local collaboration. Since its establishment in 1962, LTC has sought to foster widespread and equitable access to land because of the understanding that this is basic to viable economic, social, political, and environmental systems.

The **Rural Development Institute** (www.rdiland.org) is a nonprofit organization of attorneys helping the rural poor in developing countries obtain legal rights to land. Over the past 36 years, RDI professionals have worked with the governments of 40 developing countries, foreign aid agencies, and other partners to design and implement fundamental legal, policy, and programmatic reforms resulting in large-scale transfers of land ownership or ownership-like rights to the world's rural poor.

The **International Development Research Center** (www.idrc.ca) is a Canadian public corporation that works in close collaboration with researchers from the developing world in identifying the means to build healthier, more equitable, and more prosperous societies. Among the IDRC's chief areas of interest is the Environment and Natural Resources management, including specific emphasis on rural poverty and urban agriculture.

ENDNOTES

- 1 More information about the Land Net project can be found at www.landnetamericas.org.
- 2 Roy L. Prosterman and Tim Hanstad, Land Reform in the 21st Century: New Challenges, New Responses, RDI Reports on Foreign Aid and Development No 117, Rural Development Institute (March 2003), at 14.
- 3 See, e.g., Timothy Donais, The Politics of Privatization in Post-Dayton Bosnia, 3 Southeast European Politics 3-19 (June 2002).
- 4 William C. Thiesenhusen, Recent Reforms to the Urban Housing System in Central and Eastern Europe, Working Paper No 35, Land Tenure Center, University of Wisconsin-Madison (April 2000) at 16.
- 5 Land Tenure Center, University of Wisconsin-Madison, Country Studies: Real Estate Privatization in Selected Eastern European and Eurasian Countries (March 2001). Lithuania -- 16.
- 6 Thiesenhusen, *supra* note 4, at 46.
- 7 Land Tenure Center, *supra* note 5, at Lithuania – 8.
- 8 Thiesenhusen, *supra* note 4, at 18.

Secured Transactions

KEY CONCEPTS

What is Secured Transactions Law?

The Law of Secured Transactions, alternatively known as “Collateral Law” or the “Law of Pledge,” makes credit easier to obtain for individuals and companies. It achieves this by reducing the risk of loss as a result of default by the debtor by allowing creditors to have recourse to the property secured. “Secured Transactions” pertains to the laws, procedures and institutions designed to facilitate commerce by promoting transparency, predictability and simplicity in creating and enforcing security interests in assets. The asset used as security is “collateral.” (In many jurisdictions the term “securities” also refers to shares or stock of a company. In this chapter, the terms “secured transactions” and “security interests” refer to collateral used as security, in which a creditor has a security interest, as opposed to a shareholder’s rights in relation to shares or stock.)

Security can be created over assets (“property”) and this property may be real property (such as land or buildings, as discussed in the previous chapter), personal property (including so-called “movables,” such as equipment, inventory or motor vehicles), or intangible property (for example, a

farmer’s harvest due the following year, or intellectual property rights). In each case, the property itself is the collateral and the security interest is the right that a person has to seize and sell it in case of default by the debtor.

Unless otherwise noted, this chapter deals with the use of **movable** and **intangible property** (hereinafter collectively referred to as “**personal property**”) as collateral – as opposed to real property. There is a direct relationship between Real Property Law and the Law of Secured Transactions that should not be overlooked, and, in fact, could benefit from strengthened coordination in the field.¹ Namely, both topics concern the ability of a citizenry to access capital by securing loans and other financing against property they already own. In addition, both involve the development of systems that clarify and document property rights and allow for formal registration of property. Both further implicate vital issues of enforcement – that is, the ability of a creditor to seize and sell the secured property, whether real or personal, upon the default of a debtor. Both laws thus concern the effectiveness of such implementing institutions as the judiciary, the courts, and bailiffs,

Definition: A system that taps the asset value of personal property, thereby facilitating commercial lending. Under secured transaction regimes, debtors use their property as collateral to secure loans, thereby granting creditors a “security interest” in the property – that is, a right to seize and sell the property in case of default by the debtor.

and supporting institutions as professional associations, lawyers, and law schools.

The term “Secured Transactions Law” may refer to a single, fundamental piece of legislation – for example, Article 9 of the Uniform Commercial Code (UCC) in the United States, which governs security over personal property – or it may refer to a patchwork of different statutes, case law, and other sources of authority (in Common Law jurisdictions) or a combination of Civil and Commercial Codes and special laws (in Civil Law jurisdictions).

The development of Secured Transaction Law pertaining to personal property allows individuals and companies who may not own real property, or who otherwise lack meaningful access to credit, to become much more viable participants in their economies. Borrowers who may use personal property to secure their loans give lenders greater confidence that the loan will be repaid, or that, if it is not repaid, the lender will be able to seize the secured property instead.

Before the promulgation of modern Secured Transactions laws, the convention was that the creditor had to physically take possession of any movable property offered as collateral to protect his rights. This obviously does not work, however, when a debtor needs to use collateral such as inventory or equipment to run his or her business. In modern secured transactions, the debtor can retain use of the asset that is serving as collateral for a loan.

Security can be created over the property of companies or over the property of individuals. A reliable system for allowing assets to be used as collateral is important for underpinning consumer credit and allowing individuals and companies to access business loans. Basic, historical forms of security interest in the Common Law and Civil Law worlds are labeled differently and are subject to different procedural rules – for example, the “hypotheque” in Civil Law systems is a functional equivalent of the mortgage in Common Law systems, even though the rules governing them may vary. Both Common Law and Civil Law jurisdictions also use pledges, securing charges,

liens, and security interests as property claims over personal property.

The Law of Secured Transactions varies from jurisdiction to jurisdiction. In the United States, the disjointed nature of Secured Transactions Law led to attempts to promote a single, harmonized approach, which culminated in Article 9 of the UCC.² This effort in turn inspired reform in Canada which then became the preferred reform model for Australia.³ In Civil Law systems, the EBRD’s Model Law on Secured Transactions, first published in 1994, is an attempt to encourage harmonization of law in this area.⁴ Similarly, a Model Inter-American Law on Secured Transactions was drafted with the active participation of leading specialists in the Americas and was endorsed by the Organization of American States in 2002.⁵ The advantage for transitioning economies is that it may be possible to unify the Law of Secured Transactions in a way that has proven difficult in industrialized economies.

The stability of a Secured Transactions Law is often tested in its treatment of ‘priorities’ or conflicting claims relating to the same collateral. What makes non-possessory interests in collateral possible is a system of registration that certifies that a creditor has legal right to possess and dispose of debtor’s property in the event that the debtor defaults. The registration system is charged, among other tasks, with notifying third parties that the debtor’s collateral is already subject to a prior security interest. Third parties with an interest in the debtor’s borrowing arrangements include potential purchasers of a debtor’s business, potential lenders, transaction partners, shareholders, family members of an individual, and others.

Multiple interests may be created in the same property. Secured Transactions Law adjudicates among these multiple claims by assigning them an order of priority. Where the collateral has been accurately valued and the priority of claims is clear, the disposition of the property if the debtor/borrower defaults is fairly straightforward. Questions of priority usually arise in relation to default. Where the default is due to corporate insolvency or a

Kosovo's Pledge Filing Office

"The Pledge Filing Office [established in 2001] appears efficient in its purpose of maintaining, indexing, searching-retrieving, and providing public access to all filed pledges. To date, about 15,000 pledges have been filed there. A typical life history of a filed pledge is as follows:

- most filed pledges are made on standardized forms which include the data required by Regulation 2001/5 (name and address of debtor and creditor; description of the collateral including serial numbers where applicable, etc.);
- when the creditor first takes the pledge, it transmits the form by email or fax to the Filing Office;
- the Filing Office retains the information both electronically and in hard copy;
- the data in the pledge is indexed electronically by name of debtor; name of creditor; type of collateral, and serial or other identifying number where applicable; and
- when the debt is paid the filed pledge is terminated by the filing of a termination statement.

"[S]ample searches . . . were able to find a particular purchase-money pledge of a Fiat van several times by searching under each of several categories, including company name of the debtor; individual first and last names of the responsible debtor officer; name of the creditor; make and model of the van, and serial number of the van; and we were told that any member of the public can come in and do the same. (The clerk in charge was helpful and polite, which is an important requirement for an office of this kind.) Collateral such as inventory and receivables is indexed by category type, although obviously without unique identifying data such as serial number. The fee for filing a pledge is five Euros; there is no fee for a search or for filing a termination statement."

CLIR Assessment Report for Kosovo (September 2004).

personal bankruptcy, insolvency or bankruptcy law, to the extent that it is in place and functioning, deals with the situation of multiple claims by creditors. The main purpose of a priority regime is to avoid conflict among claimants by giving advance notice to persons who wish to deal with the property about existing claims that have priority. A secondary purpose is to provide an easy means to resolve disputes in cases where they actually arise.

Company Law should be consistent with Secured Transactions Law and should require companies that create security interests to register these interests and should then provide for a register in which a company's secured interests can be registered. Bankruptcy Law should similarly be consistent with the basic principles and procedures of Secured Transactions Law. Taxation law also affects Secured

Many countries have multiple registries for different types of movable property, such as cars, ships, and even hotels. This system can lead to confusion and places the burden on potential creditors to have to search in multiple places. As the acceptable forms of collateral grow in type and number, the trend is toward the creation of a single Secured Transactions Law in a country. This trend also includes the development of a unified or linked registry scheme that allows third parties to easily assess what collateral is already the subject of a secured interest and what the debtor/borrower's exposure to other creditors may be.

Effective support for Secured Transactions Laws begins with a clear and coherent legal framework. Legislation – whether through single or multiple laws – should clearly define security interests, identify who has capacity to create them, define (or exclude) particular types of transactions in which security interests can be created, outline the procedures for creating and registering securities, outline the consequences of registration and failure to register, and define the priority of secured and unsecured creditors.

Transactions Law, particularly if the system for taxing land encourages deliberate undervaluation for avoidance of land tax or stamp duty upon transfer.

Although an integrated set of commercial laws that are complete and internally consistent is highly desirable, it has been possible in a number of transitioning economies to create a Secured Transactions Law without a functioning Company Law or Bankruptcy Law. Similarly, despite its commonalities in purpose and procedure with Secured Transactions Law, Real Property Law reform has not always been a precondition for establishing viable systems of security over movable property.

Legislation in single or multiple laws should establish a security (or collateral) registry or registries. Ideally there should be a single registry for secured interests, but more often there are different registers for different kinds of debt, property and/or security arrangement, while some security interests remain unregistered. For example, a legal system may have different registers for:

- Ships
- Intellectual property (trademarks, patents, plant varieties -- Copyright may or may not be registered)
- Crops, wool and livestock (including liens in growing crops)
- Life insurance policies

- Stock or shares (both private and public companies are usually required to register their shareholders and the extent of each shareholding)
- Land and buildings
- Chattels (including movable property such as motor vehicles or motorbikes)

If more than one register exists, it is preferable that registration is centralized, or that the registers do not overlap. In practice, when a new registry is established, it should not require registration in the old registry, or alternately, the scope or type of property covered by the new registry should be quite different from that of an existing registry or registries.

Legislation should provide for speedy, automatic enforcement of collateral by creditors in ordinary cases where the debtor defaults. In the event of a debtor's default, Secured Transactions Law, as well as the law of civil procedure, should permit the creditor to seize the collateral and sell it to satisfy the secured claim. The law should allow enforcement to take place quickly and inexpensively, because personal property typically has little value as collateral unless it can be quickly and inexpensively seized and sold. Enforcement should be supported by a system of bailiffs or court officers who are empowered to seize secured assets when a debtor defaults and implement the necessary procedures for transfer of possession, title, or liquidation.

To avoid abuse of the system by creditors, the law should permit debtors to request a stay of

Non-possessory Collateral Law Means Greater Access to Capital for SMEs in Slovakia

Until 2003, Slovak loan officers were required by law to accept only two forms of collateral: fixed assets, or movable property surrendered to the loan officer until the loan was repaid. This collateral criterion was difficult to meet for micro- and small business owners, especially farmers and other entrepreneurs whose movable assets were central to daily operations.

By introducing an amendment allowing non-possessory collateral to secure loans, the Slovak government has opened an untapped source of finance for small business owners without requiring them to surrender the value-enhancing capital necessary for successful operation of their enterprises.

Miroslav Karpaty, Collateral Law Removes Major Lending Barrier, *The Slovak Spectator*, July 1, 2002 at <http://www.slovakspectator.sk/clanok-9673.html>

enforcement proceedings, using a summary proceeding with clear, short time limits within which a decision must be made. Appeals should be allowed only in exceptional cases. Mandatory arbitration is also an option to avoid court-based litigation.

Where the debt is large, the debtor has become insolvent, and there are multiple creditors, Bankruptcy Law should provide clear procedures for confirming the priority of claims and reaching agreement among creditors about how to proceed and how to deal with the assets of the debtor.

Secured Transactions Law is a fundamental building block for transitioning to a market

The World Bank Doing Business Reports find that effective secured transactions laws eliminate legal obstacles to sharing credit information, focus public registries on supervision, give secured creditors priority to collateral, and introduce summary enforcement proceedings. Collateral registries should be cheap, efficient, and require a “notice-only” filing system. Specific recommendations concerning the secured transactions legal regime follow:

- Information sharing among private credit bureaus should be encouraged—with positive as well as negative information being shared
- The law should define the specific and complementary roles of public registries and private credit bureaus
- Courts should be made more efficient to enforce the rights of creditors, especially unsecured lenders
- Expanding the providers of credit data to include trade creditors, retailers and utilities increases the power to predict default and expands credit
- Creation of a universal security instrument covering all assets and debt, so that potential borrowers with any kind of collateral will no longer miss out on loans

The World Bank Doing Business Reports (2004-2006)

economy. Secured Transactions Law is important in both transitioning and post-industrial economies because it reduces the cost of lending by providing creditors maximum information about a potential borrower’s financial position. The establishment of a computerized collateral registry has been a success story in a number of Eastern European countries as it can further reduce the cost and improve the organization of this information. The broad-based access to finance created by a Secured Transactions Law allows entrepreneurs to finance productive investments in their enterprises, secure additional inventory, or even serve as start-up capital.

However, significant hurdles can undermine reform to a Secured Transactions Law. The benefits of a Secured Transactions Law are not always distributed evenly throughout the private sector. For example, when business conglomerates or multinationals have ample access to capital, the demand of consumers and small-scale entrepreneurs to access credit through secured collateral may be a low policy priority. Also, banks may be unwilling to lend to consumers or small businesses only on exploitative terms. In some cases, entrenched power among a corrupt elite minority may compel the elites to stall or undermine a comprehensive registry system if it undercuts their power to siphon revenue from users.

If passed, a Secured Transactions Law may face delays in implementation because often legal professionals and judges require time to understand the complexities of the law. More fundamentally, the Secured Transactions Law may underscore the need to revisit Real Property Law reform if this is unfinished business in that economy.

A more standardized and predictable system for creating interests should stimulate greater lending activity in an economy, but the effectiveness of a Secured Transactions Law is conditioned first on the structure of the economy (i.e., who the lenders are, how the economy is structured, and whether there are structural impediments to gaining credit other than the law itself) and second upon the development of the other property, commercial and procedural laws referred to above.

MAJOR GUIDELINES

Legal Framework

Secured Transactions Law can exist as a single piece of legislation (a Secured Transactions or Collateral Law) or it can be a cluster of relevant laws and/or Codes. In Civil Law jurisdictions, the Civil Code typically contains provisions dealing with pledges or security interests, while the Commercial Code and/or Company Law may contain provisions that govern a company's capacity to create security interests and obligation to register securities.

Reforms to Company Law and Bankruptcy Law in transitioning economies sometimes take precedence over a comprehensive overhaul of Secured Transactions Law. For this area of law to function effectively and promote creditor lending, different areas of law must be coordinated. It is also important for both local policy makers and consultants providing technical legal assistance to recognize social and institutional barriers to direct enforcement of security interests. An example in post-Soviet countries is the "right to occupy" a residence that may in practice take precedence over a secured lender's right to foreclose on the loan and sell the property.

Core Principles. In addition to its Model Law, the European Bank for Reconstruction and Development has developed a set of Core Principles of Secured Transactions,⁶ which generally state the following:

- Security should reduce the risk of giving credit, leading to an increased availability of credit on improved terms.
- The law should enable the quick, cheap and simple creation of a proprietary security right without depriving the person giving the security the use of his assets.
- If the secured debt is not paid, the holder of the security should be able to have the charged asset realized and to have the proceeds applied towards the satisfaction of his claim prior to other creditors.

- Enforcement procedures should enable prompt realization at market value of the assets given as security.
- The security should continue to be effective and enforceable after the bankruptcy or insolvency of the person who has given it.
- The costs of taking, maintaining and enforcing security should be low.
- Security should be available
 - over all types of assets
 - to secure all types of debts
 - between all types of persons (i.e. natural and incorporated)
- There should be an effective means of publicizing the existence of security rights.
- The law should establish rules governing competing rights of persons holding security and other persons claiming rights in the assets given as security.
- As far as possible, the parties should be able to adapt security to the needs of their particular transaction.

Types of Security. As previously stated, most jurisdictions separate the concepts of (a) mortgages in real property; and (b) security interests created over personal property (again, movable and intangible property), and regulate them through separate legislation. The law should clearly define the types of property that can be taken as security. Under Real Property Law, land and buildings are usually unproblematic and recognized as basic forms of security. Under Secured Transactions Law, any type of personal property should be able to be used as collateral. In practice, legislation typically excludes certain types of property as collateral (for example, cattle are often excluded from acceptable collateral). Different legal systems also place prohibitions on who may borrow, even where security is provided .

Under both Real Property Law and Secured Transactions Law, **ordinary securities** (such as mortgages, charges , liens and pledges) occur

when the debtor grants the creditor an interest in the property. An ordinary security creates a new proprietary interest in the property in the creditor's favor or transfers an interest from debtor to creditor. A **deemed security agreement** occurs where the creditor grants the debtor an interest in the property. In this case, the creditor becomes the owner of the property, but gives possession to the debtor. The obligation is secured because the creditor remains the owner of the property until the debt is repaid. Examples include conditional sales, hire purchase agreements and financing leases (including leasing, hire purchase agreements, bailments, sales by installment and reservation of title arrangements). These transactions are often documented in a bill of sale, regardless of whether the transaction creates a security interest. They may or may not be required to be registered.

Both ordinary and deemed security agreements protect the creditor by allowing it to claim the secured property (or collateral) in priority to the debtor's unsecured creditors. The various specific types of security that should be anticipated by a framework law are as follows:

Mortgage. A mortgage is a security interest created in real property (land and/or buildings) and is typically regulated by Real Property Law. In a mortgage, the creditor gains rights over the secured property, although the debtor usually retains possession. A mortgage can involve the creditor obtaining the legal title (ownership right) to the property, subject to the obligation to return the title when the debtor has discharged all its obligations under the loan.

Charge. A charge is an interest created in property where no transfer of ownership is involved. The debtor may continue to use and deal with the property after creation of the interest. A fixed charge affects specified property, while a floating charge (used in commercial transactions in the Common Law world) affects property in the hands of the debtor the of the time being and becomes fixed when a specified event, such as default, occurs.

Possessory pledge. A possessory pledge can be created with or without a contract (for example, where a person performing work for another may retain the customer's goods in his or her possession until the work has been paid for). This kind of security interest requires continuous possession of the property in question.

Lien. Liens are typically created by operation of law (typically by a statute). An example is allowing an unpaid vendor in a sale of goods situation to stop the goods in transit and resume possession until the price has been paid.

Assignments and transfers of intangible property. Assignment of accounts receivable is usually included in secured transactions legislation, whether or not it is a secured transaction. Transfers of rights in intellectual property also fall in this category. Where the debtor fails to repay the debt the creditor can exercise full rights of ownership over the assigned property.

Financing leases. A lessor is generally used to allow the debtor (the lessee) to possess and use property that it does not own. A financing lease usually lasts for the working life of the property and allows the creditor (lessor) to recoup its capital cost plus interest, the idea being that at the end of the lease the property will have little residual value. The lessee under a financing lease has neither the option nor the obligation to purchase the property. This approach contrasts with an operating lease, where the property is not security for the performance of the transaction and the rental paid is simply the use-value of the property, such as a rental car. Hire purchase and conditional sale are also different, in that at the end of the transaction ownership passes to the debtor.

Factoring. A "factoring" arrangement is not a security as such. Here the book debts of a business are sold to a factor, who is then entitled to receive, directly or indirectly the amounts due under those debts. This arrangement can be used by traders to raise capital, for commercial convenience, or to secure a loan. This kind of transaction is deemed to be a security and is required to be registered in

order to create predictability within the system when dealing with receivables.

Registration. A fundamental component of any modern secured financing system is the creation of a registry. The Secured Transactions Law should provide for the process of registration and for its legal effects. In most jurisdiction regulations are also used to regulate administrative aspects of the registry's operations. With respect to the process for registration of collateral, the law should set forth:

- The scope of each registry
- The type of security interests that can be registered
- The procedures necessary for registering secured interests (these are distinct from the substantive law creating and describing the range of security interests)
- Time limits for registration and penalties for situations in which registration is mandated. Often registration of a security interest is not mandatory and a creditor has discretion to decide whether to register his or her interest.
- Procedures for amending registration
- Procedures for challenging flawed or fraudulent registration
- As detailed below, specific rules pertaining to priorities and perfection.

Priorities and Perfection. If a borrower uses the same collateral to secure two loans, and then defaults on both, which creditor has the right to seize the property, sell it, and then pay himself back first? Determining priority between competing claims is a primary objective of registration. Security interests that are registered (or “possessed”) first have priority over unregistered or later registered security interests, regardless of which is “perfected” first.⁷ Under Article 9 of the UCC, a secured interest is “perfected” when (i) it has attached (that is, the security interest is enforceable against the debtor, either through possession or voluntary agreement between the parties, value has been given, and the debtor has rights in the collateral); and (ii) the creditor has

taken all the steps required by the Article – usually possession or registration. An unperfected claim is valid between the debtor and the secured creditor, but, with respect to priority, may be behind security interests created later in time, but perfected earlier than the interest in question.

Implementing Institutions

As with other areas of commercial and institutional legal reform, merely enacting a Secured Transactions Law is meaningless without implementing institutions that support the creation and enforcement of secured transactions. These implementing institutions include:

A highly competent registrar. The registrar should be free from political influence and supported in a way that allows it to create and maintain a reliable, accessible registry. The idea of registration assumes a functioning government agency that is accountable, transparent, reliable and efficient and that have sufficient incentive and resources to provide a trustworthy register and the services necessary to make it function. The registry must have a clearly defined mandate, adequate and well trained professional and administrative staff to fulfill that mandate, and sufficient resources to carry out its work. Mandatory registration carries with it the risk of bureaucratic rent-seeking through corruption. In transitioning economies the registry is typically designed with minimal or no discretion for the registrar, to avoid opportunities for corruption and/or challenges or legal liability for the registry.

A program supporting a Secured Transactions Law should identify ways to support the registrar through such approaches as short and long-term technical assistance, resident advisors and mentoring, training curriculum development and execution, public information programs, and assistance in reaching out to the comparable registries in other countries.

The utility of registration largely depends on whether the register is comprehensive, up to date, and administered professionally. Ideally the register will be computerized and accessible to the public at a minimal, cost recovery level. Where costs are too

low or zero, it may distort the process by attracting a high volume of low-value cases. In addition, the registry and its officers should be subject to general laws governing administrative procedures and administrative review (assuming that these are functional). Finally, the registrar's actions should be regarded as legally binding and should routinely be upheld by the courts if challenged unless there is concrete proof of fraud or a breach of administrative procedural law.

Independent, competent and capable Judges, Lawyers and Notaries. Lawyers and judges may have some experience with secured transactions, even in jurisdictions without a secured financing system. At the macro level, Secured Transactions Law, like any other area of commercial law, will be undermined if the state lacks an independent judiciary; if judges have no meaningful training or experience in the application of commercial law, or the principles of secured transactions; or if the judicial system is simply corrupt.

At the transactional level, lawyers and notaries will need enhanced training in the types of transactions, for which secured interests are being created. This is particularly true where a system has previously allowed a limited number of secured interests and notaries have played a gate-keeping role in checking documentation for conformity with legislative requirements.

Clerks and Bailiffs are often required or needed to execute judgments arising from Secured Transactions Law – specifically, the reclaiming of collateral upon default. Bailiffs may operate under the direction of the courts and judiciary or they may be a branch of the Ministry of Justice. For secured transactions in particular, the role of the court clerk or bailiff is very important when it comes to enforcement of secured interests. The danger of corruption at this level is very real, and the system will lose its utility if a creditor with priority cannot move against the collateral. Accordingly, this area needs to focus on the para-professional groups such as clerks or bailiffs, which may determine the success of the system in practice. Without a functioning bailiff or state-

sanctioned private enforcement system, Secured Transactions Law may be rendered infective.

Supporting Institutions

Secured Transactions Law, like other areas of commercial or consumer law, requires support from the private sector in order to become part of routine, reliable business transactions. Banks and non-bank lenders are central to secured transactions where they are the source of the finance and so their institutional willingness and ability to embrace new forms of secured transactions will be important for the viability of the system.

Private credit providers, such as leasing companies, may initiate the development of new forms of secured transactions and establish industry-wide standards for these transactions. For assets to be used as effective collateral in commercial or consumer transactions, they must be able to be reliably valued, and in the case of default, there must be a reliable system for realizing the value of the assets for creditors either through private sale or auction. Accordingly, institutions such as **appraisers and auctioneers** will emerge and will be necessary over time to implement a system of secured transactions.

Business associations can play an important role in both identifying problems with provision of government services such as registries, and in explaining in lay-terms to members how new forms of secured interest may operate to support and extend commercial transactions. **Consumer groups** will similarly serve as an important voice for advising the public of their rights in relation to consumer credit. **Lawyers, notaries and universities** will also constitute important sources of support for the principles and implementation of a meaningful Secured Transactions Law.

ADDITIONAL GUIDANCE, TOOLS, AND RESOURCES

In Northern Europe and North America, the commercial law reform agenda, including public education, legislative drafting, and professional development, is often driven by well established

business and professional organizations. It is unthinkable that a law would pass in many countries without significant input from the bar association and numerous other trade and professional organizations. Moreover, law reform efforts often start with public policy studies and research by specialized academic units or think tanks, usually with a clear articulation of the rationale and likely cost/benefit outcomes of the reform. In contrast, the trade and professional organizations in many less developed and transitioning economies do not have sufficient political strength or membership commitment to voice a collective opinion about such laws.

Professional and non-government organizations are responsible for themselves and are not the responsibility of the state. Even so, the state can encourage their contributions to the legislative reform agenda by actively engaging these organizations to provide input into the reform process. The arena of Secured Transactions Law is one in which the business community has a particularly strong interest with respect to developing and pursuing an agenda of reform. CLIR projects can assist in stimulating and encouraging the development of broad-based input into the enactment and implementation of a Secured Transactions Law. Specifically, the private sector should be asked for feedback on legal reforms. Many associations have members with the capacity to provide cost-benefit analyses to determine the economic impact of proposed changes. Once associations begin to understand that their feedback is valued, they will tap into these resources. Unfortunately, many groups feel that any attempt at change is likely to be ineffective, a feeling encouraged by lack of consideration when they do attempt to assist in reforms. CLIR projects can assist by working with state institutions to understand the ultimate value of private input and to devise ways of acknowledging and integrating the perspectives of those groups most affected by changes in the law.

Accessing Key Resources

Easily accessible, key resources exist that detail, develop and debate the numerous and complex

components of Secured Transactions Law, as well as provide information about regional and international initiatives to support legal reform in this area. These resources include the following:

USAID (www.USAID.gov) has engaged in numerous projects throughout the world supporting the development and implementation of Secured Transactions Laws. Important lessons can be drawn from USAID-sponsored activities in Russia.

The **European Bank for Reconstruction and Development** (www.ebrd.com) has developed a Secured Transactions Project which encourages countries to modernize their collateral laws and offers assistance at all stages of the reform process.

Since 2002, the **UN Commission on International Trade Law (UNCITRAL)** (www.uncitral.org) has sponsored a **Working Group on Security Interests**, which convenes regularly to discuss and report on issues of mutual concern.

The **Handbook on Albanian Collateral Law**, by Yair Banares and Ronald C.C. Cuming, details a successfully implemented collateral law and registry system in the international development context.

Secured Credit for Jobs and Economic Growth (IRIS, 2000), by Allen Welch, examines weaknesses of substantive law in Bangladesh relating to movable property financing, and outlines concrete policies that would improve the legal climate for movable property financing law.

ENDNOTES

¹ See Jolyne Sanjak, Effective Property Rights Systems/ Secured Transactions Frameworks (Power Point Presentation prepared for IADB Roundtable, October 2003), located at www.iadb.org/mif/v2/files/USAID2003.ppt.

² The Legal Information Institute of Cornell University Law School maintains a copy of the UCC at www.law.cornell.edu/ucc/ucc.table.html.

³ See Australian Law Reform Commission, ALRC 64: Personal Property Securities (1993).

⁴ The EBRD's 2004 edition of its Model Law on Secured Transactions can be found at www.ebrd.com/country/

[sector/law/st/core/modellaw/model.pdf](#).

⁵ See OAS, Department of International Law, Model Inter-American Law on Secured Transactions (www.oas.org/dil/CIDIP-VI-securedtransactions_Eng.htm). An appendix to this Model Law, called the Inter-American Rules on Electronic Documents and Signatures (IAREDS), was also approved by the OAS and recommended for adoption among the member states.

⁶ The EBRD's list of Core Principles for a Secured Transactions Law can be found at <http://www.ebrd.com/country/sector/law/index.htm>.

⁷ See, e.g., EBRD Model Law on Secured Transactions, *supra* note 4, at Section 17.2.

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Bankruptcy

KEY CONCEPTS

Definition: Bankruptcy is a system for ensuring the equitable payment of debts when a debtor is no longer able to meet its debt obligations, either by reorganizing the debtor or liquidating the debtor and its assets.

What is **Bankruptcy Law**? The fundamental goal of Bankruptcy Law is two-fold: first, to allow for both the fair and efficient dissolution of businesses that are not viable and, second, for those businesses that have a chance at achieving viability, the opportunity to extend, reduce, or wipe out debt and protect themselves from pursuit by creditors. A modern, credit-based economy requires predictable, transparent and affordable methods of enforcing debt collection. Although Bankruptcy Law – also known as the Law of Insolvency – tends to attract interest mainly when enterprises face difficult times or even certain failure, the very existence of a clear and enforceable Bankruptcy Law has an important role to play in fostering economic growth. Insolvency systems provide a pre-determined set of rules concerned with the legal definition of insolvency, the liquidation or reorganization of the insolvent business, and the allocation of the financial consequences between stakeholders. In theory, this allows for efficient reallocation of the debtor's resources, which itself leads to greater public confidence in the security of their investments. In the absence of such a scheme, large, insolvent

companies may persist in draining public resources, at the expense of developing potentially productive enterprises; or, insiders may unfairly drain the assets of the company, while other legitimate creditors are denied access to the payments they are owed. Conditions such as these necessarily discourage foreign direct investment.

Creditors and debtors alike need convenient access to legal remedies in the event of a firm's insolvency. Without effective legal mechanisms and processes that are applied in a predictable manner, creditors may be unable to collect on their claims.¹ Without orderly procedures, the rights of debtors (and their employees) may not be adequately protected and different creditors may not be treated equitably.

Insolvency systems provide economic benefits beyond the firm in a variety of ways. Bankruptcy Law can provide businesses and their management with incentives for maintaining fiscal discipline and acting prudently with respect to corporate governance. This is a benefit to shareholders. The manner in which creditors and debtors are treated under a particular insolvency law can also influence the perceptions

of investors. Although insolvency procedures are implemented through the courts, the very existence of an effective insolvency system may establish incentives for negotiations between debtors and their creditors, which may lead to out-of-court agreements being reached “in the shadow” of the law.

Insolvency reform can be relevant for economies in transition, where it can play a critical role in addressing the problems of insolvent state-owned enterprises and for failing enterprises in need of a rescue or exit strategy.² In addition, the investment community and international financial institutions look at the quality of a transitioning country’s insolvency laws when assessing the quality of the country’s investment climate. Since the mid-1990s, insolvency has been one of the principle areas of legal reform efforts in developing and transitioning countries. The quality of a Bankruptcy Law (and its enforcement) may influence the extent to which parties are willing to extend credit to businesses and to commence insolvency proceedings in the event of a company’s failure. Financial institutions can leverage their lending capacity by securitizing financial assets if there is clarity as to the rights attaching to those assets, both prior to and following insolvency.

A sound Bankruptcy Law typically provides two options for businesses facing insolvency:

Liquidation or Rehabilitation. Liquidation, the more common form of bankruptcy, is the process of assembling and selling a debtor’s assets in an orderly and expeditious fashion in order to dissolve the enterprise and distribute the proceeds to creditors according to established law. Liquidation involves the appointment of an administrator (also called a “trustee”) who collects the non-exempt property of the debtor, arranges for its proper and supportable valuation, sells it, and distributes the proceeds to the creditors. Liquidation can include a piecemeal sale of the debtor’s assets or a sale of all or most of the debtor’s assets in productive operating units or as a going concern.

Rehabilitation – also known as “workout” or “turnaround” – is the process of reorganizing or restructuring an enterprise’s financial relationships

to restore its financial well being and render it financially viable. This process may include such measures as debt forgiveness, debt rescheduling, debt-equity conversions (swapping debt for an ownership interest), and other means. It may also involve selling the business as a going concern (selling the company as a whole, functioning business), in which case the procedure may be equivalent to similar sales under a liquidation proceeding. The rescue of a business preserves jobs, provides creditors with a greater return based on higher going concern values of the enterprise, potentially produces a return for owners, and obtains for the country the fruits of the rehabilitated enterprise. Thus, although the insolvency regimes of many countries only include the option of liquidation, increasing attention has been dedicated in recent years to rehabilitation as a crucial component of a sound Bankruptcy Law. Like other commercial law topics, rehabilitation may implicate alternative dispute resolution techniques such as mediation, which may help enable debtors and creditors to agree on how they will both strive to achieve commercial viability so that the enterprise may, in the future, be able to pay its debts.

Bankruptcy can either be entered into voluntarily by a debtor or initiated by creditors. The process of entry into bankruptcy is one that warrants especially close consideration – it should be neither too easy nor too difficult for either creditors or debtors to file for bankruptcy. Specifically, bankruptcy should be neither a tool for debtors to avoid debt nor a device for creditors to harass debtors. When a bankruptcy proceeding is filed, creditors, for the most part, may not seek to collect their debts outside of the proceeding. The debtor is not allowed to transfer, sell or dispose of property that has been declared part of the estate subject to proceedings. Furthermore, certain pre-proceeding transfers of property, secured interests, and liens may be delayed or invalidated.

Bankruptcy Law establishes the priority of creditors’ interests. When an enterprise enters into bankruptcy – either voluntarily or involuntarily – its debts are evaluated to determine the priority of claims. The difference between secured and

non-secured debt (discussed in the Secured Transactions chapter of this Guide) can be critical. When a secured creditor has taken the required steps to register or “perfect” his or her claim against specific collateral – thereby establishing a charge or lien against the collateral – the charge or lien is senior both to any other charges or liens that arise after perfection, and to all unsecured debt. (An unperfected lien is valid between the debtor and the secured creditor, but may be behind liens created later in time, but perfected earlier than the lien in question.) Thus, in a bankruptcy proceeding, secured claims are typically paid from the proceeds of the collateral. If the collateral is insufficient to pay the claim in full, the balance becomes an unsecured claim.

After secured claims are dispensed of, Bankruptcy Law assigns priorities to other types of expenses and debt. “Priority” refers to the order in which unsecured claims in a bankruptcy case are paid from the money available in the bankruptcy estate. Claims with higher priority are typically paid in full before claims in a lower priority receive anything. The following list is an example of how priorities may be considered under a Bankruptcy Law:

- Administrative expenses of the bankruptcy
- Unsecured, post-petition claims in an involuntary case
- Wage claims of employees and independent salespersons
- Contributions to employee benefit plans
- Claims of farmers and fishermen against debtors operating storage or processing facilities
- Layaway claims of individuals who didn't get the item they made the deposit on
- Claims for debts to spouse or children for court-ordered support
- Recent income, sales, employment or gross receipts taxes.

To be effective, the content and implementation of the Bankruptcy Law must be compatible and coordinated with other aspects of a country's legal

system. Whether a Bankruptcy Law will contribute to the realization of an economy's goals of financial stability and minimization of investment risk is significantly related to such matters as corporate governance, enforcement of contracts, Property Law, and Secured Transactions Law. For example, with respect to Corporate Governance, the prospect of an enterprise being forced into bankruptcy by its creditors may affect the degree of seriousness with which a company's board treats its duties. In addition, responsible corporate behavior is promoted where Bankruptcy Law assigns liability to those directors and officers who make decisions that are detrimental to creditors after the enterprise is clearly insolvent.

Bankruptcy Law shares with other commercial laws certain fundamental necessities, such as the ability to execute judgments, the need for competently administered registries for real and movable property, and the existence of sound implementing and supporting institutions such as courts, administrators and valuation professionals. Reforms to secured lending laws in particular can increase the access to credit of the many segments of society currently excluded or forced to rely on high-cost informal credit. But insolvency law reform should not be

The World Bank Doing Business Reports find that good bankruptcy regimes have the following features:

- Allowance for continuous operation of viable business;
- Simplify liquidation procedures and provide for efficient summary proceedings;
- Involve stakeholders in the insolvency process, including establish creditors' committees;
- Include judicial training in commercial litigation matters;
- Put in place an improved foreclosure process; and
- Pay bankruptcy administrators on the outcome of bankruptcy based on market proceeds.

The World Bank Doing Business Reports (2004-2006)

“Admirable in its objectives, the Bulgarian insolvency legislation bends over backward to include every possible opportunity for creditor participation. However, this attempt at ultimate fairness undermines the system’s effectiveness, generating lengthy, unnecessary litigation, numerous delays due to excessive exercise of appeal rights, and inconsistent legal standards for major issues such as valuation. The practical aspects of the system are further hampered by involvement of incompetent officials, improper compensation to receivers, inability to abide by legal time triggers within the Code, and overburdening of judges with administrative matters.”

CLIR Diagnostic Assessment Report for the Republic of Bulgaria
(March 2002).

conducted without considering and reforming Secured Transactions Law – and vice versa.

Moreover, to be properly implemented, an insolvency system’s procedural and substantive rules must be in step with the capacity of the relevant courts or agencies. Assistance programs involving such cross-cutting topics as court administration, establishment of registries, alternative dispute resolution, and anti-corruption all touch upon the development of effective bankruptcy systems. Projects involving Bankruptcy Law require careful coordination with the CLIR and other law-related initiatives of other donors, agencies, or international organizations.

MAJOR GUIDELINES

Legal Framework

Although many nations historically have attempted to address insolvency issues through broad provisions in their civil or commercial codes, an effective insolvency regime generally calls for a single Bankruptcy Law that covers certain fundamental aspects of enterprise liquidation and rehabilitation. That law is inextricably linked with the content and effectiveness such laws as Contract Law, Real Property Law, and Secured Transactions Law. The insolvency process should apply to all enterprises or corporate entities. Exceptions apply to financial institutions and insurance companies, which should be dealt with through a separate law or through

special provisions in the insolvency law whether they are state-owned or privately held.. State-owned enterprises should be subject to the same insolvency law as private enterprises.

The legal framework for Bankruptcy Law will typically include the following key components:

Commencement of proceedings. Debtors should typically be allowed access to

the bankruptcy system upon showing proof that the creditor is either in serious financial difficulty or insolvency Debtors should not be permitted, however, to use bankruptcy as a shield against a single creditor ; where such tactics are attempted, creditors should be able to seek dismissal of the proceeding.

For their part, creditors’ access to bankruptcy should be conditioned on demonstrating a debtor enterprise’s insolvency, which typically will be evidence of the enterprise’s failure to pay a matured debt. The preferred test for insolvency is the debtor’s inability to pay debts as they come due, like the “liquidity test.” This test is generally preferred over the “balance sheet test,” which determines whether an enterprise’s liabilities exceed the fair market value of its assets. The balance sheet approach is generally considered more costly and difficult to administer because it requires a appraiser to review books, records and financial data to determine the enterprise’s fair market value, or reasonable value that can be obtained between a buyer and a seller.

Commencement. Commencement of a bankruptcy action means (1) that debtors may not dispose of their assets (including repayment of debts that arose prior to the initiation of bankruptcy) without court authorization; and (2) that creditors, even secured creditors, may not seek to enforce their rights or remedies against a debtor or the debtor’s assets through such means as collection, adjudication, or

execution. The purpose of these restrictions includes the following:

- To promote the highest possible value of the enterprise. The sale of an entire business tends to generate more value than its piecemeal distribution among creditors and others. That said, it is generally agreed that a “stay” or moratorium on the ability of secured creditors to collect on the enterprise’s secured debts should be limited to a duration that allows fair opportunity to assess the business’s prospects or to sell the business, in whole or in part, for a higher price. After this reasonable period, the law should allow secured creditors to collect on the enterprise’s obligations as permitted under the Secured Transactions Law, the Property Law, or any other relevant law.
- To improve chances for enterprise rehabilitation. Although the moratorium on a secured creditor’s ability to collect the debt should be limited, the bankruptcy procedure itself is intended to provide for “breathing room” to evaluate whether the enterprise may in fact be rehabilitated. Where rehabilitation is judged to be possible, steps must be taken to negotiate with secured creditors to withhold, at least temporarily, from collection on the debt.

Creditor’s involvement and treatment. Bankruptcy Law provides for the safeguarding of creditor interests through the establishment of a creditor’s committee that enables creditors to participate in the insolvency procedure and monitor the process to ensure fairness and integrity. The law should provide for such mechanisms as a general creditor’s assembly for major decisions, and, in the case of rehabilitation, for creditor selection of an independent administrator who is charged with leading the enterprise into viability. The law should also anticipate the conflicting views of secured creditors and unsecured creditors. Namely, unsecured creditors will have a greater interest in sustaining the life of the business, which would increase the chances of their collecting on their debts. Secured creditors will almost always favor quick sale of their collateral, rather than the more

laborious and uncertain process of reviving the business. Administrators have the challenging role of reconciling the often opposing viewpoints in the course of a bankruptcy.

The role of the court. Bankruptcy Law should provide guidance as to how a court should exercise its discretion when deciding matters that involve a company’s economic or commercial viability. When the capacity of the judiciary is limited, consideration may also need to be given to actually eliminating the role of the judge entirely when determinations are made regarding the viability of the enterprise. For example, any authority of the court to overrule the creditors’ views on such matters should be treated very cautiously. Moreover, consideration can also be given to allowing the specified period of the rehabilitation proceedings to be extended only upon a vote of the creditors.

Corporate reorganization. Bankruptcy Law should set forth specific procedures for reorganization, or reference a set of rules that identify those procedures. The question of who actually controls the enterprise during the process of rehabilitation is a difficult one. Bankruptcy Law typically provides for two possible approaches: (1) control by an independent administrator; or (2) supervision of management by an independent administrator or supervisor. The decision to displace the enterprise’s management entirely should not be taken lightly, because such a radical step may undermine the enterprise’s ability to regain solvency. Specifically, the existing management’s understanding of the details of the business may be crucial to rehabilitation, just as their support may be necessary for complete turnaround. On the other hand, where fraud, gross negligence or other severe abuses are at issue, the law should provide for transfer of control of the enterprise into the hands of new management.

Corporate liquidation. Bankruptcy Law should set forth specific procedures for liquidation, or reference a set of rules that identify those procedures. In liquidation proceedings, management should be replaced by a qualified court-appointed administrator with broad authority to administer the estate in the interest of creditors. Control over

Thailand's Bankruptcy Regime: Inadequacies and Challenges

Thai Petrochemical Industry (TPI) has begun restructuring itself following the largest bankruptcy declaration in Thailand since the baht was floated in 1997. The experience of TPI has shown the systemic inadequacies of Thailand's Bankruptcy laws, and of the judiciary implementing these laws.

"In April [2003], the bankruptcy court booted out the creditors' managers at Mr. Prachai's (former President of TPI) behest, and put him back in charge, even though the law gives the creditors the right to appoint the administrators of a bankrupt firm, and the creditors by then held a majority shareholding. Supposedly neutral court functionaries helped Mr. Prachai mount the petition. ... Since then, the court has rejected the creditor's choice of administrator, and announced that the government should run the company instead...

[The government] is currently suggesting that the company be run by a committee of representatives of both Mr. Prachai and the creditors, with a government official in the chair to keep the peace—effectively condoning the abrogation of the creditors' rights."

Regulating Capitalism in South-East Asia: Unreformed, Unrefined, Unrepentant, Economist, June 19, 2003 at http://www.economist.com/World/asia/displayStory.cfm?story_id=1866973.

the estate should be surrendered immediately to the administrator except where management has been authorized to retain control over the company, in which case the law should impose the same duties on management as on the administrator.

Criminal provisions. Examples of crimes that may be enumerated in a Bankruptcy Law include knowingly and fraudulently concealing assets, lying under oath or on bankruptcy schedules, or knowingly and fraudulently filing a false proof of claim.

Implementing Institutions

Bankruptcy proceedings are generally supervised by and litigated in **courts**, which may be special Bankruptcy Courts (as in the United States), general commercial courts, or regular civil courts.

Regardless of their form, **judges** charged with handling bankruptcy cases must have a highly refined understanding of the purpose of Bankruptcy Law and the methods of its implementation. If final authority for insolvency cases is not lodged in a court, then an **insolvency agency** may serve a comparable role.

Administrators, known as **trustees**, are those individuals who are designated in place of a debtor's management to handle either the rehabilitation or the liquidation of an enterprise and who are accountable to the court, tribunal or agency with jurisdiction over insolvency cases. Administrators charged with liquidation typically catalog the assets of the debtor, hold initial meeting(s) of creditors, oversee bankruptcy sales, investigate claims, and pay creditors. (The actual selling of property and distribution of assets may be designated to another individual or entity known as the **liquidator**).

Administrators charged with rehabilitation must be knowledgeable about business matters and must

be capable of restoring the enterprise's financial well being, which may include restructuring debt, changing business practices, improving methods of corporate governance, or even selling the enterprise as a going concern. All parties involved with the liquidation and administration of an insolvent enterprise should be impartial and have knowledge of the law and adequate experience in commercial and financial matters.

Creditors will normally act as decision-makers in a number of key areas. For example, during liquidation proceedings, creditors should have the authority to dismiss the administrator, approve the temporary continuation of the business by the administrator, and approve a private sale. In rehabilitation proceedings, they should normally

have the authority to dismiss the administrator and propose and approve a rehabilitation plan. In addition, the Law should give them a role in requesting or recommending action from the court, including, for example, a recommendation that the rehabilitation proceedings be converted to liquidation. Giving creditors an active role in the process is particularly important when the institutional framework is relatively underdeveloped. Creditors will lose confidence in the process if all of the key decisions are made by individuals that are perceived as having limited expertise or independence.

Supporting Institutions

Throughout the bankruptcy process, **lawyers** play an important support role by representing both creditors and debtors. When a country enacts a bankruptcy law, therefore, it is important that law schools are prepared to teach the information – CLIR programs may thus find themselves involved with teaching those who will teach the law students. Appraisers must be able to inform the administrator of the value of both the parts and the whole of the business. These appraisals are based on an understanding of the local economy, the market for the product produced by the enterprise, the market for the enterprise's assets, and other factors.

Enforcement of bankruptcy proceedings should further be supported by a system of **bailiffs or court officers** who are empowered to seize assets and implement the necessary procedures for transfer of possession, title and /or liquidation.

Professional associations (e.g., associations of Bankruptcy Judges, Administrators, attorneys, etc.) address the needs of bankruptcy constituencies and promote the effectiveness of the bankruptcy system as a whole. Such associations can formulate a common voice for judges, trustees and others by issuing publications, hosting conferences and educational programs, and providing timely updates on topics of interest to their membership. The association can also bring specific issues of concern to the attention of the executive, legislative and judicial bodies, the media, and the public.

ADDITIONAL GUIDANCE, TOOLS, AND RESOURCES

Easily accessible, key resources exist that detail, develop and debate the numerous and complex components of Bankruptcy Law, as well as provide information about regional and international initiatives to support pro-competition law and policy.

The **World Bank** has for many years focused on Bankruptcy Law as a priority, and has developed significant resources including the **World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems** (April 2001) (www.worldbank.org/ifa/ipg_eng.pdf) which can be used to assess the extensiveness of insolvency laws in various countries. The World Bank Principles emphasize contextual, integrated solutions and the policy choices involved. There are 35 core principles identified by the World Bank that distill international best practice in the design of insolvency and creditor rights mechanisms and are used to benchmark strengths and weaknesses of existing systems. They allow flexibility in domestic policy choices and take comparative domestic laws and institutions into account. They rely on the fundamental premise that sustainable market development requires access to affordable credit.

The World Bank has begun to conduct its own assessments of country compliance with the World Bank Guidelines. In 2003, it developed a template for conducting regional reports on insolvency compliance (www.worldbank.org/ifa/icross_template.pdf).

Another major source of guidance is the **International Monetary Fund**. In particular, its document entitled *Orderly and Effective Insolvency Procedures* (May 1999) (www.imf.org/external/pubs/ft/orderly/) details the general objectives and features concerning insolvency procedures, liquidation procedures, rehabilitation procedures, and central institutions and participants in Bankruptcy Law.

The **Asian Development Bank** (www.ADB.org) has developed an extensive on-line library of resources

pertaining to insolvency in Asia. One ADB report, **Good Practice Standards for an Insolvency Regime** (April 2001), focuses on the most important issues and the principal policy choices that need to be made when resolving these issues. The report concludes that the degree to which an insolvency law is perceived as pro-creditor or pro-debtor is, in the final analysis, less important than the extent to which these rules are effectively implemented by a strong institutional infrastructure. In particular, given the complex and urgent nature of insolvency proceedings, effective implementation requires judges and administrators who are efficient, ethical, and adequately trained in commercial and financial matters and the specific legal issues raised by insolvency proceedings. A pro-debtor law that is applied effectively and consistently will engender greater confidence in financial markets than an unpredictable pro-creditor law.

The **European Bank for Reconstruction and Development** has created an **Insolvency Checklist (2002)** based upon the World Bank Principles in combination with the other international standards mentioned above.³ The EBRD Insolvency Checklist was developed with the implicit assumptions that its principal functions include the following:

- Alternative remedies for the financial problems of an insolvent or nearly insolvent debtor
- Convenient access to those remedies for both an insolvent debtor and the creditors of the debtor
- The efficient, proper and timely administration of an insolvency case.

The EBRD Insolvency Checklist is divided into five substantive areas:

- (1) Commencement and effects of proceedings
- (2) Assets of the estate
- (3) Creditors: involvement and treatment
- (4) Reorganization process
- (5) Terminal (bankruptcy/liquidation) process.

The EBRD checklist also applies the criterion that, “on balance, the interests of creditors should be paramount.”

The **United Nations Commission on International Trade Law** (www.uncitral.org) adopted a **Model Law on Cross-Border Insolvency** in 1997. The Model Law does not attempt to harmonize the substantive insolvency laws of participating jurisdictions, but provides a procedural framework to facilitate co-operation between courts and office holders in differing states. Countries are free to adopt and adapt the Model Law by modifying and excluding its provisions to accommodate local laws. Unlike the EU’s Regulation on Insolvency Proceedings, the Model Law does not contain rules determining jurisdiction or choice of law.

The **International Insolvency Institute** (www.iiglobal.org) is a non-profit, limited-membership organization dedicated to “advancing and promoting insolvency as a respected discipline in the international field.” Its primary objectives include improving international co-operation in the insolvency area and achieving greater co-ordination among nations in multinational business reorganizations and restructurings.

GLOBAL INSOLvency (www.globalinsol.com) is a joint project of the American Bankruptcy Institute and INSOL International, a worldwide federation of national associations for accountants and lawyers who specialize in workout and insolvency. It serves as a comprehensive source of information both on current issues in international insolvency and restructuring law and on the legal framework for insolvency and restructuring around the world. From current commentary and recent filings to international protocols and bankruptcy statutes to advice on cross-border lending, the GLOBAL INSOLvency website offers a range of information for insolvency practitioners, judges, accountants, trustees and others.

The **OECD** (www.OECD.org) has been active in insolvency reform, particularly with respect to Asia and Central and Eastern Europe, since 1993.

ENDNOTES

¹ See Florencio Lopez de Silanes, *The Politics of Legal Reform*, G-24 Discussion Paper Series (April

2002) at 16-18, located at www.unctad.org/en/docs//pogdsmdpbg24d17.en.pdf.

² Rafael La Porta et al., Law and Finance Working Paper 5661, National Bureau for Economic Research (July 1996), located at <http://post.economics.harvard.edu/faculty/shleifer/papers/lawandfinance.pdf>.

This paper is one of the first to analyze relationships between legal rules and rates of external finance. It documents the legal basis for the protection of shareholders and creditors in 49 countries, the historical origins of these legal rules, and how well they are enforced.

³ EBRD, Insolvency Law Assessment Project: Report on the Results of the Assessment of the Insolvency Laws of Countries in Transition (June 2003), located at www.ebrd.com/country/sector/law/insolve/assess/report.pdf.

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Competition Law and Policy

KEY CONCEPTS

Definition: A legal and regulatory framework that prevents businesses from unreasonably limiting the quality, quantity, and price of goods or services available in the marketplace and seeks to limit anticompetitive government regulation of the marketplace.

What is Competition Law and Policy? The fundamental goal of Competition Law is to foster a culture of competition that ultimately benefits consumers through better quality, service, and pricing for good and services. Competition Law provides a regulatory framework to maintain and improve efficiency in markets, promote competitive pricing practices, and restrain price rises in markets. Competition Law by itself does not create competition, but when effectively applied, can counteract the dangers of private anticompetitive behavior. For example, cartels may deliberately create artificial shortages, with the result that some consumers are able to obtain the product while other consumers pay an inflated, or monopoly, price. Dominant firms may abuse their market power through such means as mandating the purchase of two products without a legitimate business purpose. Entry of new participants may be blocked by

firms with market power that erect protectionist barriers.

Competition Law and Policy are intended to enhance consumer welfare – more and better goods at the best prices. In Western democracies, Competition Law (generally referred to in the United States as Antitrust Law) historically emerged from monopolistic and predatory business practices that limited the choices available to consumers, drove prices to unnaturally high levels, and discouraged the formation of new businesses. Until recently, most developing countries have operated without formal Competition Laws, due chiefly to the significant state control exercised over economic activity. The case in those countries for Competition Law, generally appropriate only after the fundamental commercial legal framework has been established, arises from the enormous structural changes they have experienced during the last two decades. Countries undergoing

Forms of Anticompetitive Business Practices

- **Horizontal and vertical restraints**, i.e., collusive price-fixing, input/output allocation, bid rigging; and Abuse of dominant position, i.e. exclusion, discrimination, predation; and certain mergers and acquisitions
- **Abuse of dominant position**, i.e., exclusion, discrimination, predation; and certain mergers and acquisitions.

privatization and deregulation, along with changes in technical, economic, political and ideological environments, may significantly benefit from formal “ground rules” of competition that allow them to thrive within liberalized markets and greater integration of the world economy.

Where institutions are weak, corruption is pervasive, or the country lacks a cadre of appropriately trained professionals to carry out other commercial law initiatives, the implementation of a Western-oriented Competition Law may not yet be an appropriate measure of action. Whether a country is ready for a fully integrated competition regime, which includes a highly independent administering authority, is a crucial question prior to launching a program in support of Competition Law.

Competition Law and Policy can be used to counteract inefficient government regulation and promote efficiency within the public sector.

Competition authorities can use the competition law to perform a comprehensive review of existing and proposed laws and regulations, providing suggestions and advice on government policies and measures that promote anti-competitive practices or inefficiencies. Activities often include the review of possible sources of public restraints on competition in trade policies (tariff and non-tariff barriers, antidumping duties and discriminatory export practices), investment policies (exclusionary lists, ownership restrictions, licensing requirements) and sectoral regulation (power, transportation, telecommunications, natural monopolies).

Effective support for consumer welfare typically requires at least three sets of laws. A comprehensive legal framework for competitive markets generally has three parts, each supporting the fundamental objective of consumer welfare: classic **Competition Law**, **Consumer Protection Law**, and **Trade Law**.

A classic **Competition Law** prevents parties from limiting the quality, quantity, and price of goods or services available in the marketplace. At its most basic level, classic Competition Law prohibits contracts, combinations, and conspiracies in restraint of trade or commerce among domestic

enterprises, or between domestic and international business concerns. (Such acts as price-fixing, bid-rigging, restriction of output or exclusive dealing contracts are examples of restraint of trade). In addition, classic Competition Law typically prohibits any merger or acquisition of stock or assets where the effect of such an acquisition would be to substantially lessen competition or to tend to create a monopoly. A sound Competition Law defines prohibited conduct; identifies the state’s Administering Authority charged with enforcing its provisions, including terms of membership on the authority; sets forth the jurisdiction and powers of the Administering Authority; and establishes penalties for violation of the Law.

Consumer Protection Law prohibits “unfair methods of competition,” along with “unfair or deceptive acts or practices” pertaining to commerce. Although some classic Competition Laws include Consumer Protection provisions, many states choose to create a separate Consumer Protection Law. In general, Consumer Protection Law supports the disclosure of truthful information about products and the reliability of express or implied promises. In addition to underscoring prohibitions against conspiratorial business practices, Consumer Protection Law may incorporate prohibitions against false advertising, provisions pertaining to product safety, and the general right to return defective items for a refund and enforce warranties.

Trade Law extends certain of the protections afforded by domestic Competition Law and Consumer Protection Law to the practices and effects of international commerce. Very generally, Trade Law prevents states from protecting their home enterprises from market forces with subsidies. Trade Law further prevents foreign businesses from “dumping” their goods into domestic markets at less than fair market value with the intent to injure or destroy a domestic industry.

This discussion will focus primarily on classic Competition Law and secondarily on the aspects of Consumer Protection Law directly related to competition. Trade Law is detailed elsewhere in this Guide.

Competition Law requires a balancing of economic priorities.

Economic freedom encompasses numerous values that many people in developed countries take for granted, such as secure property rights, the assurance that contracts will be honored and upheld, the opportunity to start a new business, and the ability to buy and sell goods and services in an open and competitive marketplace. Although each of these principles may fruitfully coexist, they do push and pull at each other. Typical scenarios in countries where large state-owned enterprises dominate the economy, adopt a fully developed Competition Law toward the interests of consumers and small-scale entrepreneurs. Secondly, some countries' primary concern may be that of preserving the "good old days" of fixed costs, prices and wages. Or third, an elected government may view the support of a few highly powerful business leaders (or "oligarchs") as a way to sustain economic growth and hold on to power. Fourth, politicians may be biased against the private sector and may welcome the opportunity to promote laws aimed at fostering consumer welfare, while at the same time stonewalling such "pro-business" initiatives such as Secured Transactions Law, meaningful bankruptcy reform, or improved enforcement of contracts. Moreover, many countries foster powerful doubts over allowing foreign concerns to compete freely with domestic enterprises.

Thus, the primary challenge of Competition Law is establishing a balance among various commercial law initiatives. It also underscores the difficulty of helping political leaders, state officials, business people, the labor force, consumers and others arrive not only at a Competition Policy in particular, but also at a shared set of priorities in the area of economic development generally. Significantly, the impetus for the enactment of a Competition Law – popular support, as experienced recently in South Africa, or as condition for development assistance, as in Indonesia – may have an important bearing on the relative effectiveness of the law. Ultimately, Competition Law should be viewed as a means of facilitating economic development and not of distracting or impeding it

MAJOR GUIDELINES

Legal Framework

Since 1990, as more than 50 developing countries completed legislation for Competition Laws and over 25 more launched the process for doing so, a general consensus has emerged over the necessary components of a classic Competition Law which is best suited to support a developing country's emergence into the world economy. In 2003, the United Nations Conference on Trade and Development, completed a Model Competition Law (along with accompanying commentary and legislative alternatives)¹ that sets forth the following components:

- Restrictive agreements or arrangements
- Acts or behavior constituting an abuse of a dominant position of market power
- Notification, examination and prohibition of mergers affecting concentrated markets
- The relationship between the Administering Authority and regulatory bodies including sectoral regulators
- Possible aspects of Consumer Protection
- Sanctions and relief
- Appeals
- Actions for damages

Although the extensive details and policy considerations associated with each of these provisions can be found through reference to the Model Law on Competition and other resources identified at Part C below, the central principles of the legal framework are as follows:

Objectives, definitions and prohibited acts. A Competition Law should clearly identify the goals of the legislation, including the country's overriding interest in controlling or eliminating practices that limit access to markets or otherwise unduly restrain competition. The Law should set forth the scope of its application and provide clear definitions of such terms as "enterprise," "dominant position of market

power,” “mergers and acquisitions,” and “markets.” The Law should further specify the exact conduct that is prohibited, including price-fixing; collusive tendering; market or customer allocation; restraints on production or sale, including quotas; concerted refusals to purchase or supply; and collective denial of access to an arrangement that is crucial to competition. In civil law countries, definitions and descriptions of prohibited conduct require a much higher degree of specificity than is generally required in common law systems, which rely more on general principles or rules of law derived from case precedent.²

A survey of Competition Laws in 50 countries in 2002 found significant difference among countries concerning the definition of “domination of market power,” with the countries almost evenly divided between those using qualitative terms and those using quantitative means of assessing dominance, with widely varying thresholds.³ Thus, key issues in developing a legal framework may include whether the definition of domination is to incorporate a qualitative or quantitative analysis, and, with respect to a quantitative approach, what the benchmark of product market dominance will be. For example, developing and transitioning countries in Africa have designated, on average, a share of 20-45 percent of the market as exhibiting dominance, while those in East Asia typically assign a much higher percentage of market share – 50-75 percent – as constituting dominance.

Notification, examination, and prohibition.

Notification refers to the obligation of enterprises that intend to engage in a merger, takeover, joint venture or another type of acquisition that tends to create a high degree of market power or dominance, to notify the Administering Authority and provide full details of these plans. In turn, the law obliges the Administering Authority to review and provide authorization for the transaction, or, after a full hearing, issue a finding against it. Like many aspects of a Competition Law, the specific information to be contained in a notification will depend on the circumstances and be developed further by administrative regulations.

Administering Authority. A Competition Law should establish the Administering Authority, specify its composition, and delineate the qualifications, tenure, terms of office, and possible immunities of the Authority’s membership. The functions and powers of the Authority should be set forth, including such possible activities as making inquiries and investigations; making decisions based on inquiries, including the recommendation or imposition of sanctions; making and issuing regulations; undertaking studies, publishing reports and providing information to the public; issuing forms and maintaining a register; assisting in the preparation, amending or review of legislation related to restrictive business practices or competition policy generally; and promoting the exchange of information with other States. Significantly, the Administering Authority will likely be compelled by the Competition Law to serve as an advocate for regulation and regulatory reform. In particular, regulatory barriers to competition incorporated into the State’s economic and administrative regulations should be assessed and acted upon by the Authority.

Consumer Protection. In many countries, Consumer Protection legislation – which aims in part to eliminate such anti-competitive activity as unfair or deceptive business practices – is entirely separate from the classic Competition Law, which applies to restrictive or predatory business practices. Some countries, however, devote at least a chapter of their Competition Law to Consumer Protection. Regardless of whether a country chooses to integrate Consumer Protection issues into its classic Competition Law, links between the two bodies of law more often than not result in enforcement being in the hands of the same Administering Authority.⁴

Sanctions, Relief and Appeal. A Competition Law will identify sanctions for violations of the Law, and for failure to comply with decisions or orders of the Administering Authority or appropriate judicial authority, failure to supply information or documents as directed, and making false statements. The penalties for unlawful conduct should be clear, designed to correct the competitive injury caused

by the offense, and sufficiently stringent to deter future violations. At the same time, the penalties should not be structured in a way that will deter pro-competitive conduct. Penalties may include fines, imprisonment, injunctive relief, permanent or long-term orders to cease and desist, restitution to injured consumers and divestiture or rescission from completed mergers, acquisitions, or restrictive contracts. The Law should establish an avenue for appeal.

Sanctions, retrospective in nature, are designed to punish past conduct. They are generally appropriate when there is no viable remedy and deterrence of others is needed. Sanctions are often used in cartel cases, or when a reportable merger fails to notify the competition agency, or when companies engage in destruction of documents or submit false information, or when a company has failed to comply with an ordered remedy. Thus, fines are used to punish violations of the law, but also to deter violations of the law. Experience has shown that deterrence is one of the most important benefits of a Competition Law. The size of fines should reflect that amount necessary to deter firms from engaging in violation of the law. If a fine is too low, it will simply be considered one of the costs of doing business.

Actions for Damages. A Competition Law should permit a broad range of entities to seek enjoinder or termination of prohibited practices, and/or damages, including consumers, competitors, and the State. The opportunity for private actors to seek redress under the law may lessen the burden on the Administering Authority, as private actors will supplement the effort to dismantle uncompetitive practices and, ideally, the mere possibility of legal action may deter unlawful practices.

Implementing Institutions

From the outset of the design and implementation of any project pertaining to Competition Law and Policy, it is necessary to appreciate that mere enactment of a classic Competition Law is meaningless in the absence of a network of implementing institutions that support a culture of

competition not merely in theory, but in fact. These implementing institutions include:

A highly competent Administering Authority.

The Administering Authority should be free from political influence and capable of compelling compliance, enforcing meaningful sanctions, and serving as an advocate for Competition Policy. Anti-competitive behavior occurs when enterprises agree to fix prices, limit output, divide business between them or abuse their market power, with no benefits to consumers. In these situations, a properly empowered Administering Authority should use its enforcement powers to act promptly and rigorously to protect the interests of consumers and overall economic welfare. For an Administering Authority to be effective, it must have a clearly defined mandate, adequate and well trained professional and administrative staff to fulfill that mandate, and sufficient resources to carry out its work.

Chile: Toward an Independent Competition Authority

The Chilean government is in the process of revising its competition law regime, vesting complete authority over competition adjudications in an independent Competition Tribunal. Since 1973, Chile's competition regime has been administered through three separate government agencies, staffed in part by part-time volunteers who also served full-time as employees of several government ministries. Furthermore, the institutions dedicated to Competition law had no budget, and thus were staffed with scant resources, and heavily dependent upon resources seconded from several ministries.

The new administrative framework for Chile's competition law, supported by the business community, would create a single entity responsible for enforcement of Competition law (Competition Tribunal), along with the Prosecutor's office. The Competition Tribunal would be allocated ample resources and staff to ensure complete independence from any government ministry.

Competition Law and Policy in Chile: A Peer Review, OECD (2004).

A particular concern in the development of such an institution is that of reducing opportunities for corruption or even excessive state interference in the economy by way of the Authority. A program supporting Competition Law and Policy should identify ways to support the Administering Authority through such approaches as short and long-term technical assistance, resident advisors and mentoring, training curriculum development and execution, public information programs, and assistance in reaching out to the Authority's sister agencies in other countries.

Competition advocacy is the ability of the Administering Authority to provide advice, influence and participate in economic and regulatory policies in order to promote more competitive industry structure, firm behavior and market performance. Programs engaged in capacity building of an Administrative Authority should in most cases include an advocacy component.

An independent regulator of private or state-owned monopolies. For private or state-owned monopolies – such as telecom, aviation, power or water providers – there should be an independent regulating authority to guard against unfair pricing, restriction of output or access, and other possible interferences with the interests of consumers. This institution similarly must be adequately staffed, trained, guarded against opportunities for corruption, and responsive to the needs of the public.

A regulatory and licensing system that, in practice, does not undermine the pro-competition agenda of the Administering Authority. Many anti-competitive laws are disguised as entry restrictions to a given area of economic activity. Thus, a Competition Law's prohibition of cartels may be thoroughly subverted by a licensing authority's practice of effectively keeping newcomers out. Restrictive strategies may include overly burdensome requirements for property ownership, lengthy and cumbersome permitting processes, or inappropriate fees or deposits. A state's regulatory and licensing agencies serve to implement a state's overall competition policy and should thus reflect

the aspired-to culture of competition through their enabling statutes, regulations, and practices.

A sufficiently trained and knowledgeable legal community, including courts capable of interpreting the law. The court system itself may pose a barrier to effective implementation of a Competition Law: the state may lack an independent judiciary and judges may have no meaningful training or experience in the application of commercial law, the use of economic analysis, or the principles of competition. Also, the judicial system, including the system of court administration, may harbor significant corruption. These concerns about competency and conduct extend beyond the courts and into the legal community in general, which may be called upon to serve as an important implementing force through private means of redress under the Competition Law (rather than exclusive enforcement of the law by the Administering Authority). Accordingly, a comprehensive Competition Law program should incorporate the needs of courts, judges, and the legal community, and closely coordinate with other donor-funded or local initiatives to leverage training and technical assistance opportunities to the greatest extent possible.

Consumer Protection Enforcement Authority. With respect to Consumer Protection Law, the Administering Authority may have certain enforcement responsibilities, or a separate Consumer Protection agency may be established for the purpose of safeguarding consumer rights. As previously noted, the Competition Law's framework will determine whether issues of Consumer Protection – so closely related to the consumer-oriented priorities of Competition Law – will be enforced by the Competition Law's Administering Authority or by another implementing institution. Regardless of how a State resolves this question, issues of competency, training, staffing and public information pertaining to Consumer Protection will also arise.

Supporting Institutions

The fact that Competition Law is a reflection of an overall policy to encourage a culture of competition

means that myriad institutions will play some part in sustaining, or supporting the ultimate effectiveness of, the Law. **Business associations** can play an important role in notifying their memberships in practical terms about what is expected of them – that is, explaining in lay-terms just what it means to engage in unlawfully restrictive business activity, what practices they should avoid, and what could happen if they ignore or violate the law. **Consumer groups** will similarly serve as an important voice for advising the public of its rights and opportunity for redress. **Lawyers, economists, statisticians** and **universities** will also constitute important sources of support for the principles and implementation of a meaningful Competition Law and Policy.

ADDITIONAL GUIDANCE, TOOLS, AND RESOURCES

Various observers have argued that the decision to invest in a Competition Law, including the development of requisite policies and institutions, may take place at the cost of other approaches to eliminating restrictive business practices and may even amount to a “significant detraction of human and economic resources from the more fundamental needs of transitioning and developing economies.”⁵ Other approaches encouraging increased competitiveness may be determined to be more effective under the circumstances, such as infrastructure improvement, or legal reforms that eliminate licensing-related barriers to entry, deregulate prices, or discourage collusive business habits (such as legally mandated membership in a Chamber of Commerce).⁶

On the other hand, the reality of ever-increasing integration of world economic activity supports the conclusion that a common set of rules pertaining to collusive business practices, mergers and acquisitions, and competition in general is critical. Moreover, increasing access to information and choice in developing countries has resulted in a greater consumer consciousness about the price and quality of goods they can buy. States that foster a culture of competition signal a genuine interest

in their citizens’ quality of life, which is itself an indicator of greater economic improvements to come.

Building Support for Reform

Competition Law and Policy Reform is not considered a high priority for many transitioning and developing countries; thus donors should consider the need to engender, nurture, and sustain support for reform prior to embarking on a full-scale initiative. Approaches to achieving such support must continue throughout the process of program development and implementation. Coalition-building is essential. A coalition for competition reform should include allies from inside and outside the official institutions of the State, such as politicians, executive branch officials, business and civic leaders, judges, professional associations, universities, and others. These efforts must be strategic and sustained, and a media strategy that informs the public about the overriding reasons in support of a Competition Law is also vital.

Accessing Key Resources

Easily accessible, key resources exist that detail, develop and debate the numerous and complex components of Competition Law and Policy, as well as provide information about regional and international initiatives to support pro-competition law and policy:

The United Nations Conference on Trade and Development (UNCTAD) (www.UNCTAD.org) devotes significant resources to Competition and Consumer Policy development. In addition to the Model Competition Law and myriad documents addressing substantive elements of Competition Law and Policy, the UNCTAD web site provides a Directory of Competition Authorities and an annual Handbook on Competition Legislation.

OECD (www.OECD.org) is highly engaged in the development of sound competition law, policy and institutions throughout the world. Extensive resources pertaining to the legal framework of classic Competition Law, as well as related laws, can be found at the OECD web site.

The **European Commission** has developed a wealth of information pertaining to European Union competition law, which will be of interest in particular to those nations slated for or aspiring to EU membership. The Commission's web page (entered through www.Europa.eu.int) includes legislation, case law, international agreements, reports and other documents. Full text of competition legislation from individual member states is also available, as well as links to competition authorities and related ministries in each country.

The **Asia-Pacific Economic Cooperation (APEC)** organization has created a policy and law database (entered through www.APECSEC.org) that includes numerous categories of information, including competition policy. The database is searchable by topic and country. The amount and quality of information available varies from country to country.

The **International Competition Network** (www.internationalcompetitionnetwork.org) is an informal, consensus-based network of competition authorities from throughout the world. Its membership includes about 75 competition authorities from developed and developing countries. The ICN seeks to provide competition authorities with a specialized yet informal venue for maintaining regular contacts and addressing practical competition concerns. Membership is voluntary and open to any national or multinational competition authority entrusted with the enforcement of antitrust laws. The ICN does not exercise any rule-making function.

OECD Global Forum on Competition, February 6, 2002).

³ See Ajit Singh, Competition and Competition Policy in Emerging Markets: International and Developmental Dimensions at 7 (paper prepared for the meeting of the G-24 Technical Group, March 2002).

⁴ See Model Law on Competition, supra note 1, at 53 (Commentaries on Chapter VIII and Alternative Approaches to Existing Legislations).

⁵ Cynthia L. Clement, Andrew Gavil, Georges Korsum and William Kovacic, Competition Policies for Growth: Legal and Regulatory Framework for SSA Countries 3-4 (2001). See also Ioannis Lianos, Report of the Workshop: Competition Policy and Economic Development: The Costs and Benefits of Multilateral Principles on Competition for Developing Economies (Institute for International Law and Justice, New York University Law School, November 2, 2002).

⁶ Id. at 5.

ENDNOTES

¹ UNCTAD, Model Law on Competition – Substantive Possible Elements for a competition law, commentaries and alternative approaches in existing legislations (2003) (www.unctad.org/en/docs//tdrbpconf5d7rev1_en.pdf) (hereinafter Model Competition Law).

² See Federal Judicial Center, A Primer on the Civil-Law System at 36-37 (1995); see also U.S. Federal Trade Commission and U.S. Department of Justice, Antitrust Division, The United States Experience in Competition Law Technical Assistance: A Ten Year Perspective (publication submitted for Discussion Session at the

Commercial Dispute Resolution

KEY CONCEPTS

Definition: The process through which courts or other tribunals and services (such as Alternative Dispute Resolution [ADR] mechanisms) resolve commercial disputes, for example those concerning the interpretation and enforcement of contracts, the liquidation or rehabilitation of a business, the settlement of property rights disputes, or general adherence to the commercial law.

What is Commercial Dispute Resolution?

Facilitation of foreign investment and trade, as well as domestic economic development, requires public confidence that disputes which inevitably arise can be settled fairly and efficiently, without exorbitant expense or delay. In many countries, business people rely on courts to ensure that business obligations will be enforced and contractual breaches will be redressed. The very ability of courts to enforce the law encourages good faith business dealings and discourages breach in the first place – that is, parties to a transaction are more likely to perform their obligations and otherwise act lawfully if there is a real likelihood that a court will enforce those obligations in a timely, effective manner.¹ Of course, certain economies – China, for one, and Indonesia, prior to 1997 – have demonstrated that overall political stability and relatively low risk may compensate for a weak rule of law, particularly for large investors that are favored by the host government.² Increasingly, however, empirical evidence supports the assertion that efficient and effective dispute resolution systems are necessary for increased business activity and investment, particularly for smaller businesses and investors.³

Simplifying procedures, improving case management and court administration, and increasing the flexibility of courts and judges have been shown to improve both efficiency and access to the judiciary, thereby improving a country’s business environment.⁴ Moreover, a crucial link has been suggested between judicial independence – the ability of judges to decide cases impartially, according to the law, and not based on external pressures and influences – and economic development functioning institutions of judicial independence – such as separation of powers, judicial ethics and professionalism, and associations of judges are strong predictors of economic freedom.⁵

Reform of commercial dispute resolution processes is a multi-faceted proposition. Poorly functioning judiciaries – that is, courts that are inaccessible, slow, inconsistent, influenced by politics, unduly formalistic, or corrupt – are commonplace in most fragile states and many transitioning countries. There is no single fix that can remedy systemic ineffectiveness; however, lessons learned within individual countries and across the developing world can assist the development professional in devising a common sense

approach to reform that will prioritize and resolve various issues.⁶ The World Bank's Doing Business reports (2004, 2005 and 2006) identify types of reform that have been shown to improve commercial dispute resolution:

- Establishing information systems in the courts
- Taking transactions that are not disputes, such as business registration, out the hands of judges
- Reducing procedural complexity
- Establishing small-claims courts and specialized commercial courts
- Introducing case management, through which one judge oversees a case from inception through resolution
- Reducing abuse of appeals
- Providing better incentives for enforcement, often through privatizing the enforcement process

In addition to these approaches, USAID programs have engaged various other methods toward strengthening the environment for resolving commercial disputes, including:

- Emphasizing prevention of disputes among private actors, through better risk-assessment, the use of contracts, and improved collection practices, as well as more private-sector involvement in the legal reform process
- Promoting judicial professionalism, including judicial ethics, judicial leadership, judicial institution-building, and training
- Creating and supporting avenues for Alternative Dispute Resolution as a viable alternative to traditional litigation
- Developing improved and more accessible information resources in commercial law and dispute resolution.

The following table sets forth some examples of where and how USAID and other donors have recently engaged in these general categories of commercial dispute resolution reform. CLIR

professionals can benefit from accessing and sharing experiences from these and similar initiatives, building upon their lessons learned. Depending on the initiative, details may be obtained from a variety of sources, including program officers, mission websites, and project documents, reports, and websites. Much of this information or points of contact can be generally accessed through USAID's primary web site (www.USAID.gov) or through the Development Experience Clearinghouse (www.DEC.org), the largest online resource for USAID funded, international development documentation. In addition, the table identifies certain key sources of guidance.

Resources and Program Examples in Commercial Dispute Resolution Reform

Approach	Resources and Program Examples
<p>1. Establishing information systems in the courts</p>	<ul style="list-style-type: none"> • USAID Office of Democracy and Governance, Case Tracking and Management Guide (September 2001) www.usaid.gov/our_work/democracy_and_governance/publications/pdfs/pnacm001.pdf. • Important examples in automating courts have taken place with USAID support in many countries, including: <ul style="list-style-type: none"> – Bulgaria – Croatia – Dominican Republic – Egypt – Macedonia – Mongolia – Morocco • With U.S. support, the bi-annual Court Technology Conference (CTC) of the National Center for State Courts has been attended over the past 10 years by scores of judges and court administrators from fragile and transitioning countries. The CTC is the world's only conference dedicated exclusively to court technology. See www.ncsconline.org.
<p>2. Taking transactions that are not disputes, such as business registration, out the hands of judges</p>	<ul style="list-style-type: none"> • Through legislation passed in 2003, Serbia and Montenegro removed the business registration procedure from the court system. See USAID/Economic Policy for Economic Efficiency Project, Commercial Law Reform Legislative Matrix (June 2003) (www.epee.org.yu). • In Kosovo, the registration procedure was removed from the Commercial Courts and taken over by the Ministry of Trade and Industry. The commercial judges in Kosovo are ambivalent about losing this function, complaining in particular about problems in accessing reliable information about companies. The challenge thus remains in helping judges see beyond this traditional administrative function, and improving access to company information. See USAID/Booz Allen CLIR Diagnostic Assessment for Kosovo (September 2004) (www.bizlawreform.com).

Approach	Resources and Program Examples
<p>3.Reducing procedural complexity</p>	<ul style="list-style-type: none"> • In Bosnia, efforts to streamline and simplify court procedures have taken place through draft civil procedure legislation (www.usaid.ba). • ABA/CEELI assisted in the reform of formal court procedures in Slovakia, which graduated from USAID assistance in 2000 (www.usaid.gov/locations/europe_eurasia/countries/sk/l.html).
<p>4. Establishing small-claims courts and specialized commercial courts</p>	<ul style="list-style-type: none"> • USAID has supported Morocco’s efforts to strengthen the ability of the judicial system to handle business-related cases. Morocco has established six new commercial courts and three commercial courts of appeal have been established. • Brazil introduced small claims courts at both the state and federal levels as a means of simplifying and speeding up the rate at which small disputes can be resolved. At the federal level, although both civil and criminal small claims courts were authorized, the small claims courts began by dealing only with social security cases, with plans for expanding later. The state small claims courts deal with cases whose value does not exceed 40 “minimum salaries” (about \$3000), and incorporate such commercial topics as professional fees and certain possessory actions with regard to real property.
<p>5. Introducing case management, through which one judge oversees a case from inception through resolution</p>	<ul style="list-style-type: none"> • USAID Office of Democracy and Governance, Case Tracking and Management Guide (September 2001). • Important examples in case management have taken place with USAID support in: <ul style="list-style-type: none"> – Serbia – Montenegro – Egypt – Macedonia – Mongolia – Bulgaria – Bosnia – Russia

Approach	Resources and Program Examples
<p>6.Reducing abuse of appeals</p>	<ul style="list-style-type: none"> In the Central American countries of Nicaragua, El Salvador, Costa Rica, Honduras and Guatemala, the challenge of reducing the opportunity for appeal of judicial systems has been highlighted in recent CLIR country reports (www.bizlawreform.com).
<p>7. Providing better incentives for enforcement, often through privatizing the enforcement process</p>	<ul style="list-style-type: none"> In Armenia, USAID has supported the development of legal and administrative structures for the enforcement of repossession of collateralized assets. (See www.usaid.gov/am/private.html). With USAID and World Bank support, the International Foundation for Election Systems has conducted considerable baseline research in the area of enforcement of judgments, including in Argentina, Mexico, and Kosovo. (See www.ifes.org). With USAID support, the American Chamber of Commerce in Croatia intensively studied the country’s crisis in enforcement and issued a detailed plan for reform. (See www.amcham.hr/dwnls/EU&TL_CommitteeReport.rtf).
<p>8.Emphasizing prevention of disputes among private actors</p>	<ul style="list-style-type: none"> In Macedonia, a National Entrepreneurship and Competitiveness Council was established for the purpose of assisting businesses in crafting national strategies for improving business conditions that help Macedonian companies and clusters develop, promote and export their high-value products or services, and thus create higher and rising incomes for the average Macedonian citizen. (See www.mca.org.mk/index_en.htm.) In Tanzania, USAID has sponsored advocacy training in the Tanga Region, specifically promoting improved private sector policies, procedures, and regulations. Through partnership and open-dialogue, Tanga has demonstrated how the public and private sectors can collaborate to create an enabling environment for regional economic growth. (See www.usaid.gov/tz/apg3.html#Collab). In USAID-sponsored competitiveness programs throughout the world, opportunities exist to connect businesses and business associations to the law-related knowledge they need, such as uniform contract development, common collection methods, shared information about customers, etc.

Approach	Resources and Program Examples
<p>9. Promoting judicial professionalism</p>	<ul style="list-style-type: none"> • Many ideas for and experiences in the judicial professionalism arena are set forth in the USAID/Office of Democracy and Governance publication, <i>Guidance for Promoting Independence and Impartiality</i> (January 2002). • The Justice Studies Center of the Americas (http://www.cejamerica.org) is an autonomous, intergovernmental organization whose mission is to support the countries of the region in their judicial reform processes. The Center is headquartered in Santiago, Chile, and it includes all of the active member states of the OAS. • With USAID support, the American Bar Association, Central and East European Law Initiative has developed a Judicial Reform Index and Legal Profession Reform Index (www.abaceeli.org) that establishes baselines for judicial and legal competency throughout countries in Central Europe and Eurasia. • The Open World Leadership Center (www.openworld.gov/?lang=1), an initiative developed by the Library of Congress, conducts a specialized rule of law programming through which U.S. federal and state judges host Russian judicial delegations in association with a grantee organization and its local hosting network. The program acquaints participants with the U.S. judicial system and the role of rule of law in society. Sub-themes include judicial ethics, legislation and the law, and legal/judicial training.
<p>10. Creating and supporting avenues for Alternative Dispute Resolution</p>	<ul style="list-style-type: none"> • The ADR Practitioner's Guide (www.usaid.gov/our_work/democracy_and_governance/publications/pdfs/pnacb895.pdf), developed by USAID's Office of Democracy and Governance, is intended to help practitioners make informed decisions with regard to incorporating ADR into rule of law programs and other conflict-management initiatives. • Working with the Palestinian legal community and other partners, USAID has created and developed two alternative dispute resolution (ADR) centers, one in the West Bank and one in Gaza - the only centers of their kind in the Palestinian areas. See http://www.usaid.gov/wbg/program_democracy.htm. • In the Philippines, the USAID-funded Barangay Justice Service System (BJSS) mediation have resolved 85% - 95% of 1,512 total cases, cutting in half the backlog of cases coming to local courts in just two years. See www.usaid.gov/stories/philippines/fp_philippines_justice.html

Approach	Resources and Program Examples
<p>11. Developing better and more accessible information resources in commercial law and dispute resolution</p>	<ul style="list-style-type: none"> • In collaboration with the African Development Bank, the Commercial Law Development Program of the U.S. Department of Commerce co-sponsored the establishment of an African Law Institute (ALI), an independent non-governmental think-tank and resource center that will examine contemporary commercial law issues in the region and will undertake activities to foster greater systemic legal reliability. Temporarily housed at the African Development Bank, ALI held an inaugural meeting in February 2003 in Abuja, Nigeria to announce its existence to a wider group of regional stakeholders, develop an operational strategy, finalize a headquarters location and develop a program of action for research topics. (http://cldp.doc.gov/page.wv?section=root&name=Success+Story&successStory.id=19). • With support from USAID, ABA/CEELI established the Center for Free Access to Information in Sarajevo, Bosnia in February 2002. The office is open five days a week and has assisted journalists, law students and private citizens in submitting hundreds of requests for information. The center has become the leading expert on freedom of information issues in BiH, and is respected for its expertise regionally. It has achieved this distinction by researching a variety of substantive legal areas and identifying documents that contain relevant information. This approach has led to a positive response rate of more than 75 percent on requests for information submitted on behalf of clients.

Pre-transaction Checklist:

- Check on transaction partner, including credit checks, reputation check, professional memberships, third-party recommendations, etc.
- Transaction planning through documentation, including delivery specifications and payment schedule
- Specific issues pertaining to goods and services: What are the specifications for the goods? For the services? Which events will constitute non-performance? On what basis can a party cancel the contract? Is timing important? What law governs the contract? What will the dispute resolution steps be?
- Formalities: Does the contract need to be in a special form (e.g. notarized)? What are the legal requirements to which it must adhere in order to be enforced?
- Do the parties need a local lawyer to draft/approve the contract?

Prevention of commercial disputes. A business dispute will never need resolving if it can be prevented in the first place. Prevention begins with the parties to a transaction or business development scheme. Namely, prevention entails pre-transaction risk-assessment and planning, which includes a variety of strategies to ensure to the fullest extent possible that parties to a transaction will deliver upon their promises, or that a proposed business activity will not violate the law. Simply using a written contract, as opposed to relying on oral representations, constitutes an important way of avoiding misunderstanding or non-compliance with a presumed agreement. With respect to newer or more complex areas of the law, such as Competition Law or intellectual property, engagement of competent legal counsel early in a venture may be not only desirable, but critical. As detailed in this Guide's chapter on Contract Law, prevention also involves

The World Bank Doing Business Reports identify nine types of reform that have been shown to improve commercial dispute resolution:

- Establishing information systems in the courts;
- Taking transactions that are not disputes, such as business registration, out of the hands of judges;
- Reducing procedural complexity by reducing the amount of time, number of steps, and cost it takes to enforce a judgment;
- Eliminating the requirement for “legal justification” of the complaint, which prevails in Civil Law countries;
- Establishing small-claims courts, which are typically cheaper and quicker to use than regular courts;
- Establishing specialized commercial courts, which generally entail procedural simplification aimed at “mass production”;
- Introducing case management, through which one judge oversees a case from inception through resolution;
- Reducing delays in deciding cases by limiting opportunities to abuse appeals; and
- Providing better incentives for enforcement, often through privatizing the enforcement process

The World Bank Doing Business Reports (2004-2006)

institutional strengthening within the private sector, such as encouragement of business communities to develop standardized contracts and to adopt common methods of notice and collection.

Next, when a business problem arises – such as a late payment or delivery of services – there is a stage at which the problem can possibly be resolved through relatively fast, informal means. These early-stage solutions include verbal discussion between the parties; a written warning or notice of non-compliance; a formal letter of demand, followed by negotiation; and certain mechanisms of self-

help, including suspending payment, finding an alternative supplier, or purchasing a replacement. In many instances, the law of the country will require that informal methods of solving the problem be attempted prior to bringing the issue to court.

Prevention and early-stage solutions depend upon actions taken by the parties themselves, and are not typically subjects included in donor-sponsored CLIR programs. Rather, these informal dispute resolution solutions may be most effectively developed through programs specifically targeting the private sector, possibly through business associations.

At some point, a problem will reach a point where informal methods will not effectively resolve a dispute, requiring a state-sanctioned forum for commercial dispute resolution. Depending on the law and the business environment, a party may seek redress from a court of general jurisdiction, a commercial court, a small claims court, or a forum for ADR.

Specialized commercial courts. Certain countries have a tradition of placing certain categories of commercial disputes within specialized courts, rather than in courts of general jurisdiction (examples include the bankruptcy courts in the U.S., or the arbitration courts in Russia, which handle most disputes between businesses). In recent years, there has been a pronounced trend toward strengthening existing commercial courts (as in Serbia), establishing commercial courts (as in Tanzania and Morocco), or commercial “divisions” within courts of general jurisdiction. Specialized courts generally improve efficiency, in part because such courts tend to have streamlined procedures and they offer an alternative forum for litigants that may compete with regular courts.⁷ In addition, commercial judges tend to be more familiar with the commercial law framework than judges of general jurisdiction. Also, commercial court judges may be more oriented toward resolving commercial disputes with consistency, efficiency, and due consideration for the original intent and representations of the parties. On the other hand, the efficiency of commercial courts can be undermined by assigning judges

responsibility for non-adjudicatory services such as registering companies, as in Bulgaria and Croatia.⁸

Alternative Dispute Resolution. ADR creates competition and choice for parties experiencing a dispute. Namely, the existence of sound ADR institutions in a country can not only facilitate the resolution of commercial disputes, but can also encourage courts to improve their effectiveness and reduce opportunities for judicial corruption.⁹ Four major approaches to ADR are of interest to the CLIR professional: court-annexed options, commercial arbitration, mediation, and community-based dispute resolution mechanisms.

Court-annexed ADR. Court-annexed ADR takes place at some point during the time leading up to a formal finding of fact in a case filed in court. This type of ADR, which in many countries is mandatory, includes mediation (also referred to as “conciliation”) – the process through which a neutral third party assists disputants in reaching a mutually acceptable solution – as well as variations of early neutral evaluation, a summary jury trial, a mini-trial, and other techniques. Ideally, such methods decrease the cost and time of litigation, improving access to justice and reducing court backlog, while at the same time preserving important social relationships for disputants. There is no general agreement, however, concerning the ultimate benefit of mandatory court-annexed ADR. For example, when the judge who is managing a case also serves as its mediator, there is a jeopardized sense of trust in the process.¹⁰ Also, it is not altogether clear that mandatory court-annexed ADR results in speedier, less costly resolution.¹¹ Court-annexed solutions are viewed as improving efficiency to the extent that they simplify procedures for litigants and increase the flexibility of the process.¹²

Commercial arbitration. Private arbitration services and centers have an established role in the United States for commercial dispute resolution, and are spreading internationally as business, and the demand for harmonization, expands. Over the last decade, many countries have passed legislation based on the 1985 UNCITRAL Model Law on International Commercial Arbitration, which makes

an arbitral award legally binding and grants broad rights to commercial parties choosing arbitration. Yet critics argue that arbitration, once considered an alternative to litigation, is now afflicted by the same problems of cost, delay, complexity, and dependence on legal representation. Moreover, in some countries the process of arbitration has been significantly limited by the virtual monopoly held over its practice by the state-sanctioned National Economic Chamber, such as Macedonia.¹³ Few if any arbitration of domestic disputes have taken place, notwithstanding the legal viability of this option.

Private mediation initiatives. Numerous donor-sponsored and locally initiated mediation centers that resolve commercial disputes (and other issues) have been established in recent years.¹⁴ Mediation is an area in which the business community in particular can be encouraged to demand improvements to the quality of dispute resolution. Specifically, the private sector can make a practice of including mediation clauses in standard business contracts; encourage business lawyers to request mediation before commencing lawsuits; train in-house counsel or client managers in mediation techniques to ensure better negotiation and problem-solving skills; create an in-house mediation capacity for internal disputes; and work through professional associations and donor projects to start mediation programs for business entities. Any initiative to develop mediation services will likely include components in training, public education, establishment for rules of mediation, and development of codes of conduct for mediators.

Community-based ADR. Community-based ADR is often designed to be independent of a formal court system that may be costly, distant, or otherwise inaccessible to a population. Other initiatives sometimes build on traditional models of popular justice that relied on elders, religious leaders, or other community figures to help resolve conflict. India, for example, embraced village-level people’s courts in the 1980s, where trained mediators sought to resolve common problems that in an earlier period may have gone to the panchayat, a council

of village or caste elders. Elsewhere in the region, bilateral donors have supported village-based shalish mediation in Bangladesh and nationally established mediation boards in Sri Lanka. In Latin America, there has been a revival of interest in the *juece de paz*, a legal officer with the power to conciliate or mediate small claims.

MAJOR GUIDELINES

Legal Framework

A country's legal framework for commercial dispute resolution begins with its Constitution, which generally will establish the court system and its jurisdiction (including courts of first instance and appellate courts), the terms and qualifications for judges and conditions for their removal, and other indicia of judicial organization and independence. The legal framework for dispute resolution often then turns on the country's legal tradition. That is, in Civil Law countries, various codes will set forth the avenues for commercial dispute resolution, including a Code of Civil Procedure, a Law on Courts, a general Commercial Code, a Law on Execution of Judgments, or other pertinent commercial laws. Many countries have specific laws on Alternative Dispute Resolution or Arbitration, which speak to the conditions under which ADR is permitted, the extent to which decisions made in ADR can be subject to judicial review, and conditions for enforcement. Common Law jurisdictions also rely on various commercial laws to establish procedures for dispute resolution, as well as on court-made rules and the precedents established by case law.

Most of the laws detailed in this Guide – Company, Contract, Real Property, Secured Transactions, Bankruptcy, and Competition – will identify procedures for dispute resolution or incorporate by reference their country's relevant law of civil procedure or courts. In addition, a viable system of commercial dispute resolution relies on a variety of other laws to regulate information and bargaining conditions. For example, the integrity of contractual exchange relies on fraud law to punish those who have positively misled their contracting partners into

a contractual relationship and to deter others from doing so in the future.

Implementing Institutions

At the heart of an effective system of Commercial Dispute Resolution are institutions that support the creation and enforcement of commercial relationships, as discussed below.

Courts and judges. The main implementing institutions for commercial dispute resolution are the courts and the judiciary. Relevant tribunals may include traditional courts, courts of general jurisdiction, commercial courts, small claims courts, and administrative courts. Improved commercial dispute resolution begins with improved judicial capacity, including the following:¹⁵

Overall standards of judicial practice and case management. Of central significance is whether judges will consistently require timely appearance and compliance with court rules by parties and attorneys, as well as tangible (rather than undocumented or conjectural) evidence in court proceedings.

Whether courts are consistent in their treatment of commercial obligations. Where various judges in a single court do not act in a standard, predictable manner, and prospects for meaningful enforcement vary, the public is unable to develop the necessary confidence that commercial contracts will be enforced. This increases the perceived risk of entering into business transactions.

Quality of rulings and judgments. For lawyers, poorly written rulings do not provide the legal profession with guidance as to what constitutes effective advocacy and what are correct applications of contract law. In order for lawyers to improve their future pleadings, advise their clients more effectively, or otherwise avoid unnecessary lawsuits or actions in the future, judges should provide reasoned decisions to parties appearing before them. Appellate judges are often burdened by insufficient information and records to make an appropriate decision on appeal, and must often request additional information from

the courts or parties, thus increasing delays and expenses associated with final enforcement.

Whether judges understand the limited role they must play in reviewing execution documents.

When the parties to a contract have chosen international standards or rules to govern their contractual relationship, judges should defer to those standards. When an execution judge receives a valid execution document, the only appropriate discussion with the parties should concern how and when to enforce the document. Where execution judges inappropriately reconsider the merits of a case, the result is delays, higher litigation costs, confusion, and a loss of respect for the courts and judiciary.

Whether judges are willing to take proactive measures in the enforcement of obligations, such as a willingness to issue and enforce orders to banks to deliver proof of a debtor’s assets;

Alternative Dispute Resolution tribunals and services. Depending on the specific country context, the capacities of the following institutions may be of concern: **arbitration associations**, including professional arbitrators; **mediation services** and their practicing mediators; and organizations that sponsor ADR, such as **chambers of commerce or bar associations**. Significant additional information about developing and supporting these institutions can be found in the **ADR Practitioner’s Guide**, developed by USAID’s Office of Democracy and Governance.

Supporting Institutions

Judges Associations can do much to improve the environment for effective dispute resolution, including the following:

- They can enhance the sense of professionalism, collegiality, and self-esteem among judges, which is particularly important in countries where the judicial profession is held in low regard
- They can develop judicial training centers and provide continuing legal education both in substantive legal areas and areas pertaining generally to the judicial profession, such as

judicial stewardship, case management, opinion writing, etc.

- They can serve as persuasive sources of advice in certain areas of law reform, such as civil procedure and laws on execution of judgments
- They can adopt codes of ethics and other mechanisms of self-regulation, and heighten awareness of ethical issues, including through publications and continuing legal education.

Bar Associations. Private lawyers are key actors in Commercial Dispute Resolution. Maintaining a high level of professionalism among lawyers, however, is a continuing challenge in emerging democracies.¹⁶ Associations of lawyers can serve many roles in improving the quality of lawyers and strengthening the influence of lawyers in the commercial law reform process. Examples of how bar associations can improve the environment for Commercial Dispute Resolution include the following:

- They can provide continuing legal education both in substantive legal areas and areas pertaining generally to professional development, such as legal writing, law office management, media relations, etc.
- They can propose standardized contracts across the profession and develop form books
- They can lobby for change in commercial law and procedure
- They can develop and provide their own dispute resolution services, such as a mediation service or early neutral evaluation service
- They can serve as a watchdog on the judicial branch, surveying their members to identify those areas where training and knowledge of judges are inconsistent or insufficient.

Law Schools. Strong legal education builds a foundation for strong lawyers. To effectively engage in commercial dispute resolution, lawyers must understand not only the substantive law, but also the details of civil procedure, motions practice, and trial advocacy. Law school curriculum that fails to include

significant opportunities to develop skills in legal writing, oral advocacy, and general problem-solving are failing their students. For several years, USAID has supported implementation of legal education programs that expand and improve upon the law school experience in developing countries. These efforts include the following:

- Classroom based-courses utilizing simulations and case studies and skill development such as contract drafting
- Externship programs where students receive academic credit for work in with judges, practitioners and nongovernmental organizations (NGOs)
- Law clinics through which students work with faculty and practitioners to provide legal services
- Training of law faculty and practitioners, developing teaching materials, practice guides and ethics standards, and providing financial support for salaries and infrastructure.

Future reforms can continue to develop such programs, with increasing emphasis on how improved skills relate to improved commercial dispute resolution and, in turn, a sounder environment for business.

Notaries. In countries with a Civil Law tradition, the law often requires that various forms of agreements be witnessed or certified by a notary (who are in most cases also lawyers), in order for the documents to be legally enforceable. Notaries are regulated quite differently from jurisdiction to jurisdiction. It is important to understand how the notaries are professionalized within a country and whether there are any qualifications for becoming a notary, whether training or examination is required, and so forth. In addition, the CLIR professional might challenge a legal community to take a critical eye toward the role and effectiveness of its notaries. What is their purpose, and is the value they add to transactions worth their cost? How much time does the notaries' input add to the dispute resolution process, and, again, what is the ultimate benefit of that time spent?

ADDITIONAL GUIDANCE, TOOLS AND RESOURCES

In nations with long democratic traditions, expectations upon all judges – whether they work in civil law, criminal law, commercial law, and/or other areas – are very high. Judges are obliged to uphold the integrity and independence of the judiciary; they must avoid even appearance of impropriety; and they are expected to perform their duties impartially and diligently.¹⁷ By meeting these expectations, judges in democratic societies hold great public confidence, which in turn allows even controversial court decisions to be respected and enforced. CLIR professionals should aspire to achieve this same degree of public confidence in judges in developing and transitioning economies.

In recent years, significant effort has been devoted to bringing judges together for the purposes of peer consultation and professional development. For example, U.S. judges often participate in USAID-sponsored rule of law and commercial law projects on a short-term basis, bringing to various conferences, training programs, and other projects a “judge to judge” perspective in substantive, procedural, and ethical aspects of the judicial profession. There have been many international efforts to bring judges together to discuss issues of common concern, including the Center for Democracy/IFES annual meeting for appellate judges,¹⁸ international conferences on judicial training,¹⁹ the International Association of Judges,²⁰ and others.

Less fully developed is the promising concept of judicial mentoring, which necessarily entails a longer, more fully developed commitment. In general, mentoring “provides a constructive forum for exchanging ideas, sharing potential approaches and solutions to issues, and obtaining constructive feedback on work performance from a neutral evaluator.”²¹ With respect specifically to the judicial profession, “the mentor can educate the mentee about the nature of court activities and the work of judges, as well as traditions, values, customs, policies and procedures that go along with the profession of

judging.”²² Experiences with mentoring programs in countries that lack a stable history of judicial independence – such as Haiti – have established that the most important ingredient in a successful mentoring relationship is trust. Where such confidence is established, one judge from a country with a long tradition of judicial independence can be a vital source of guidance to a judge or group of judges from a tradition lacking in such independence and impartiality, or bogged down in legal formalism. There is very little formal experience to date in the area of commercial law mentoring, but the possibility remains open and the potential for significant, in-depth sharing of knowledge and good will is great.

Accessing Key Resources

Easily accessible, key resources exist that detail, develop and debate the numerous and complex components of Commercial Dispute Resolution, as well as provide information about regional and international initiatives to support pro-competition law and policy. These resources include the following:

USAID’s Office of Democracy and Governance has developed significant expertise in rule of law topics, including judicial reform, court administration, and case management. Publications include the groundbreaking **Guidance for Promoting Judicial Independence and Impartiality** (January 2002), the new **Guide to Rule of Law Country Analysis** (draft, February 2005) and the **Alternative Dispute Resolution Practitioner’s Guide** (March 1998), along with many additional technical papers and other forms of guidance found through its web page (www.usaid.gov/our_work/democracy_and_governance).

The **World Bank’s *Doing Business*** project (<http://www.doingbusiness.org/Default.aspx>) is an important source of a wide variety of statistics and recommendations that are pertinent to systems of commercial dispute resolution.

The **Legal and Judicial Reform Practice Group** of the **World Bank’s Legal Vice Presidency** (www4.worldbank.org/legal/leglr/index_english.html) has

developed extensive resources in its work to with governments, judges, lawyers, scholars, civil society representatives and other organizations to build stronger legal institutions and judicial systems that address the needs of the poor and the most vulnerable.

The **International Foundation for Election Systems** has established a Rule of Law Tool Kit (http://www.ifes.org/rule_of_law/ROL_TK.htm) that provides extensive guidance with respect to reform of courts and judiciaries generally.

ENDNOTES

¹ World Bank, *Doing Business in 2005: Removing Obstacles to Growth* 59 (2005) (hereinafter *Doing Business in 2005*).

² See Eric Jensen, *The Context for Judicial Independence Programs: Improving Diagnostics, Developing Enabling Environments, and Building Economic Constituencies*, published in USAID Office of Democracy and Governance, *Guidance for Promoting Judicial Independence and Impartiality* (Technical Publication Series, January 2002, Rev.Ed.) at 182-83.; see also Thomas Carothers, *Promoting the Rule of Law Abroad, The Problem of Knowledge* 6-7 (Carnegie Endowment for International Peace, Carnegie Paper 34) (2003).

³ Erik Jensen, *The Context for Judicial Independence Programs*, supra note 2, at 183-84 (discussing the interest of SMEs in independent and effective courts); see also *Doing Business in 2005*, supra note 1, at 53-54 (“Legal protections of the rights of small investors are needed.”)

⁴ Juan Carlos Botero, et al., *Judicial Reform*, World Bank Research Observer (Spring 2003) at 72-73 (hereinafter *Judicial Reform*); see also *Doing Business in 2005*, supra note 1, at 63-64.

⁵ *Judicial Reform*, supra note 4, at 80.

⁶ See, e.g., CLIR Diagnostic Assessment Reports posted at www.bizlawreform.com; see also rule of law resources listed on page 17 of this Guide.

⁷ *Judicial Reform*, supra note 4, at 69.

⁸ See CLIR Diagnostic Assessment for the Republic of Bulgaria (March 2002) at 41-42 (located at www.Bizlawreform.com).

⁹ Kotaro Tsuru, Toward Enhancing Judicial Efficiency - Role of ADR as Engine of Judicial Reform, Economics Review (2003), located at www.rieti.go.jp/en/special/economics-review/016.html.

¹⁰ Judicial Reform, supra note 4, at 71.

¹¹ Id.

¹² Id. at 72.

¹³ See CLIR Diagnostic Assessment for the Former Yugoslav Republic of Macedonia (July 2000) at 33-34 (located at www.Bizlawreform.com).

¹⁴ See, e.g., USAID/West Bank and Gaza, First Mediation and Arbitration Center Opens in Ramallah (September 20, 2002) (located at www.usaid.gov/wbg/headline/57.htm); USAID/LAC Bureau, USAID Supports Alternative Dispute Resolution in Latin America and the Caribbean (located at www.usaid.gov/locations/latin_america_caribbean/pdf/dg_conflict.pdf).

¹⁵ American Chamber of Commerce in Croatia, Special Report: Enforcement of Commercial Obligations: Prospects for Change (July 2003) at 4-9.

¹⁶ See Discussion of Legal Profession initiatives, www.abaceeli.org.

¹⁷ See, e.g., Code of Conduct for United States Judges, located at www.uscourts.gov.

¹⁸ Extensive information about this annual conference can be found at www.centerfordemocracy.org/publications.html#english.

¹⁹ Information about the bi-annual conferences on judicial training can be found at www.nji.ca/internationalForum/flyer/. In addition, ABA/CEELI has developed extensive expertise in judicial training, both in individual countries and through the CEELI Institute. See www.abaceeli.org.

²⁰ The International Association of Judges was founded in 1953 as a professional, non-political, international organization, grouping not individual judges, but national associations of judges. See www.iaj-uim.org/ENG/frameset_ENG.html.

²¹ Christie S. Warren, Judicial Mentor Program: Handbook for Mentors, at 5 (prepared for Judicial Mentor Program conducted in Haiti).

²² Id.

Foreign Direct Investment

KEY CONCEPTS

Definition: A system of laws, regulations, and institutions that regulates the treatment of direct investment from outside the country.

What is Foreign Direct Investment? Foreign direct investment (FDI) is a category of investment involving a “lasting interest” and control by an entity from one economy (the *foreign direct investor*) in an enterprise located in another economy (the *FDI enterprise*). FDI has three components: equity capital, reinvested earnings, and intra-company loans. In developing countries, the implication of “lasting interest” and control underscores the benefits of establishing a long-term relationship between the foreign direct investor and the FDI enterprise. The process of FDI in developing countries typically involves setting up production facilities or becoming significantly involved in the operations of an existing enterprise, a far more stable and compelling relationship in most instances than short-term lending or speculative portfolio investment. **Thus, benefits of FDI may include not only the actual funds invested, but also the transfer of innovative production techniques, advanced technologies, knowledge transfers, marketing expertise, and practical experience working within the principles of competitiveness. In addition,**

increased FDI may improve a developing country’s access to foreign markets. Notwithstanding this emphasis on long-term engagement, any legal framework in support of FDI must necessarily allow foreign direct investors to repatriate their profits and transfer proceeds out of the country in the event of liquidation. Legal or practical impediments to doing so will dramatically discourage FDI.

Why do outsiders invest? In examining a country’s relative attractiveness to foreign investors, it is, as a preliminary matter, worth considering why a company or individual would be interested in investing in an enterprise that is located beyond its own borders. In virtually every case the answer is that of *maximizing profit*. The “market-seeking” investor may seek to *expand its markets*, having found that its home market is already saturated with a certain type of goods or services, or that another economy demonstrates a particular demand for (and ability to support) the new product or service.¹ The

Potential foreign investors may be:

- Market-seeking
- Efficiency-seeking
- Resource-seeking

to maximize Profit

Foreign Direct Investment

“efficiency-seeking” investor may desire to *reduce production costs* or otherwise *improve efficiency* (as a prominent example, the cost of skilled *or* unskilled labor may be cheaper in the foreign market than at home). The “resource-seeking” investor may be engaged in relatively speculative hopes of tapping a new source of raw materials or other resources that has been heretofore undiscovered or underused. In all cases, foreign investors will not “go in alone” – prior to establishing a new enterprise or joining an existing one, they engage attorneys, accountants, financial experts, property consultants, and other professionals for the purpose of gathering all relevant, available information and assessing *risk*. Thus, the quantity and veracity of available information in a given country, including the many aspects of its investment environment, significantly affect its attractiveness as a place to invest. As underscored in the World Bank’s *Doing Business in 2005*, the extent to which information is available on company ownership, financial performance, and business transactions has direct bearing on the confidence potential investors may have in the business opportunities they pursue.²

FDI does not necessarily imply a controlling share in the firm, but it does signify considerable influence. FDI can take the form of investment in a new establishment, or the merger with or acquisition of an existing local enterprise. The presence of FDI is often considered to be established when the foreign direct investor owns 10 percent or more of the FDI enterprise. Although this 10 percent criterion is specified by such institutions as the OECD as defining FDI in a country’s balance of payments, some countries choose other criteria to measure FDI. (China, for example, measures FDI by the presence of at least 25 percent aggregate control by the foreign direct investor in the FDI enterprise.) In addition, certain countries restrict the extent to which specific industries may come under foreign ownership; the media and the utility sectors, for example, are areas where various countries have exhibited wariness over foreign control. Regardless of measures used or share limitations set, FDI implies that the investor may exert a significant degree of influence over the management of the FDI enterprise. Although the

foreign money may be welcome, such influence may be less so. Accordingly, local operators of FDI enterprises may benefit from donor-funded activities that provide them with a realistic set of expectations about changes in business practices or attitudes that they might expect to encounter. Donors can help bridge the gap between the private sector in the countries, the government, and the FDI investor.

Investors require clear, accessible, and predictable laws and regulations. Countries may improve their chances of attracting foreign investment by providing unambiguous and accessible information on laws, rules, procedures, and the decision-making process. The following factors will influence the final investment decision:

- Whether the foreign direct investor was promptly directed to sources of information on laws and regulations pertaining to the investment project
- Whether the information was clear, current and comprehensive
- Whether questions or objections were thoroughly addressed, by government officials, local counsel, prospective business partners, and others
- Whether government actions pertaining to the investment were consistent with those taken in the past
- Whether the costs of seeking information and dealing with state institutions were reasonable
- Whether, during the course of developing the relationship, the rules remained constant, or, if they changed along the way, whether the foreign direct investor was notified and consulted.

In light of the importance placed by foreign investors on access to clear, reliable and consistent information, donor-funded programs in support of FDI should act to verify, improve, or support the establishment of mechanisms that enable such access.

Investors need protection. For the bulk of developing countries, stock markets generally do not represent a satisfactory means of FDI. Until their

The World Bank Doing Business Reports recommend the following ways to improve the protection of foreign and domestic investors in firms incorporated in a particular country:

- notifying investors of directors' interests in business deals;
- requiring approval by disinterested directors or investors for related party transactions;
- eliminating loopholes in rules requiring shareholder approval; and
- helping investors bring lawsuits (where courts are strong).

The World Bank Doing Business Reports (2004-2006)

financial markets are vastly improved, developing countries will need private direct investments, which, of course, are scarce. As emphasized in Doing Business in 2005, investors who are tempted to become engaged in a company in a developing country necessarily will seek assurances of protection from expropriation of the money they invest.³ There are many ways that FDI can be expropriated by company insiders or majority shareholders, such as sale of assets or products at below-market prices; purchase of assets or products at above-market prices; issuance of loans at preferential rates; or bad-faith taking away of potential business opportunities.⁴ Potential investors can judge the likelihood of such action based on the presence or absence of sound practices of corporate governance in a country, which itself is evidenced by the amount of available information pertaining to company ownership and finances. **In addition to disclosure of company information, investors also need legal protection in the courts and enforcement capabilities in the courts or by securities regulators, as discussed in various chapters of this Guide.**

FDI reflects a country's overall commercial viability and capabilities. Rather than encapsulating a single law or set of laws and an accompanying set of discrete institutions, FDI represents a lens through which a country's overall investment environment can be studied. A country's rate of FDI provides insight into all types of commercial investments, not simply those made from abroad. Naturally, foreign direct investors go where the best opportunities lie. If a country cannot

attract foreign investment effectively, it is unlikely that the environment is healthy for local investors either. Moreover, states that engage in extensive discrimination against local investors in favor of foreign capital may be signaling an unhealthy climate for local investment. In general, countries where the rule of law prevails and is predictable

and enforceable, where the judicial and regulatory systems are efficient, where corruption is low, and where enterprise ownership is diverse, receive more investment, both locally and from abroad.

Corruption significantly reduces domestic and foreign investment levels. Defined as "the misuse of public office for private gain," corruption increases the cost of investment through the price of bribes themselves, the management cost of negotiating with officials, and the risk of breached agreements or detection. Although it has been asserted that corruption reduces costs by cutting red tape, an emerging consensus holds that the availability of bribes induces officials to contrive new rules and delays. Corruption can also shield companies with connections from fair competition, thus allowing inefficient firms to survive. With respect to potential investors, corruption may be found in customs, occupations linked to the judicial system, tax officials, parliamentarians, police, and ministry officials. Where there are individuals and institutions practicing corruption along the way, an investor may be inclined to give up and seek out another location to do business. Thus, any FDI-related commercial law and institutional reform program would be well advised to access and coordinate with one or more public ethics or anti-corruption initiatives that are taking place in a country.

Support of FDI entails not only legal and institutional reforms, but also reforms pertaining to the overall economic environment. The factors that affect FDI and other commercial investment involve not only the legal environment, but also

Brazil: FDI Incentives and Reforms

Since the late 1990s, FDI in Brazil has decreased from approximately \$30 billion to \$10 billion, following the regional trend of FDI flight. In response, Brazil has passed a Public-Private Partnership law guaranteeing returns on investments in national infrastructure projects. This incentive initiative was passed on the heels of other key institutional and legal reforms, including tax reforms, social security reforms, and a new bankruptcy law. Also, Brazil is taking steps to reduce bureaucratic red-tape in environmental procedures by including officials from the environmental ministry at the earliest possible stage, to identify and address concerns in advance.

Geraldo Samor, Brazil Leader Tailors Pitch to Investors, Wall St. J., June 25, 2004 at A9.

most other sectors of the development arena. These sectors encompass the quality of infrastructure, such as roads, airports, and other transportation options; production standards practiced by various industries (such as sanitary conditions in agricultural production); and the capacities of the workforce, including their health and literacy. FDI-related commercial law and institutional reform programs must therefore be conscious of all aspects of the enabling environment for investment. Donor-funded projects should regularly communicate and cooperate with each other so that resources are leveraged and opportunities are seized.

In general, artificial incentives for FDI will not stimulate investment, if “real” incentives are lacking or the disincentives are overwhelming.

In addition to the rule of law, efficient judicial and regulatory processes, low corruption and a diverse community of enterprise ownership, “real” incentives for potential investors include:

- domestic market size;
- regional market access;
- growth history;
- political and social stability;
- a stable, convertible national currency;
- limited foreign exchange restrictions;
- freedom to acquire ownership and effective control; and
- MFN and/or National Treatment; and adequate investment and property rights protection.

Conversely, investors will take into account such “disincentives” as political and social instability; civil disturbances; habitual mismanagement of the economy; resistance to macroeconomic reforms and restructuring; rampant corruption; poor infrastructure; and the absence of the rule of law. States may seek to obscure disincentives by establishing certain “artificial” incentives designed to attract investment. Artificial incentives include any measurable economic benefit afforded to specific investors or enterprises that are not reflective of commercial norms, but rather are designed to reduce the real costs of investment. They include tax or other fiscal incentives, financial incentives, trade protection, or other forms of preferential treatment. Even when such artificial incentives exert some “pull” in investor decision-making, they may still present problems for the offering government and ultimately prove counterproductive. Incentives should therefore focus on those activities that create the strongest potential for spillovers, including linkages between foreign-owned and domestic firms, education, training, and research and development.

MAJOR GUIDELINES

Legal Frame Work

The legal framework through which FDI enters a country and is then regulated consists of the country’s constitutional provisions, laws, regulations, policies, and practices that define the rights and obligations of both the foreign investor and the host state. Bilateral investment treaties or multilateral or regional conventions, as well as agreements for the

“Real” FDI Incentives	“Artificial” FDI Incentives	FDI Disincentives
<ul style="list-style-type: none"> • General indicia of rule of law • Efficient judicial and regulatory processes • Low corruption • Diverse community of enterprise ownership • Domestic market size • Regional market access • Growth history • Political and social stability • Stable, convertible national currency • Limited foreign exchange restrictions • Freedom to acquire ownership and effective control • Most Favored Nation and/or National Treatment • Adequate investment and property rights protection 	<ul style="list-style-type: none"> • Tax benefits • Financial incentives • Trade protection • Relaxed regulations 	<ul style="list-style-type: none"> • Political and social instability • Economic mismanagement • Resistance to macro-economic reforms and restructuring • Corruption • Absence of the rule of law • Poor infrastructure

avoidance of double taxation may supplement this framework.

There is an ongoing debate over whether countries should have a separate foreign investment code or other discrete set of FDI-specific laws. On the one hand, as exhibited by the high level of FDI in the United States, it is not necessary to have a separate FDI law; rather, it is sufficient to offer an attractive investment climate with few restrictions based on the source of capital or nationality of investors. On the other hand, policy-makers in transitioning or developing countries may believe that a discrete code may serve to “package” their relevant incentives and restrictions in a way that is useful to potential foreign investors. Regardless of whether a separate code exists, the key to an effective legal framework is legal information that is available prior to investing.

International best practices recommend that foreign and domestic investors be treated the

same for most purposes. For example, foreigners should not be required to maintain specific targets or production requirements. Nor should they be subjected to an unduly burdensome licensing regime that may not apply to domestic enterprises. Foreigners do have some unique needs, chiefly the ability to repatriate profits, make payments to suppliers in a foreign currency, and transfer proceeds out of the country in the event of liquidation. (Generally the need to transfer money is unique to enterprises with foreign direct investment.)

Corruption. The legal framework of the host country in one of several sources of relevant authority. The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions was entered into force in February 1999 and has since been ratified by all 35 signatory countries.⁵ OECD member countries account for more than three-quarters of global trade

Specific elements of a legal framework in support of FDI include:

- Admission/Establishment (including all licensing procedures);
- Restrictions on Foreign Investment;
- Availability of Incentives for Foreign Investors;
- Investment Protection;
- Property Rights;
- Taxation/Profits;
- Remission/Capital Repatriation rules; and
- Clear and Enforceable Systems of Dispute Resolution.

and, under the terms of the OECD Convention, they were each required to create implementing legislation. Largely modeled on the U.S. Foreign Corrupt Practices Act (FCPA), which was enacted in 1977, the OECD Convention makes it possible to prosecute companies in their home countries for paying bribes abroad. Unfortunately, a study in 2002 by the London-based Control Risks Group found that only 56 per cent of British companies, 38 per cent of German companies, and 30 per cent of Dutch companies were familiar with the convention.⁶ Moreover, new laws had not yet resulted in any criminal convictions. Nonetheless, transitioning countries and even fragile states engaged in FDI promotion may send an important signal by noting their understanding and support of the OECD Convention in all promotional literature pertaining to FDI.

Implementing Institutions

A country that wishes to provide a welcoming environment for FDI requires a network of implementing institutions that support the development and implementation of meaningful investment opportunities. These implementing institutions include:

FDI agencies. Most transitioning countries have established some sort of agency responsible for promoting or monitoring FDI.

This agency may or may not in practice serve as a “one-stop shop” for investors seeking information about opportunities, incentives, restrictions, procedures and resources. Even if the FDI agency does aspire to serve as a facilitator for all requisite information and incentives, it is likely that most investors will be required to deal with a host of other regulatory institutions, such as the Ministry of Labor, the competition authority, regional or local licensing agencies, commercial registries, and courts. Thus, the effectiveness of an FDI agency turns on the clarity of its mandate and its ability to assist potential foreign direct investors in finding answers. It may also depend on the quality of its personnel – the ability to speak and prepare materials in relevant foreign languages, for example, is key. The FDI agency may also find itself in an advocacy role, helping to inform other national or

China: FDI Magnet Needs Solid Legal Institutions

“At \$30 per capita, China receives less FDI than other major developing countries, such as Brazil with \$195 per capita. Moreover, in the 25 years since China opened the door to foreign investment, much of the spending has been concentrated in low-technology, labour-intensive manufacturing projects. A relatively low share of FDI has come from the world’s most prolific investors, historically OECD member countries.

China’s challenge now is to develop a more transparent business environment with a clear legal and regulatory framework. That should help attract higher-quality investments that are focused on long-term, high-technology, capital-intensive projects.”

Reforms Could Boost China’s Ability to Attract Foreign Investment OECD (2003)

regional institutions, as well as the public, about the importance of putting the country’s “best foot forward” with respect to attracting investment. Donor-funded programs should be able to provide significant technical assistance with this advocacy role.

Ministries, registries, and other licensing agencies. Not only should investors be provided with a clear explanation of what it takes to invest in an existing business or start a new one, but also all of the members of the implementing community should similarly be aware of how their respective regulations and procedures impact the FDI process. Implementing institutions should be able to provide potential investors with a clear sense of how long a certain process will take, such as company registration or entry into the employment system. Unduly bureaucratic, duplicative or discriminatory links in the chain should be identified and addressed. The inability to provide clear and consistent answers to questions posed by potential investors may be an indication of corruption.

Courts. As discussed in previous chapters, courts often review or approve the licensing and formation of companies, and in many instances they have the primary role of registering companies, including those operated by foreign investors. Courts are also the primary site for resolution of lawsuits against companies, including suits by shareholders, creditors, and employees. For courts to effectively address the needs of all commercial litigants, including foreign investors, they must have judges who are endowed with meaningful benchmarks of judicial independence, including sufficient professional capacity and transparent, efficient methods of processing cases. As noted in *Doing Business in 2005*, “As in any other commercial dispute, the speed, cost, and fairness of the judgment determine whether small investors would use the courts and succeed in getting compensation.”⁷

Supporting Institutions

Those supporting institutions that have a role in the implementation of Company Law, Contract Law, the Law of Secured Transactions and other

laws pertaining to an enterprise’s ability to conduct business will necessarily hold important roles with respect to FDI. These institutions include notaries, customs agencies, professional associations, and trade groups. In addition, certain donor-established groups such as **national competitive councils**, or **commercial law roundtables**, may also play an important role in creating a sound investment climate.

Three additional groups – the media, the specialized service sector, and the donor community – are worth considering as having particular importance with respect to supporting FDI:

The media. A tone of receptiveness or hostility is often struck and perpetuated by influential media outlets in developing countries, including newspapers, magazines, television stations or Internet-based media. Where FDI is treated as a negative or threatening concept in the local media, those institutions that support the increase of FDI (including state agencies, business groups and donor institutions) should systematically respond to charges, by sharing information, correcting myths, and, where necessary, altering conditions.

Specialized services. As opposed to local investors who are used to the prevailing bureaucratic structure, foreign investors are less likely to receive poor services without vocal objection. They may insist on prompter attention, clearer answers, friendlier customer service, and more tangible results in the various business-related activities they encounter, such as the postal services, computer servicing and repair, or the attention of landlords. Foreign investors can provide insightful commentary on how local services measure up to international standards and best practices. Where they encounter exceptionally strong service and assistance, they also can help direct these better local enterprises into new areas and opportunities.

The community of donors. Development projects funded by individual countries, regional organizations and multi-lateral institutions may require coordination to minimize duplication of effort or conflicting approaches. All aspects the FDI

environment are inter-related. Thus, FDI is an area of CLIR that mandates especially strong efforts to coordinate among donors.

ADDITIONAL GUIDELINES, TOOLS, AND RESOURCES

Achieving an investor-friendly environment for FDI takes a deep level of commitment to the rule of law, efficient judicial and regulatory systems, low corruption, and a commitment to competition (as exhibited by diverse commercial ownership). Although certain small-scale initiatives, such as improving access to investment-related information, may help improve a transitioning country or fragile state's relative attractiveness to foreign investors, FDI will typically follow where that country's overall commitment to meaningful governmental, societal and economic reforms has been demonstrated. In addition, as enunciated in USAID's Strategy for Building Trade Capacity in the Developing World, published in 2003, the increased ability to trade in a global marketplace is highly correlated with improvements in the local investment climate. Trade and investment are considered complementary engines of economic growth. Pursuant to this Strategy, USAID will likely focus specific programs on Trade Capacity Building assistance rather than promoting investment per se.

Building Support for Reform

Improvement of the FDI environment requires broad-based commitment to reform. A coalition in support of FDI should include allies from inside and outside the official institutions of the government, such as politicians, executive branch officials, business and civic leaders, professional associations, universities, and others. Donors can establish and support coalitions through the creation and facilitation of new institutions such as national competitiveness councils, commercial law roundtables, and public information campaigns.

Public education is vital if all segments of a society are to learn how they may have a role in improving a country's investment environment. Initiatives such

as newsletters, town hall meetings, radio call-in shows, or video presentations may demonstrate in a tangible, accessible way that a society can make itself attractive to foreign investors through commitment to literacy, work quality, improved services, and international standards.

Accessing Key Resources

Easily accessible, key resources exist that detail, develop and debate the various aspects of FDI, as well as provide information about regional and international initiatives to support investment. These resources include the following:

The **World Bank's Doing Business** project (<http://www.doingbusiness.org/Default.aspx>) is an important source of a wide variety of statistics that are relevant to a country's attractiveness to foreign investors.

The **Multilateral Investment Guarantee Agency (MIGA)** (www.miga.org) was created in 1988 as a member of the World Bank Group to promote foreign direct investment into emerging economies for the purpose of improving people's lives and reducing poverty. MIGA fulfills this mandate by offering political risk insurance (guarantees) to investors and lenders, and by helping developing countries attract and retain private investment. In addition, MIGA has developed the Investment Promotion Network (IPAnet), now the leading international investment-specific portal Web site providing free access to online foreign investment and privatization resources. IPAnet provides an extensive searchable database of over 12,000 Web-based documents, including research on economies and product markets, investment-related laws and treaties, and information about specific investment opportunities.

The **United Nations Conference on Trade and Development (UNCTAD)** (www.UNCTAD.org) has developed a variety of initiatives pertaining to Investment, Technology and Enterprise Development. UNCTAD analyses trends in foreign direct investment and their impact on development; helps countries to promote international investment and understand the issues involved in international

investment agreements; devises strategies for the development of small and medium-sized enterprises; and identifies policy options and implements capacity building programs to encourage the use of new technologies.

Since 1993, **OECD** (www.OECD.org) has published a series entitled OECD Reviews of Foreign Direct Investment, covering OECD member countries and several important non-member countries. The Reviews present the results of periodic examinations of FDI trends and policies in these countries. Policy areas covered include: screening mechanisms, real estate legislation, monopolies and concessions, measures taken for public order and essential security, investment protection, taxation of foreign affiliates and investment incentives. The Reviews also consider questions of corporate organization and the possibility of restrictive private practices. Sectors where restrictions on foreign direct investment are maintained (such as energy, finance, insurance, transport, professional services, etc.) are discussed individually, along with an assessment of the reasons for these restrictions.

Transparency International (www.transparency.org) has developed a “Corruption Fighters Toolkit” which may prove useful in designing commercial legal and institutional reform programs that seek to improve the FDI environment by decreasing corruption.

ENDNOTES

¹ Indeed, FDI in services is almost by definition local market-seeking, rather than oriented toward greater exports or improved efficiency. Peter Nunnancamp, *Determinants of FDI in Developing Countries: Has Globalization Changed the Rules of the Game?*, Kiel Institute for World Economics, Working Paper No. 1122 (July 2002).

² World Bank, *Doing Business in 2005: Removing Obstacles to Growth 49* (2005) (hereinafter *Doing Business in 2005*).

³ *Id.* at 51.

⁴ *Id.*

⁵ More information about the OECD Convention on

Combating Bribery of Public Officials can be found at www.oecd.org/document/21/0,2340,en_2649_34859_2017813_1_1_1_1,00.html.

⁶ The Control Risks Group survey can be found at www.crg.com/static/Control_Risks_Group_Global_Corruption_Survey_2002_Results.pdf.

⁷ *Doing Business in 2005*, supra note 2, at 55.

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International Trade

KEY CONCEPTS

Definition: A system that governs the cross-border sale of goods and services.

What is International Trade Law?

International Trade law and policy serves many purposes, from establishment of and compliance with a clear set of ground rules, to promotion of greater consumer choice and lower prices, to raising incomes and supporting economic growth. **Trade and investment are powerful engines that drive economic growth and reduce poverty.** By trading with other countries and attracting foreign investment, nations can take advantage of global market forces – competition, human resource development, technology transfer, and technological innovation – all of which can generate growth. The experience of the past few decades has confirmed that when countries open themselves up to investment and trade with the rest of the world, and accompany this “openness” with reduced regulation, they stimulate economic growth, which in turn reduces poverty.¹ The central challenge of transitioning economies is

removal or reduction of trade restraints, such as unnecessary regulations, inadequate legal structures, security problems, regional inconsistencies in law and practice, poor technology, and corruption. In contrast, the poorest countries often suffer from a fundamental lack of “supply-side competitiveness” – that is, an absence of basic infrastructure, little if any agricultural surplus, and a weak to nonexistent manufacturing base.² For these countries, such conditions must be overcome as a prerequisite for achieving the long term benefits from trade.

The topic of International Trade is enormously broad, encompassing a myriad of international, regional, and bilateral agreements, along with a vast array of domestic laws and institutions. The improvement of a country’s legal and institutional environment for trade is a multi-faceted proposition. On the one hand, reform involves accession to and compliance with international or regional trade agreements which serve to reduce tariffs, address other trade barriers,

The **Most Favored Nation (MFN)** principle provides that a member’s lowest tariff rate must be extended to all members of a trade pact.

The **National Treatment** principle requires a commitment to treat foreign goods, once they have lawfully entered a country, no differently than goods produced domestically.

and consolidate markets. In general, membership in these agreements is based on the principles of non-discrimination – the Most Favored Nation (MFN) principle provides that a member’s lowest tariff rate must be extended to *all* members of a trade pact, and the principle of National Treatment requires a commitment to treat foreign goods, once they have lawfully entered a country, no differently from goods produced domestically.

On the other hand, international trade reform also involves many aspects of domestic law reform and institutional capacity building that directly or indirectly affect a country’s ability to compete in the global marketplace. Thus, rather than detailing all legal and institutional considerations pertaining to international trade, the discussion in this chapter merely sets forth various themes in the field about which the development professional must be aware, along with references to several of the resources available for the purpose of obtaining additional information.

Building Trade Capacity. USAID-sponsored CLIR activities contribute to the ability of developing and transitioning countries to participate in trade negotiations, implement trade agreements, and respond to opportunities for trade. The United States supports developing and transitioning countries in their efforts to become full participants in the rules-based trading system of the World Trade Organization, as well as in important regional trade agreements, such as the European Union, the Central American Free Trade Agreement (CAFTA), the Caribbean Community (CARICOM), and the

pending Free Trade Area of the Americas (FTAA). In addition, through Trade Capacity Building (TCB), USAID aspires to increase the ability of developing and transitioning countries to harness global economic forces to accelerate growth and reduce poverty. In March 2003, USAID published a *Strategy for Building Trade Capacity in the Developing World*,³ which sets forth: (a) USAID’s position on the relationship between trade and development; (b) the conceptual framework for USAID engagement in TCB; and (c) the Agency’s plan for increasing its own capacity to deliver more – and more effective – TCB assistance. The Strategy promotes tangible improvements in the effectiveness of developing countries’ commercial laws and institutions, and, over time, improvements in the quantity and quality of individual developing country’s exports, imports, and foreign investment.⁴

“Economic Responsiveness” to Opportunities for Trade. TCB activities aimed at enhancing economic responsiveness, competitiveness and productivity address a wide range of development needs in the public and private sectors, from helping states create a competitive and enabling environment, to supporting local enterprises’ abilities to identify and produce goods and services that the world is willing to buy.

Almost all categories of assistance in “economic responsiveness” implicate legal and institutional reform, and those categories include the following:

- **General Commercial Law reform**, including improved laws, institutions, and enforcement

“It is clear that integration into the global economy can be a powerful force for economic growth and poverty reduction. Trade and investment are the principal mechanisms through which global market forces – competition, human resource development, technology transfer, and technological innovation – generate growth in developing and developed countries. Trade expansion is particularly critical for many of the smallest and poorest developing and transition economies, where local demand is too weak to support rapid expansion of production, employment, and incomes. Integration into the global economy can also enhance economic and social stability, a factor in conflict prevention. Participation in the rules-based trading system reinforces good governance and strengthens legal and institutional reforms, creating a more predictable and conducive environment for mobilizing private finance and generating economic growth.”

USAID, *Strategy for Building Trade Capacity in the Developing World* (March 2003)

pertaining to companies, contracts, bankruptcy, secured transactions, and dispute resolution;

The World Bank Doing Business Report proposes several regulatory and transport solutions to international trade barriers on goods, including electronic filings of customs clearance and trade documentation; Customs agencies using a risk assessment policy for inspections; and promoting harmonized regional customs reforms and transport rules.

The World Bank Doing Business Report (2006).

- **Improved Governance and the Rule of Law**, specifically making policies more transparent, as well as helping the different agencies of a host country function more effectively in the trade policy arena;
- **Financial Sector development and Good Governance**, to help make financial systems responsive to the needs of trade, including reforms in banking and securities markets and implementation of laws and regulations that protect and promote trade-related investment;
- **Customs Operation and Administration**, encompassing assistance to help countries modernize and improve their Customs offices;
- **E-Commerce Development and Information Technologies**, helping countries acquire and use IT to promote trade by creating business networks and disseminating market information;
- **Export Promotion**, including assistance to increase market opportunities for developing country and transitioning economy producers;
- **Business Services and Training**, for the purpose of improving the associations and networks in the business sector, as well as enhancing the skills of business people engaged in trade;
- **Regional Trade Agreements**, including assistance to a regional association or to an individual country that increases the ability of the RTA to facilitate trade;
- **Human Resources and Labor standards**. To help workers participate in the gains from trade and protect their rights in trade-related sectors, assistance programs can support workforce skills development, publicize worker rights and labor standards, and promote elimination of child labor exploitation and gender bias;
- **Physical Infrastructure Development**, establishing and/or supporting trade-related telecoms, transport, ports, airports, power, water, and industrial zones;
- **Trade-related Agricultural Development**, which endeavors to extend the benefits of trade to rural sectors through support for trade-related aspects of agriculture technology development and agribusiness;
- **Environmental Sector Trade and Standards**. To assure that trade is environmentally neutral or positive, assistance includes efforts to improve environmental regulations and standards, as well as to promote transfer of environmental technology for sustainable development;
- **Competition Policy**, for the purpose of ensuring open and free markets, protecting consumers, preventing conduct that impedes fair competition among businesses, and stimulating enterprise innovation and efficiency which supports the design and implementation of competition laws;
- **Foreign Direct Investment**, which, though complementary in impact to trade generally, involves the promotion of “lasting interest” and control by an entity from one economy (the foreign direct investor) in an enterprise located in another economy (the FDI enterprise); and
- **Services Trade Development**, which helps developing countries and transitioning economies increase their flows of trade in the following are U.S.: Tourism Sector Development (Assistance to help countries expand their international tourism sectors, including eco-tourism); and Other Services Development (Assistance to help countries develop trade in services sectors such

The World Trade Organization

The WTO is located in Geneva and was established in January 1995 in the Uruguay Round Negotiations (1986-94) of the post-World War II initiative called the General Agreement on Tariffs and Trade (GATT). The WTO has approximately 150 Members, including about 10 new members since 2000. About 31 countries held “observer” status as of March 2007. The primary functions of the WTO are to administer WTO trade agreements (which consist of several multilateral agreements, understandings and decisions, and a variety of plurilateral agreements); act as a forum for trade negotiations; handle trade disputes; monitor national trade policies; and cooperate with other international organizations.

A dispute arises when a member government believes another member government is violating an agreement or a commitment that it has made in the WTO. The authors of these agreements are the member governments themselves — the agreements are the outcome of negotiations among members. Ultimate responsibility for settling disputes thus lies with member governments, through the WTO’s Dispute Settlement Body.

as financial services, energy, transportation, and education among others).

Donor-provided legal and institutional support for Trade Capacity Building typically incorporates WTO awareness, accession and compliance.

Countries seeking membership in the WTO require a basic understanding of the various WTO agreements and a commensurate understanding of what laws, regulations, policies, and procedures will need to be changed for the purpose of completing negotiations on the terms of WTO membership. In general, the fundamental requirements for WTO accession include the following:

- **Tariffication:** Member countries must agree that all restrictions or limitations on foreign trade must be expressed in terms of tariff *rates* and not in terms of quantities or other conditions;
- Member countries must adhere to binding tariff rate commitments;
- **Most Favored Nation Principle:** Member Countries commit to the *absence of discrimination* in foreign trade by application of the lowest tariff rates to all WTO member countries;
- **Transparency:** Trading rules and regulations must be adopted and made available in an open manner;

Trading on the Same Terms: The Role of the International Chamber of Commerce

The International Chamber of Commerce (ICC) has developed standard trade definitions most commonly used in international sales contracts, the International Commercial Terms (Incoterms). Devised and published by the International Chamber of Commerce, the Incoterms are at the heart of world trade. Among the best known are EXW (Ex works), FOB (Free on Board), CIF (Cost, Insurance and Freight), DDU (Delivered Duty Unpaid), and CPT (Carriage Paid To). ICC introduced the first version of Incoterms in 1936. Since then, ICC lawyers and trade practitioners have updated them six times to keep pace with the development of international trade.

International Chamber of Commerce, www.iccwbo.org.

- **National Treatment:** Member countries further commit to non-discrimination between national and foreign goods once they enter a country by treating foreign goods in the same way as goods produced within the country (the so-called “National Treatment” rule).

In addition, donor support for compliance with WTO agreements includes building the capacity of numerous state-based institutions – including Trade Ministries, Customs agencies, and Competition and

Intellectual Property authorities – so that developing and transitioning countries may reap the benefits of membership.

Trade Capacity Building assistance must address the everyday details of establishing and enforcing trading relationships. Companies engaging in International Trade must be able to rely on clear and enforceable terms of doing business. Accordingly, a sound domestic legal environment should facilitate the following:

- The making of an agreement for either the sale of goods or the sale of services
- The obligations of performance, including delivery and transportation
- The mechanisms and guarantees of payment
- The allocation of risk, including insurance.

Not only must a domestic legal and regulatory environment allow companies to enter into international trading relationships, it must also enable parties to enforce their international contracts. The overall weakness of domestic court systems in developing countries generally precludes their involvement in rendering judgments on disputes. Instead, international trading partners

often designate in their contracts specific forums for conflict resolution, typically either the court system of the trading partner from the wealthier country or an international arbitration tribunal. Execution of a foreign court decision or an arbitration award, however, necessarily depends on the effectiveness of local courts (including the ability of judges to understand the awards and the capacity of domestic institutions to carry out the execution of judgments). Where the experience of international traders is that the local courts will not enforce judgments against local defendants, they are significantly less likely to engage in trade in that country.

MAJOR GUIDELINES

Legal Framework

The scope and number of laws that are implicated by International Trade law and policy are so vast that only the most prominent among them can be mentioned in this publication. All that has been said with respect to the drafting, refinement, and enforcement of the basic Commercial Law infrastructure – including Company Law, Contracts, Property, Secured Transactions, Bankruptcy, and Competition – ultimately supports TCB, and must

be newly considered with respect to legal frameworks in support of trade. In addition, domestic law pertaining to International Trade takes numerous forms, often beginning in a nation's **constitution** and found also within a country's legal framework pertaining to **foreign relations** or **International Trade** generally.

Trade in Goods. Trade in goods is a multi-faceted subject which implicates a country's laws and institutions pertaining to all phases of the trade relationship, from determining the origin of an item, to the obligations of its seller and buyer, to its transportation to market, to its crossing of international borders, and so forth. Certain multilateral treaties play an

Dumping and Countervailable Subsidies: Two Central Topics in International Trade Law

Dumping occurs when a foreign producer sells a product in another country at a price that is below that producer's sales price in the country of origin or at a price that is lower than the cost of production. The difference between the price (or cost) in the country of origin and the price in the foreign market is called the "dumping margin." Unless the conduct falls within the legal definition of dumping, a foreign producer selling imports at prices below those of domestic products is not necessarily dumping.

A Countervailable Subsidy exists when a government subsidizes industries by providing financial assistance to benefit the production, manufacture or exportation of goods. Subsidies can take many forms, such as direct cash payments, credits against taxes, and loans at terms that do not reflect market conditions. The amount of subsidies the foreign producer receives from the government is the basis for the subsidy rate by which the subsidy is offset, or "countervailed," through higher import duties.

important role in this field -- notably the **U.N. Convention for the International Sales of Goods**⁵ -- and others that deal with dispute resolution and the enforcement of resulting adjudications.⁶ A country's **Customs Code** is of central importance -- in general, the law should define its purpose and scope; set forth all matters under Customs supervision and control; identify those goods subject to duties and fees, along with the process for collecting duties and fees; define any special zone or warehouse provisions; explain the duties and obligations of the Custom agency, including the qualifications for and responsibilities of agency management and staff; and establish penalties and the procedure for collection of penalties. Countries often have laws pertaining to **Exports** and the **prevention of unfair competition** (which includes prohibitions against dumping or illegal subsidies).

Other legal regimes implicated in the sale of goods include those pertaining to **agriculture, information technology products, market access for goods, sanitary and phytosanitary measures** (food safety and animal and plant health and safety), **Rules of Origin** (determining where a product comes from), **state trading enterprises**, and, as further discussed below, **Intellectual Property**.

Trade in Services. A large part of International Trade today consists of trade in services, such as banking, call-processing, insurance, travel,

transportation, oil extraction, and other services. Domestic legal regimes generally address various aspects of trade in services. Banking law often covers the rights and responsibilities of foreign banks in domestic markets, foreign banking, and international lending. For companies engaged in trade in banking and all other services, contractual arrangements are often very extensive and require great precision. The **WTO's General Agreement on Trade in Services (GATS)** sets forth certain fundamental standards for trade in services that member states are expected to observe. Namely, the GATS covers: (1) **cross-border supply** (services supplied from one country to another); (2) **consumption abroad** (consumers or firms making use of a service in another country, i.e. tourism); (3) **commercial presence** (a foreign company setting up subsidiaries or branches to provide services in another country, i.e., foreign banks setting up operations in a country); and (4) **presence of natural persons** (individuals traveling from their own country to supply services in another).

Significant legal and policy concerns arise from these four aspects of the trade in services. Implicated issues include the value and desirability of "outsourcing;" the treatment that foreign businesses are to receive when doing business in another country; and domestic policies toward foreign workers.

Intellectual Property. The trading of goods and services that contain or constitute intellectual property has provoked significant concern in recent years as many countries have shown a lack of concern for or ability to protect intellectual property rights. The WTO's **Trade-Related Aspects of Intellectual Property Rights (TRIPS)** Agreement is an attempt to narrow the gaps in the way intellectual property rights are protected around the world, and bring them under common international rules. The TRIPS agreement establishes minimum levels of protection that each member state must give to the intellectual property of fellow WTO members. In doing so, the TRIPS Agreement strikes

Basic principles of GATS

- All services are covered by GATS
- Most-favored-nation treatment applies to all services, except the one-off temporary exemptions
- National treatment applies in the areas where commitments are made
- Transparency in regulations, inquiry points
- Regulations have to be objective and reasonable
- International payments: normally unrestricted
- Individual countries' commitments: negotiated and bound
- Progressive liberalization: through further negotiations

[www.wto.org: services: rules for growth and investment](http://www.wto.org/services/rules_for_growth_and_investment)

The TRIPS Agreement covers five broad issues:

- How basic principles of the trading system and other international intellectual property agreements should be applied;
- How to give adequate protection to intellectual property rights;
- How countries should enforce those rights adequately in their own territories;
- How to settle disputes on intellectual property between members of the WTO; and
- Special transitional arrangements during the period when the new system is being introduced.

www.wto.org/intellectual_property_gateway_page

a balance between the long-term benefits and possible short-term costs to society. The assumption underlying intellectual property is that society benefits by encouraging creation and invention, and thus intellectual property gives the inventor exclusive rights for a limited time afterwards to reward creative behavior. When the period of protection expires, the creations and inventions enter the public domain. Member states are permitted to authorize the use of intellectual property under certain circumstances such as to tackle public health problems. And, when there are trade disputes over intellectual property rights, the WTO's dispute settlement system is available to resolve the matter.

Legislative drafting and trade. Membership in the WTO signals a country's understanding and agreement that the various phases in foreign trade activities shall be **reasonable, fair, simple, and transparent**. Article VIII of the General Agreement on Tariffs and Trade (GATT) specifically admonishes WTO member countries to recognize "the need for minimizing the incidence and complexity of import and export formalities and for decreasing and simplifying import and export documentation requirements." The WTO Agreement on Technical Barriers to Trade similarly states that members "shall ensure that technical regulations are not prepared, adopted or applied with a view to or with the effect

of creating unnecessary obstacles to International Trade."

Thus, WTO membership imposes significant obligations on both lawmakers and state officials who are required to draft and enact laws directly or indirectly relating to trade. In order to comply with WTO requirements, they must ask themselves when they introduce a measure of control: "Is this measure really necessary? Does it fall within the range of controls allowed by the WTO? Aside from achieving its desired purpose, will it benefit trade?" If the above questions cannot be answered in the affirmative, then it is likely that the intended measure may contravene the objectives of the WTO or otherwise undermine the trade of the country by reason of onerous requirements.

Implementing Institutions

The institutions charged with implementing International Trade law and policy will typically be state agencies, including trade ministries and trade-related administrative agencies. In fact, when trade is regarded under the broader context of TCB, many institutions will have an implementing role – that is, with respect to specific aspects of trade, they have primary responsibility for the implementation and enforcement of framework and subsidiary laws. These institutions include the following:

- Legislatures, Parliaments and other legislative bodies
- Government ministries, including those overseeing Trade, Labor, Agriculture, Commerce, Information, Patent & Copyright, and the Environment
- Other state agencies, such as Competition authorities, Customs agencies and other agencies empowered to make regulations
- Courts
- Public registries, including those for companies, property, or collateral.

Each of these institutions should have qualified, trained staff sufficient to handle their trade-related

needs. They should employ institutional mechanisms for ensuring effective public-private sector collaboration, exchange of ideas, and evaluation of policy options. There should rarely, if ever, be a state monopoly over trade in goods or services. For example, state monopolies over telecoms tends to drive up costs for business while also providing poorer services. Finally, each implementing institution should foster the availability of accurate trade-related data for the purposes of attracting investment, avoidance of possible problems, and of dispute resolution.

The chief implementing institution for trade-related initiatives is generally referred to as a **Trade Commission**, although it may frequently be known as the Ministry of Trade, different titles will exist worldwide. The Trade Commission is the entity responsible for compliance with WTO requirements, or, in the absence of WTO membership, and other relevant trade laws and agreements. To be effective, the Trade Commission must have a clearly defined mandate; sufficient authority, funding, support, and professional and administrative staffing to carry out its mandate; detailed internal regulations and operating procedures; and sufficient opportunities for training and professional development resources for staff to continuously stay current in the field.

The **Customs Agency** is often viewed as the “face” of a country’s commitment to trade – that is, the effectiveness and professionalism of its officers generally reveal whether trade is viewed by a state as an opportunity for economic development, or as a way-station for bureaucracy, political favoritism, or individual enrichment. As the major implementing institution for facilitating trade, it is important that the Customs Agency be managed, staffed and equipped to achieve the appropriate balance between facilitation and control. A modern customs administration should have basic organizational capacity, with solid leadership in management; reliable and sufficient equipment; and well trained staff in appropriate numbers with the ability to execute key functions, such as risk-management, payment collection, automation, basic procedures, inspections, public-private sector cooperation, and regional integration. The effectiveness of a Customs Agency is revealed by such indicators as the time it takes for goods to cross a border, its use of technology, the professionalism of Customs officers and inspectors, the perception and reality of corrupt practices at the border, and numerous other variables.

Immigration Agencies play an important role concerning the movement of people across borders

An Example from El Salvador: The Importance of Trade-Related Institutions

“El Salvador has made great strides facilitating trade over the past few years. It is a leader in the region in its performance of trade facilitation.” Indications are that some aspects of the trading system have improved: 1) development of a stronger Customs agency; 2) development of open markets nationally, regionally and internationally; 3) good working relationships between the public and private sector; 4) increases in security environment; and 5) upgrades in infrastructure.”

“However, the trade-related institutions still encumber traders with trade transaction costs through delays and administrative burdens. Trade facilitation remains important to El Salvador, because declining tariffs, just-in-time manufacturing and fierce global competition all make the cost of getting a good from the seller to the buyer more important than ever before. By eliminating the unwarranted and onerous constraints embodied in laws, regulations and procedures, El Salvador can capture greater savings and efficiencies. In fact, improving the trade facilitation environment can reduce trade costs by as much as 15 percent of the value of traded goods. In El Salvador’s market, where \$12 billion in goods and services were exchanged in 2003, this can lead to significant savings. In turn, these savings will make Salvadoran exporters more competitive, lead to lower prices for Salvadoran consumers and enhance El Salvador’s overall attractiveness as an investment opportunity.”

Trade and Commercial Law Assessment – El Salvador (January 2005).

for the purpose of providing services. Again, the challenge before the Immigration Agency is to maintain the proper balance between facilitation and control. Although Immigration officers are obliged to prevent the illegal movement of people across borders, they also should understand the economic significance of trade in services and minimize bureaucracy where the movement is for legitimate engagement in legal trade.

Supporting Institutions

The institutions that sustain an environment conducive to trade permeate a society. They include everything from a **pool of skilled and trained labor and management**, to **market-responsive producers** who are ready and willing to develop market capacity and are responsive to market conditions. Additional trade-related supporting institutions include the following:

The financial sector is a critical component of an economy that is capable of supporting meaningful trade. Financial sector development and good governance assistance includes financial sector work, monetary and fiscal policy, exchange rates, commodity markets and capital markets.

Private business support organizations, chambers of commerce, and trade associations can be crucial to trade facilitation by offering services that are often too costly for any one firm to obtain alone. For example, business support organizations may provide: trade leads, partners and contacts for businesses, data and information on export markets, training in foreign business practices and export requirements, and organization for trade missions. They may also serve as advocates for policy changes that affect the ability of local businesses to trade in international markets. These organizations may include: chambers of commerce at the national, regional or local level, industry or business associations, women's business associations, for-profit consulting firms, non-governmental organizations that provide technical assistance or training, or business training organizations.

Similar to FDI, the tone of receptiveness or hostility is often struck and perpetuated by influential **media outlets** in developing countries, including newspapers, magazines, television stations or Internet-based media. Where trade is treated as a negative or threatening concept in the local media, those institutions that support the increase of trade (including state agencies, business groups and donor institutions) should systematically respond to charges, by sharing information, correcting myths, and, where necessary, altering conditions.

ADDITIONAL GUIDELINES, TOOLS, AND RESOURCES

As mentioned at the outset of this discussion, much of the details of trade law and policy currently have less effect in the poorest countries – generally categorized as fragile states – where vast supply-side limitations render participation in international trade by most businesses more difficult. For these fragile countries, many in Sub-Saharan Africa, building capacity for trade must also include fundamental areas of infrastructure -- roads, ports, electricity, and telecommunications.

“Economic growth in the poorest countries depends crucially on a more dynamic agricultural sector.”⁷ The topic of agricultural subsidies and farm liberalization is one of great concern and even controversy, due to demands on both wealthier and poorer countries to “totally and definitively” eliminate export subsidies.⁸ Other issues of specific concern to the poorest countries include the following:

- Nonagricultural market access (including textiles and clothing)
- Trade in services, in particular the temporary movement of people to supply services
- Anti-dumping barriers, which poor countries often perceive as being used disproportionately against them (but which they also have increasingly come to use themselves)
- Preferencing schemes that benefit certain regions or sectors, but may also prove disadvantageous

to those countries that do not benefit from the preferences

- International assistance in promoting improved trade facilitation, such as reduced bureaucracy and better technology
- Obligations with respect to intellectual property, including protection of medicines that may be necessary for the public health.

The trade limitations affecting fragile states are all the more severe in those countries that are landlocked, especially remote, or very small. Trade Capacity Building in these countries thus is all the more of a challenge and at the same time more important, one in which the themes of donor coordination, leveraging resources, and sharing of experiences becomes all the more important.

Building Support for Reform

As in most aspects of commercial legal and regulatory reform, approaches to achieving support for trade must engender, nurture, and sustain support for reform. Coalition-building is necessary. A coalition for trade development should include allies from inside and outside the official institutions of the state, such as politicians, executive branch officials, business and civic leaders, professional associations, universities, and others. These efforts must be strategic and sustained, and often should incorporate a media strategy that informs the public about the overriding arguments in support of trade.

Accessing Key Resources

Easily accessible, key resources exist that detail, develop and debate the various legal and institutional aspects of trade, as well as provide information about regional and international initiatives to support investment. These resources include the following:

U.S. Government organizations and activities involved in trade capacity building

The **USAID/Trade Capacity Building Database** (<http://qesdb.cdie.org/tcb/index.html>) offers access to a vast array of TCB-related data, beginning in FY1999, in an easy-to-use, web-based format.

The **USAID/Seldon Project for Global Trade Law Assessment and Assistance** (www.bizlawreform.com) and its successor Business Climate Legal and Institutional Reform Project (BIZCLIR) is a program launched to develop and apply an assessment tool that identifies inefficiencies in the commercial laws and institutions of developing countries. By identifying key gaps between law and implementation, the assessment tool assists governments, donor organizations, and private sector and civil society stakeholders in designing and targeting legislative, organization improvement, and capacity-building projects to maximize the effectiveness of commercial reform efforts, in turn bolstering a country's capacity to seize the benefits of international trade.

The **Office of the U.S. Trade Representative** (www.ustr.gov) is responsible for negotiating trade agreements and developing trade policies which promote world economic growth and create new opportunities for American businesses, workers, and agricultural producers. The USTR plays a key role in capacity building related to WTO accession and participation, as well as in particular WTO Agreements and in Regional Trade Agreements that facilitate U.S. trade.

The **Department of State's Trade Policy and, of the Economic Bureau Programs Division** (www.state.gov/e/eb/tpp/) works to promote U.S. business and agricultural producer interests, to expand world trade, to expand the scope of multilateral trade agreements, and to enforce rules to eliminate foreign trade barriers. The TPP Division is engaged in capacity building efforts related to the WTO, regional trade agreements, trade facilitation, trade-related agricultural development, and technical barriers to trade.

The **Department of Agriculture** has several agencies and offices engaged in technical assistance and capacity building related to trade, including the following:

- The **Foreign Agricultural Service** (www.fas.usda.gov/) provides trade-related agricultural development assistance.

- The **Trade Support Team** of the **Animal & Plant Health Inspection Service** (www.aphis.usda.gov/) provides analytical and strategic guidance to help APHIS attain its broad trade-related goal of facilitating trade while maintaining the United States' biosecurity. The Trade Support Team tracks pending trade issues and initiatives and works to ensure that the issue of biosecurity is considered by other U.S. government agencies as they develop and implement broader trade policies.
- The **Agricultural Marketing Service** (www.ams.usda.gov) provides technical assistance in the area of trade-related agricultural development, particularly by helping developing countries improve their market information.
- The **Agricultural Research Service** (www.oirp.ars.usda.gov) provides technical assistance and research collaboration to support trade-related agricultural development.

The **Trade and Development Agency** (www.tda.gov) advances economic development and U.S. commercial interests in developing and middle-income countries. The agency funds various forms of technical assistance, feasibility studies, training, orientation visits and business workshops that support the development of a modern infrastructure and a fair and open trading environment. TDA plays a key role in many trade-related areas, including physical infrastructure development, services trade development, and trade facilitation.

The **U.S. International Trade Commission** (www.usitc.gov) is an independent, nonpartisan, quasi-judicial federal agency that provides trade expertise to both the legislative and executive branches of government, determines the impact of imports on U.S. industries, and directs actions against certain unfair trade practices, such as patent, trademark, and copyright infringement.

The **Department of Commerce** has several agencies and offices engaged in technical assistance and capacity building related to trade, including the following:

- The **International Trade Administration** (www.ita.doc.gov) has four units - The Commercial Service, Trade Development, Market Access and Compliance, and Import Administration – each charged with supporting various aspects of International Trade throughout the world.
- The **Trade Compliance Center** (www.export.gov/tcc) helps American exporters overcome foreign trade barriers and works to ensure that foreign countries comply with their commitments to the United States.
- The **Patent & Trademark Office** (www.uspto.gov) provides technical assistance in the area of intellectual property rights, in particular supporting trade capacity building in the WTO Agreement on TRIPS.
- The **National Institute of Standards and Technology** (www.nist.gov) provides technical assistance in the area of the WTO Agreement on Technical Barriers to Trade (TBT).
- The **Commercial Law Development Program** (<http://cldp.doc.gov/>) provides training and consultative services to lawmakers, regulators, judges, lawyers and educators seeking assistance in the evaluation, revision and implementation of evolving legal systems. CLDP plays a key role in governance/transparency, inter-agency coordination, financial sector development, and WTO accession and agreements.

International Organizations

The **World Trade Organization** (www.wto.org) provides detailed information about trade generally, along with information about all of its multilateral and plurilateral agreements, including:

- General Agreement on Tariffs and Trade
- Agreement on Agriculture
- Agreement on Sanitary & Phyto-Sanitary (SPS) Measures
- Agreement on Technical Barriers to Trade (TBT)
- Agreement on Trade-Related Investment Measures (TRIMs)

- Agreement on Anti-Dumping
- Agreement on Customs Valuation Methods
- General Agreement on Trade in Services (GATS)
- Agreement on Rules of Origin
- Agreement on Subsidies & Countervailing Measures (CVM)
- Agreement on WTO Trade Policy Review Mechanism (TPRM)
- Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs)
- Agreement on Import Licensing Procedures
- Agreement on Safeguards
- Understanding on Rules and Procedures Governing the Settlement of Disputes
- Other Specific WTO Agreements
- It also has training courses on line

UNCITRAL. The United Nations Commission on International Trade Law (UNCITRAL) is the core legal body within the United Nations system in the field of International Trade law. The U.N. General Assembly established UNCITRAL in 1966, when it was recognized “that disparities in national laws governing International Trade created obstacles to the flow of trade, and it regarded the Commission as the vehicle by which the United Nations could play a more active role in reducing or removing these obstacles.” The general mandate of the Commission, which is comprised of 36 member states elected by the General Assembly, is to “further the progressive harmonization and unification of the law of International Trade.” UNCITRAL has prepared a wide range of conventions, model laws and other instruments dealing with the substantive law that governs trade transactions or other aspects of business law that have an impact on International Trade.

UNCITRAL texts are initiated, drafted, and adopted by the United Nations Commission on International Trade Law, a body made up of elected member States representing different geographic regions. Participants in the drafting process include

member States of the Commission and other States (referred to as “observer States”). Observer States may participate actively in the drafting process. In addition, interested international inter-governmental organizations (“IGO’s”) and non-governmental organizations (“NGO’s”) may participate.

UNCITRAL legislative texts, such as conventions, model laws, and legislative guides, result in the voluntary enactment of law by domestic legislators. UNCITRAL non-legislative texts, such as the UNCITRAL Arbitration Rules, are intended for the voluntary use of private persons in their contractual relationships.

Legislative texts include the following:

- Convention on Contracts for the International Sale of Goods
- Convention on the Limitation Period in the International Sale of Goods
- Model Law on International Commercial Arbitration
- Model Law on Procurement of Goods, Construction and Services
- Convention on Independent Guarantees and Stand-by Letters of Credit
- Model Law on International Credit Transfers
- Convention on International Bills of Exchange and International Promissory Notes
- Convention on the Carriage of Goods by Sea
- Convention on the Liability of Operators of Transport Terminals in International Trade
- Model Law on Electronic Commerce
- Legislative Guide on Privately Financed Infrastructure Projects
- Model Law on Electronic Signatures
- Model Law on International Commercial Conciliation
- Convention on the Assignment of Receivables in International Trade

Non-legislative texts include the following
Arbitration Rules

- Conciliation Rules
- Notes on Organizing Arbitral Proceedings
- Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works
- Legal Guide on International Countertrade Transactions

The **International Trade Center** (www.intracen.org) is the technical cooperation agency of the **United Nations Conference on Trade and Development (UNCTAD)** (www.UNCTAD.org) and the **World Trade Organization (WTO)** for operational, enterprise-oriented aspects of trade development. ITC supports developing and transitioning economies, and particularly their business sector, in their efforts to realize their full potential for developing exports and improving import operations.

- Product and market development
- Development of trade support services
- Trade information
- Human resource development
- International purchasing and supply management
- Needs assessment, program design for trade promotion

ITC's technical assistance concentrates on the three issues for which it believes the need for national capacity building is most critical: helping businesses understand WTO rules; strengthening enterprise competitiveness; and developing new trade promotion strategies.

The **Integrated Framework for Technical Assistance to Least Developed Countries (IF)** (www.integratedframework.org) was established by WTO ministers in 1997 to promote the integration of LDCs into the global economy. Participating agencies include the WTO, the International Monetary Fund, the International Trade Centre, the United Nations Development Programme, UNCTAD, and the World Bank. The IF has undertaken a detailed series of Diagnostic Trade

Integration (DTIS) Studies of LDCs. These studies should be looked at prior to developing a TCB plan to identify priorities, identify stake holders and help with donor coordination.

OECD (www.OECD.org) provides analytical underpinnings to support continued trade liberalization and foster an understanding of trade policy linkages of public concern.

The **National Law Center for Inter-American Free Trade** (www.natlaw.com) is dedicated to developing the legal infrastructure to build trade capacity and promote economic development in the Americas. Among other activities and services, the Center publishes the Inter-American Trade Report, a monthly digest of trade, commerce, and legal developments, important legislation and regulations, and relevant court decisions from across Latin America, and has created a database of laws, regulations and secondary source materials for several countries in the Americas.

ENDNOTES

¹ See Bineswaree Bolaky and Caroline Freund, Trade, Regulations and Growth, World Bank Working Paper No. 3255 (March 2004); David Dollar and Aart Kraay, Trade, Growth and Poverty, Finance and Development (September 2001).

² U.N. Millennium Project, Investing in Development: A Practical Plan to Achieve the Millennium Development Goals (Chapter 14, “A global breakthrough in trade”) at 211 (hereinafter Investing in Development).

³ USAID, Strategy for Building Trade Capacity in the Developing World (March 2003) (www.dec.org/pdf_docs/PDABX241.pdf).

⁴ Id. at 4.

⁵ United Nations Convention on Contracts for the International Sale of Goods (1980).

⁶ United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958).

⁷ Investing in Development, supra note 2, at 214.

⁸ Id.

Appendix A: Cross-Cutting Themes in CLIR, 2005-2010

When developing and implementing programs pertaining to one, a few, or all of the topics discussed in this guide, several cross-cutting matters must be considered and addressed.

DONOR COORDINATION

The ever-increasing complexity of the international development arena makes project coordination among donors – and, of course, among all U.S. agencies engaged in international assistance – more important than ever. Programs of CLIR-related assistance – no matter how thoughtfully conceived or well managed – can not afford to be designed and implemented in the absence of careful consideration of the universe of related work that has been done to date or is planned for the future. This universe includes the history of CLIR assistance provided in recent years by *all* donors in a single country or region, including lessons learned about opportunities, challenges, baselines, successes, failures, reformers, obstructors, laws, institutions, and a myriad of other factors. The information universe also encompasses regional or global initiatives that may be directly relevant to the design of new programs.

In January 2004, USAID’s Bureau of Policy and Program Coordination (PPC), Office of Donor Coordination and Research, issued a report entitled *Donor Coordination, Strategies and Perspectives*,¹ a useful starting point for planning around the issue. The report defines the key characteristics, objectives, and types of donor coordination; identifies the major actors and issues pertaining to donor coordination; and sets forth strategies and special issues pertaining to donor coordination.

Fundamentally, the report emphasizes that donor coordination is a *means to an end*, meaning that it is used to advance development objectives by addressing certain relational or circumstantial issues that technical design and implementation alone

Cross-Cutting Themes in CLIR

- Donor Coordination
- CLIR’s Crucial Connections
 - The Doha Development Agenda and other free-trade initiatives
 - The World Bank’s Doing Business Reports
 - The Millennium Challenge Account
 - The World Bank/IMF Poverty Reduction Strategy Papers
 - The Integrated Framework for LDCs
 - The United Nations’ Millennium Development Goals
- CLIR and SMEs
- Enforcement of Judgments
- CLIR and Democracy and Governance
 - Rule of Law
 - Governance
 - Civil Society
- CLIR and Legal Education
- CLIR and Administrative Law
- CLIR and Corruption

cannot resolve. Donor coordination is *intensely process-oriented* and puts a priority on *relations* and *linkages* among actors.

It is widely agreed that the most effective donor coordination occurs where a country has taken “ownership” of its own development strategy and is committed to harnessing the various competencies and strengths of the donor community. As summarized by the PPC report, the four major types of donor coordination range from the basic and often perfunctory, to quantifiable efforts to align programs that reduce transaction costs and strengthen host-country capacity. In order of relative effectiveness, they include the following:

The objectives of donor coordination include the following:

- Addressing the foreign policy context (i.e., conflict prevention)
- Reducing redundancies
- Encouraging collaboration on activities
- Forging consensus on issues, processes, and frameworks
- Supporting country leadership
- Compensating for weak host-country capacity
- Advancing best practices
- Making use of comparative advantages
- Knowledge sharing
- Forging macro-economic linkages

Information exchange. This is the most basic type of coordination, usually involving regular meetings of donor representatives working in a particular sector. Types of information exchanged include programmatic details, economic and political analyses or forecasting, or evaluation findings. Information exchange may include representatives of the host state. Policy differences often persist with this type.

Division of Labor. Coordination moves beyond talking about programs already in place to some sense of shared planning, however ad hoc. Donors benefit from comparative advantage and specialization. The host state may be engaged. With its central goal of avoiding duplication of effort, this type of coordination is typically static and preventative .

Common Framework. The host state and donors agree on development policy and program objectives and specific activities are planned to improve aid effectiveness, not merely to avoid duplication. In the strongest instances, the host state is actively engaged in managing aid resources and coordination. A common framework allows donors to identify key constraints and gaps. (Where the host state is particularly weak or recalcitrant, the donors may devise a framework amongst themselves.)

Harmonization. Donors align their practices and procedures to reduce transaction costs and strengthen host-country capacity. Harmonization theoretically occurs at the implementation phase, and may include alignment around a common framework for development, certain procurement practices, financial management, leveraging of resources, and joint monitoring and evaluation.

Donor coordination is everyone's responsibility, and requires sensitivity, resourcefulness and a willingness to listen to the various individuals and organizations that bring different strengths, perspectives, priorities, and even cultural norms to the table. Development professionals should also work to alleviate issues that may interfere with the overall effectiveness of the "package" of assistance the

United States provides to a given country, including communication problems among state agencies, rivalries among contractors, or weaknesses in knowledge management.

CLIR'S CRUCIAL CONNECTIONS

The commitment to coordination goes beyond communicating and even integrating the programs of other donors into a certain reform program. It requires that development professionals – whether they are employed by USAID, other donors, or as short or long-term contractors – stay up-to-date about significant trends and initiatives in their field. Some of the recent initiatives most directly related to CLIR generally are listed here, and, with respect to specific subject matter areas (such as corporate governance, competition law, contracts, etc.), several others are referenced in individual chapters of this guide.

- **The Doha Development Agenda and other free-trade initiatives.** In November 2001, the member states of the World Trade Organization (WTO) launched what has come to be recognized as a new era of partnership, one that specifically recognizes the link between trade and development.² Meeting in Doha, Qatar, the

WTO member states renewed their commitment to build the capacity of developing countries to participate in the world trading system, an effort which, of course, implicates a myriad of commercial law-related issues and endeavors. In response to the Doha Development Agenda, the United States has specifically identified Trade Capacity Building (TCB) as a central aspect of its international assistance programs.³ Within the United States' comprehensive approach to TCB are the following priorities: (a) increased funding for TCB; (b) mainstreaming of TCB into development strategies; (c) diversifying TCB assistance tools; (d) leveraging assistance by forging alliances with NGOs and the private sector; and (e) strengthening collaboration with other donors.⁴ Although implementation of the Doha Development Agenda has met serious roadblocks – the September 2003 Cancún Ministerial Conference ended in deadlock, chiefly over the issue of agricultural subsidies – the resolve of all participating countries to respond to the “needs and interests of developing and least-developed countries” has since been strongly reiterated.⁵ The WTO ministerial conference in Hong Kong in 2005 represented the next major stage of the Doha negotiations. While there are significant issues remaining to be negotiated, the underlying premise that trade is good for development remains.

- **The World Bank's Doing Business Reports.** In 2003, the World Bank launched an initiative that investigates the scope and manner of regulations that enhance business activity and those that constrain it, and then delivers a set of quantitative indicators that can be compared across 145 countries.⁶ The first set of indicators, *Doing Business in 2004*, shows comparative statistics

– such as the number of days a state procedure exhausts, or the relative cost of a procedure – for regulation of business entry, contract enforcement, credit markets (including credit information and collateral), and bankruptcy. *Doing Business in 2005* updates the 2004 figures, and adds indicators for bureaucratic hassle (including the costs for obtaining a business license), corporate governance, and property registration. *Doing Business in 2006* updates previous indicators and establish new indicators for taxation and trade infrastructure (including transport, customs, and standards).

The comparative indicators available through the *Doing Business* reports represent an important tool for working with host countries to identify reform priorities. The World Bank's conclusions drawn from the indicators also help aid professionals frame their message in explaining why certain reforms are advisable in a given country. Namely, based on quantitative analysis, the most recent *Doing Business* report made three main findings that are backed by its comprehensive statistical methodology:

1. Businesses in poor countries face much larger regulatory burdens than those in rich countries. They face three times the administrative costs, and nearly twice as many bureaucratic procedures and delays associated with them. And they have fewer than half the protections of property rights of rich countries.
2. Heavy regulation and weak property rights exclude the poor from doing business. In poor countries, 40% of the economy is informal. Women, young people, and low-skilled workers are hurt the most.
3. The payoffs from reform appear large. A hypothetical improvement to the top quartile of countries on the ease of doing business is associated with up to two percentage points more annual economic growth.⁷

These findings present an important platform for many of the issues and reforms that are discussed in

“We strongly reaffirm our commitment to the objective of sustainable development”

The full text of the Doha Ministerial Declaration, which establishes the Doha Development Agenda, can be found at http://www.wto.org/english/thewto/e/minist_e/min01_e/mindecl_e.htm.

the subject-specific sections of this guide – in effect, they answer much of the “what” question pertaining to the state of commercial law and institutions in a given country. The “why” can be examined through independent assessments performed through the CLIR Diagnostic Methodology, thus resulting in a more comprehensively developed method of determining “what is to be done.”

The Millennium Challenge Account. The “new compact for global development” proposed by President Bush in early 2001 resulted in the establishment of the Millennium Challenge Account (MCA), which is administered by a Millennium Challenge Corporation (MCC).⁸ The purpose of the MCA is to provide targeted assistance to those countries that – as demonstrated through a set of objective indicators maintained by a variety of international organizations – have proven a commitment to ruling justly, investing in their people, and encouraging economic freedom. Once found eligible, these countries may submit proposals for programs and assistance that the MCC will then consider for implementation. The USAID Administrator serves as a member of the MCC

Board, which determines country eligibility and approves MCA compacts.

In addition to selecting countries for MCA investment, the MCC has established a Threshold Program for countries that have proven qualified in most of the sixteen policy indicators that are central to the MCA eligibility criteria, but not all. These countries are eligible for assistance from USAID that will be used to address the specific policy weaknesses indicated by their scores.

- **The World Bank/IMF Poverty Reduction Strategy Papers.** Also in the spirit of increased country ownership over the economic reforms in their midst, the World Bank Group and the IMF have determined that nationally-owned participatory poverty reduction strategies should provide the basis of all World Bank and IMF concessional lending and for debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. Key to this process is the development of Poverty Reduction Strategy Papers (PRSPs), no less often than every three years.⁹

Key MCA Principles

- **Reduce Poverty through Economic Growth:** The MCC will focus specifically on promoting sustainable economic growth that reduces poverty through investments in areas such as agriculture, education, private sector development, and capacity building.
- **Reward Good Policy:** Using objective indicators, countries will be selected to receive assistance based on their performance in governing justly, investing in their citizens, and encouraging economic freedom.
- **Operate as Partners:** Working closely with the MCC, countries that receive MCA assistance will be responsible for identifying the greatest barriers to their own development, ensuring civil society participation, and developing an MCA program. MCA participation will require a high-level commitment from the host government. Each MCA country will enter into a public Compact with the MCC that includes a multi-year plan for achieving development objectives and identifies the responsibilities of each partner in achieving those objectives.
- **Focus on Results:** MCA assistance will go to those countries that have developed well designed programs with clear objectives, benchmarks to measure progress, procedures to ensure fiscal accountability for the use of MCA assistance, and a plan for effective monitoring and objective evaluation of results. Programs will be designed to enable sustainable progress even after the funding under the MCA Compact has ended.

See www.mca.gov/about_us/overview/index.shtml.

The PRSPs are expected to adhere to five core principles. First, the strategies should be *country-driven*, involving broad-based participation by civil society and the private sector in all operational steps. Second, the strategies should be *results-oriented*, focusing on outcomes that would benefit the poor. Third, the strategies must be *comprehensive* in recognizing the multidimensional nature of poverty. Fourth, the strategies must be *partnership-oriented*, involving coordinated participation of development partners (bilateral, multilateral, and non-governmental). Finally, the strategies must be based on a *long-term perspective* for poverty reduction.

As of January 2005, nearly 60 countries have presented PRSPs to the World Bank/IMF Boards or developed interim PRSPs. Of course, a completed or interim PRSP constitutes “required reading” for any donor that is in the process of developing or implementing an assistance program in a country that has created one.

- **The United Nations’ Millennium Development Goals.** The United Nations has identified eight goals which all 191 UN Member States have pledged to meet by the year 2015.¹⁰ The goals are: (1) eradication of extreme poverty; (2) achievement of universal primary education; (3) promotion of gender equality and empowerment of women; (4) reduction of child mortality; (5) improved maternal health; (6) combating of HIV/AIDS, malaria and other diseases; (7) ensured environmental sustainability; and (8) establishment of an overall global partnership for development. In addition, the U.N. has developed a comprehensive strategy for meeting these goals, which underscores the importance of, among other priorities, governance, trade, and “better quality aid.”¹¹ The U.N.’s strategy echoes the Millennium Challenge Account’s emphasis on incentives, that is, awarding aid to those countries that rule justly and otherwise exhibit transparent and accountable forms of government.

CLIR AND SMEs

Among the most important commonalities found in the numerous CLIR Diagnostic Assessments that have been conducted on three continents since 1999 is that the process of launching and growing a new business in fragile states or emerging economies is enormously difficult. Although the commercial law and institutional issues that are discussed in this guide pertain generally to all types of businesses, they especially impact the viability of micro, small and medium-sized enterprises (SMEs).¹² The ability to start and grow a business directly affects productivity and growth in a country and, indeed, individual lives. For example, as noted in the World Bank’s *Doing Business in 2005*, nearly half of the poor people in Bangladesh who receive credit lift themselves out of poverty, but only four percent of those without credit can.¹³

From the outset, new businesses face the dual obstacles of accessing capital and forging bureaucratic mazes. The process of borrowing money is often hampered by untenable interest rates, prohibitive collateral requirements, and high debt-to-collateral ratios, each a result of ineffective laws and unreliable institutions pertaining to secured transactions, commercial dispute resolution, and enforcement of judgments. In addition, the time that it takes to register a new business, along with other state-mandated costs (taxes in particular, as well as various regulatory requirements), often dissuades a new business from joining the formal economy. Those SMEs that do succeed in accessing capital and joining the formal sector (often through the assistance of family, friends, or micro-lenders, rather than traditional banks or public equity markets) must then confront the additional costs inherent in underdeveloped commercial legal systems. These costs include difficulty in enforcing contracts, limitations on further borrowing, and virtually no chance at rehabilitation in the event of insolvency.

Each of these issues implicates the various segments of the CLIR arena, including Company Law, Secured Transactions Law, Real Property Law, Commercial Dispute Resolution, and Contract Law and Enforcement. (They also implicate broader

rule of law issues, such as the quality of courts, the capacity of judges, and administrative law). Thus, for the benefit of SMEs, CLIR professionals should avoid “over-segmentation” – that is, extreme emphasis on fine-tuning the details of individual commercial laws, at the expense of a systemic approach that achieves the overriding goal of strengthening the environment for business. Implementers of CLIR programs should routinely interact with SME competitiveness projects, private sector associations, banks and other lenders, and the business community generally to share information, leverage resources, and create a vision for how reform in the CLIR sector may best be harnessed to improve the overall business environment. Further, a collective effort should be made by all donors in a given country or region to consolidate information about programs designed to assist SMEs – perhaps establishing joint databanks or common procedures for applying for assistance – so that entrepreneurs can most effectively take advantage of opportunities available to them.

ENFORCEMENT OF JUDGMENTS

Among the most important risks facing companies doing business in developing countries is the lack of predictable, affordable enforcement of judgments, even after a court has made a finding in favor of one party. Once judgments are rendered, they often fail to be executed, at least within a reasonable time-frame and at a reasonable cost.¹⁴

A number of factors contribute to sluggish and ineffective systems of executing judgments. Very significantly, a “culture of delay” exists in various regions of the world, which can be attributed in some countries to recent history in which judges and attorneys for private-sector litigants attempted to diminish the injustices propagated by authoritarian rule by undermining the state in its ability to enforce judgments through the courts. A related issue is that of judicial professionalism – that is, a lack of understanding of or consensus over such issues judicial independence, authority, and accountability. For example, judges may not fully appreciate their authority to sanction lawyers

who engage in bad faith or excessive delay. In addition, as underscored by the World Bank’s Doing Business project, “A striking difference between courts in most developing countries and those in [wealthier] countries is the overly bureaucratic judicial procedures that judges and litigants face.”¹⁵ According to Doing Business in 2005, “When the judiciary argues for more judges, it is time to also simplify procedures. It costs less and has longer term effects.”¹⁶

Other factors contributing to the great difficulty business people face in collecting upon judgments in their favor include gaps in the legal framework; excessive and poorly managed caseloads; incomplete information and insufficient mechanisms for maintaining and updating information; and a lack of capacity among executing officers. In addition, businesses that seek to enforce contracts may lack a fully developed awareness of all the “self-help” steps they can take prior to resorting to the courts, including vigilant business practices that consistently encourage payment. Finally, the corruption that exists in many judicial systems may be at the heart of the enforcement crisis.

Coping with problems pertaining to enforcement of judgments requires a comprehensiveness of approach that encompasses many sectors of reform. In addition to adopting new laws and simplifying existing enforcement procedures, the capacities of judges, court staff, property registries, lawyers, execution clerks and others must be increased. The development context of different countries will warrant different approaches. One country’s CLIR environment may warrant a project devoted specifically to enforcement of judgments, in which the various constituencies involved in the process participate in enforcement-specific reforms, including development of strategies, legal revisions, and training. Another country may address enforcement of judgments by including it as one element within sector-specific initiatives, such as judicial reform, case management, business assistance, or banking reform. However the matter is addressed, it has come relatively late to the reform table and must not be disregarded in the future.

CLIR AND DEMOCRACY AND GOVERNANCE

The work of CLIR professionals is closely related to that of individuals working to secure systems of democracy and good governance in developing and transitioning countries – that is, political systems that are inclusive, participatory, representative, accountable, transparent, and responsive to citizens’ aspirations and expectations. Democracy and governance work incorporates the areas of Rule of Law, Governance, and Civil Society, each of which intersects with commercial legal and institutional reform.

- **Rule of Law.** The term “rule of law” is multi-faceted. It embodies the basic principles of equal treatment of all people before the law, fairness, and both constitutional and actual guarantees of basic human rights. It further implies a predictable legal system with fair, transparent, and effective judicial institutions that protect citizens against the arbitrary use of state authority and lawless acts of both organizations and individuals. In many states with weak or newly-emerging democratic traditions, existing laws are not fair or are not fairly applied; judicial independence is compromised; individual and minority rights are not truly guaranteed; and institutions have not yet developed the capacity to administer existing laws.

“Rule of law” refers to at least five different goals:

- making the state abide by law;
- ensuring equality before the law;
- supplying law and order;
- providing efficient and impartial justice; and
- upholding human rights.

See Rachel Kleinfeld Belton, *Competing Definitions of the Rule of Law: Implications for Practitioners*, Carnegie Papers – Rule of Law Series, Carnegie Endowment for International Peace (January 2005).

Weak legal institutions endanger *both* democratic reform *and* sustainable economic development in developing countries. As noted in a USAID/ Office of Democracy and Governance Guide to Rule of Law and Country Analysis, “The task for the practitioner is to find ways in which a society may govern itself under the rule of law, and this can be done in many different ways that reflect the values and norms of that society.”¹⁷

Rule of law as pursued from the Democracy and Governance standpoint encompasses such vital issues as criminal law, human rights, election law, and other such issues. Legal reform pertaining to Economic Development centers on the components of economic freedom – that is, secure property rights, the assurance that contracts will be honored and upheld, the opportunity to start a new business, and the ability to buy and sell goods and services in an open and competitive marketplace.

Notwithstanding their distinctions, the two spheres share a number of priorities. These include judicial capacity building (including judicial ethics, training, professionalism, and leadership); court administration and case management; enforcement of judgments; professional development of lawyers and notaries; legal drafting; anti-corruption; judicial education; access to courts; and alternative dispute resolution. Thus, formal divisions between Democracy and Governance and CLIR-related Economic Development must not be treated as bureaucratic “stovepipes.” Information-sharing, leveraging of resources, and strategic planning among those who work in each sphere constitute critical aspects of effective program implementation. Failure to engage in these processes amounts to money wasted and opportunities lost.

- **Governance.** The term “governance” implicates a state’s ability to maintain social peace, guarantee law and order, promote or create conditions necessary for economic growth, and ensure a minimum level of social security. Many states fail to realize the long-term benefits of adopting effective governance policies and, even where they do recognize the value of such policies, they often lack the capacity to implement them.

Among the many institutional resources that assist the development professional with respect to the rule of law are the following:

USAID Office of Democracy and Governance: Rule of Law (www.usaid.gov/our_work/democracy_and_governance/technical_areas/dg_office/rol.html).

World Bank Legal Institutions of the Market Economy web page (www1.worldbank.org/publicsector/legal/index.cfm).

World Bank Legal Vice Presidency, Resources in Law and Justice (www4.worldbank.org/legal/).

International Foundation for Election Systems, Rule of Law Tool Kit (www.ifes.org/rule_of_law/ROL_TK.htm).

Carnegie Endowment for International Peace Program in Democracy and Rule of Law (www.carnegieendowment.org/programs/global/index.cfm?fa=proj&id=101).

United State Institute of Peace Rule of Law Program (<http://www.usip.org/ruleoflaw/index.html>).

American Bar Association, Central and East European Law Initiative, Judicial Reform Index and Legal Profession Reform Index (www.abaceeli.org).

Justice Studies Center of the Americas (www.cejamericas.org).

Moreover, corruption of government officials and institutions can vastly limit a country's development potential. Accordingly, both Democracy and Governance and Economic Development programs are concerned with improving state institutions – referred to throughout this guide as “implementing institutions” – so that they may more effectively implement the laws and regulations under which their mission is established and their conduct is bound. In addition to including courts and the judiciary, these implementing institutions include company, property, or collateral registries; administering authorities (such as a Competition Agency or an administrative tribunal for state contracts); ministries that are charged with supporting trade, economic development, SME assistance, etc; bailiffs; and others.

- **Civil Society** is the term that describes the ability of individuals to associate with like-minded individuals, express their views publicly, openly debate public policy, and petition their state. Many donors, including USAID, work to strengthen commitment to an independent and politically active civil society in developing

countries. Efforts incorporate coalitions of professional associations, civic education groups, women's rights organizations, business and labor federations, media groups, bar associations, environmental activist groups, and human rights monitoring organizations. A major subset of a country's civil society environment is indeed comprised of the supporting institutions that underlie the effectiveness of a country's economic environment. As detailed in the subject-specific chapters of this guide, examples include notaries, banks, consumer groups, chambers of commerce, professional associations, and other similar ancillary service-providers.

Of particular interest with respect to civil society is whether they have any meaningful involvement in *what a law says* and *how it is implemented*. Where there has been “buy-in” from affected constituencies, a law is more likely to be understood, to be used properly, and to achieve its purpose. Thus, organizations within both the Democracy and Governance and Economic Development spheres benefit from institutional capacity building measures that allow them to have a voice in the creation

of law and policy that governs a state. These measures include establishing a mission statement, drafting by-laws or implementing rules, electing officers, developing leadership and management skills, conducting meetings, keeping sound and transparent records, lobbying, publicizing activities, and others.

CLIR AND LEGAL EDUCATION

When it comes to educating new lawyers who are capable of drafting and enforcing contracts, guiding businesses through regulatory processes, advising corporate directors about their fiduciary responsibilities, and generally helping businesses navigate the law in order to grow and flourish, the news from law schools in poor and middle-income countries is, in a word, disheartening. In former Soviet bloc countries, the most powerful echelons of law faculties have virtually no meaningful background in market-based transactions, and therefore are typically ill-prepared to teach them. Teaching methods continue to be lecture-oriented, fail to encourage critical thinking, involve virtually no legal writing as a mandatory skill for new lawyers, and rarely include anonymously graded written exams. In Central America and other regions, a tradition of legal formalism stands in the way of lawyers (and, eventually, judges) learning to think proactively, such that the law is source of support for the economy, rather than a series of rules that are meant to be singularly interpreted.

In fragile states *and* many transitioning countries throughout the world, law schools are crumbling, books and other resources are thoroughly out-of-date, interactive teaching methods are either discouraged or ignored, and the quality of commercial law education in particular is weak. Law faculties generally exhibit little motivation to change, and the proliferation of private law schools, though promising in certain respects, also presents a new challenge of setting educational standards and achieving academic consistency and quality control.

There are, of course, bright lights that shine through this morass, including a new generation

of faculty that is seizing global opportunities to support improvements in their own curricula and otherwise making its mark in legal education throughout the world. There have been numerous valuable experiences in collaboration between law schools in wealthier countries and schools in fragile states and emerging economies. Although informal methods of sharing information and best practices in legal education development take place, a formal “clearinghouse” of information pertaining to international law school experiences has not yet emerged from within the public sector, international institutions, or academia. In particular, experiences to date pertaining to CLIR and legal education have been relatively isolated.

In anticipating a future in which CLIR legal education assistance has more formal bearings and a stronger base of literature to assist in developing programs, changing the commercial legal and institutional horizon will involve examining the role that law schools play in educating new lawyers. Within individual countries receiving CLIR assistance, evaluation of the “big picture” is warranted. To establish a baseline in a given country, the following questions need clear answers:

- What commercial law courses are currently available in the standard law school curriculum? Who is the faculty assigned to teach these courses, and to what extent are these faculty members themselves familiar with recent changes in the law?
- What is the universe of local and donor activity specifically targeted at the law school? Of this activity, which specifically pertains to commercial law? What is the current level of donor coordination with respect to commercial law-related assistance to the law school?
- What long-term reforms are necessary to allow the law school to provide a comprehensive and meaningful curriculum in commercial law? How can these reforms be prioritized? What existing structures are in place within the law schools to oversee and guide a long-term reform process, and what new structures might be necessary?

- What short-term methods could be used to get much-needed information and assistance to students now? How could donor and local resources be leveraged to most effectively implement these methods?

In reality, reforms to the systems of commercial legal education in fragile states and transitioning economies will likely take at least a generation. Through a shared vision of long-term reform, combined with thoughtful and well executed short-term initiatives, a shift in the learning dynamic and the quality of commercial legal education may take place in a sustained and meaningful fashion.

CLIR AND ADMINISTRATIVE LAW

Within both the Democracy and Governance and Economic Development spheres, the focus on legal reform in recent years has been directed chiefly at courts, judges, and their supporting institutions. Due to the relative urgency of these “first-tier” reforms, administrative law, a highly developed discipline in the United States, Western Europe,

and several Asian countries, has remained, for the most part, on the back burner. Nonetheless, administrative law is a vital part of a fully functioning government system that: (a) is limited in the discretion state actors are entitled to exercise; (b) has structures in place that secure the rights of the governed; and (c) assures the adequate exchange of information.¹⁸ Therefore, aid professionals must understand the purpose and dimensions of administrative law in order to plan effectively for the next generations of legal assistance.

Administrative law is, in effect, the part of government that is closest to the people. Virtually all the “regulatory” issues that feed into the establishment of a business, for example – zoning, licensing, recording and obtaining information, and so forth – are theoretically bound by restrictions on state authority.

Administrative law provides tools for people to contest adverse regulatory decisions, such as tax assessments or the withholding of business licenses. Ideally, a strong system of administrative

What is administrative law? Examples set forth in a draft study recently spearheaded by USAID’s Office of Democracy and Governance illustrate its cross-cutting place in society:

- A small retail business appeals the denial of a license to a court, claiming that both the regulatory authority’s rules governing issuance of the license and a national code of procedure were violated, specifically provisions affording an opportunity to present evidence in support of one’s position.
- A tenants’ association, upset about the pending imposition of a new schedule of rents for municipal public housing, petitions for a public hearing to present its views.
- A health ministry preparing regulations revising water quality standards is required by law to notify the public about the proposed standards by publishing a summary in specified public offices, in newspapers, and on the TV and radio. In addition, it must hold a 60-day comment period and publish the comments, with an explanation of whether and how the comments were used in drawing up the final regulations.
- A labor union uses an access-to-information law to obtain Ministry of Labor inspection reports showing a pattern of unsafe work conditions at two major employers in region.
- A transportation safety board charges a bus company with operating unsafe vehicles and schedules a hearing to determine if the company should pay significant fines and make expensive changes to its buses, or be closed down.

Malcolm Russell-Einhorn and Howard N. Fenton, *Using Administrative Law Mechanisms to strengthen USAID Programming: A Guide for USAID Officers* (publication of Center for Institutional Reform and the Independent Sector of the University of Maryland, scheduled for publication in 2005).

law affords improvements in a state's fairness, transparency, and accountability. In states where traditional forms of accountability may be largely ineffective due variously to patronage and weak parliamentary oversight, excessive executive control over administrative appointments and agenda-setting, or poor internal controls over civil servants, administrative law mechanisms may open up a number of alternative channels through which private actors can seek to influence and constrain bureaucratic actors. At a minimum, they should provide formal (or in some cases, semi-formal) avenues by which civil society can call attention to bureaucratic failings.

Of course, administrative law mechanisms are subject to many of the same constraints that affect more traditional forms of state accountability.¹⁹ Precisely because they do constitute formal mechanisms, they require support by politicians or senior political appointees in order to be adopted by legislation, decree, or regulation. These actors are themselves part of a larger political dynamic that may be hostile or apathetic toward more openness in government. Patronage and corruption may pose substantial background problems. To the extent that many administrative law mechanisms depend on courts for their ultimate enforcement, their utility may be compromised by problems with judicial independence and expertise. Mid- and lower-level bureaucrats may not be properly educated or controlled by their chain of command, resulting in disuse or subversion of many such mechanisms. And where businesses and individuals do not trust or understand mechanisms of administrative law and prefer not to call attention to themselves by using them – and if they favor other, informal means of trying to solve their problems (ranging from some kind of mediation, to gifts, or bribes to public servants) – the mechanisms will not be employed in the first place.

Integration of administrative law to a greater degree in CLIR initiatives suggests the following benefits:

- Greater direct empowerment of individuals and businesses

- Better focus on fairness and legitimacy of government decision-making
- More attention paid to the public-private sector interface
- Greater potential mobilization of key constituencies for reform by sectors (e.g., small businesses and professional associations).

In both the Democracy and Governance and Economic Development spheres, the future indeed holds increased focus on administrative law, particularly as the judiciaries mature.

CLIR AND CORRUPTION

Elected public officials are supposed to have the public's interest in mind, not their own. Judges are supposed to stand for justice – that is, fair and impartial treatment of all that come before them in accordance with the law. Civil servants, from those who staff company and property registries, to employees of licensing bureaus and various ministries charged with encouraging economic development, are supposed to do their jobs in a way that *supports* the public business, not depletes its resources and mangles the legitimate expectations of the public. When a citizenry cannot count on the integrity of its public institutions, there is a disincentive to enter the system in which they function.

Corruption – the misuse of public office for private gain – encompasses abuses by state officials, such as embezzlement and nepotism, as well as abuses linking public and private actors, including bribery, extortion, influence peddling, and fraud. Corruption arises in both political and bureaucratic offices and can be petty or grand, organized or unorganized. In the private sector, corruption increases the cost of business through the price of bribes themselves, the management cost of negotiating with officials, and the risk of breached agreements or detection. Ultimately the costs of corruption can either be internalized by the private sector, or passed along to the consumer.

During the CLIR Diagnostic Assessments conducted throughout the world since 1999, corruption has been cited as a problem within commercial law-related institutions. In some places the corruption is characterized as “low level” – perhaps arising as an expectation of “speed money” to make bureaucratic processes go faster – and in others it is said to be utterly pervasive. In many countries where corruption has been identified, reform is said to be on the government’s agendas, but definitive solutions and a collective will to disarm the problem consistently seems beyond the government’s reach.

In recent years, the issue of corruption has become of increasing prominence, and international resources directed toward understanding and addressing the issue have been strengthened dramatically. This network of support is vital to achieving corruption-free governance, given the enormous challenge of even identifying or quantifying the problem. Donor-sponsored anti-corruption initiatives can incorporate such approaches as short and long-term technical assistance, resident advisors and mentoring, training curriculum development and execution, and public information programs. No single solution will combat corruption in a country, but many tactical approaches exist that can cumulatively contribute to an environment of increased transparency, even-handedness, and overall effectiveness.

MANAGING INFORMATION AND TECHNOLOGY

As confirmed by the series of CLIR Diagnostic Assessments that have taken place throughout the world in recent years, technology is dramatically underutilized and misunderstood in the commercial legal and institutional sectors. In many countries, for example, state registries for companies and property are outfitted with little to no technology, and information that is vital to the establishment and growth of businesses is difficult to access and

Anti-Corruption Resources

The following organizations and initiatives promote understanding about the root causes of corruption and create solutions to the problem. The Internet sites include a wealth of information, including links to many projects and additional resources in the field.

USAID Anticorruption Strategy, http://www.usaid.gov/our_work/democracy_and_governance/publications/pdfs/ac_strategy_final.pdf

Transparency International, www.transparency.org

United Nations’ Global Programme against Corruption, www.unodc.org/unodc/corruption.html?id=11703

World Bank Institute’s Governance and Anti-Corruption Program, www.worldbank.org/wbi/governance/about.html

Organization for Economic Cooperation and Development anti-corruption initiatives, www.oecd.org/topic/0,2686,en_2649_37447_1_1_1_1_37447,00.html

Anti-Corruption Gateway for Europe and Eurasia, www.nobribes.org

highly susceptible to damage, illegibility and fraud. The business of courts is often partially automated, but technology capabilities are highly limited and rarely guided by a long-term plan for expansion and improvement. Available funding, of course, is almost never enough to meet the breadth of the technology needs. Moreover, the integration of technology often takes place through a “jump” from manual processes to automated processes, without the critical middle step of assessing and improving the management processes and workflows that underlie the function at hand.

Information Technology has the ability to transform institutions and processes. Technological advances in recent years, such as new wireless access devices, have opened up the possibility of affordable access for billions of new users worldwide.

Certain institutional functions pertaining to commercial law, such as collateral law registries, can use technology applications that are relatively simple and inexpensive, yet highly effective.²⁰ On the other hand, in many countries – particularly

IMPACT Macedonia: An E-Governance Initiative

The IMPACT Macedonia Project encompasses four main tasks.

First, the project aims to build institutional capacity within the Government of Macedonia for the development and implementation of a coherent and integrated e- government strategy. The ultimate goal of this strategy will be to ensure interoperability, foster transparency, and provide better services to citizens and businesses.

Second, Internews Macedonia will help both the creation of a national government body capable of developing government enterprise architecture and standards, as well as build capacity at the central municipal and levels to implement e-government activities based on state-of the art managerial and technological approaches.

Third, the project aims at the development of priority applications for government fiscal management and their use by central and local governments to increase their transparency, efficiency and curtail their opportunities of fraud, waste and abuse in the public sector. On the same token, capacity will be developed in the private sector to develop e-government applications to be used by the local governments.

Finally, IMPACT Macedonia will foster and support the creation of legal basis for inter-agency protocols for data exchange and use between key GOM keepers of financial data. The establishment of proper legislative framework for e-government authentication, data privacy and evidence of financial crimes are the main goals of IMPACT Macedonia.

Source: Dot.Com Alliance Activity, Macedonia: IMPACT Macedonia, at <http://www.dot-com-alliance.org/activities/activitydetails>.

those in which the state controls major sectors of the economy – prohibitive policy and regulatory barriers pertaining to technology undermine the extent to which genuine economic freedom may be achieved. Even where technology is embraced as a mechanism for economic advancement, the transformation process can be fraught with communication failures, user ambivalence, and opportunities to make expensive mistakes. Without proper governance, leadership, planning and accountability, investment

in Information Technology can quickly be rendered worthless.

The intersection of commercial legal and institutional reform and technology is one that does not yet have reliable set of best practices. Nonetheless, there is enormous opportunity at this time for comparisons of experiences and sharing of lessons learned, as well as innovation and creative thinking.

Resources in Managing Technology

- Through the Bureau of Economic Growth, Agriculture, and Trade program on Information and Communication Technology (ICT) (www.usaid.gov/our_work/economic_growth_and_trade/info_technology/index.html), USAID supports ICT partnerships, policy reform, access, capacity building, and applications for development.
- The Digital Opportunity through Technology and Communications Alliance (www.dot-com-alliance.org) is a partnership between USAID and more than 75 partners, each with specialized experience in using ICT for development.
- The International Development Research Center (www.idrc.ca) studies the transformative nature of ICT and encourages sharing of experiences among donors and countries engaged in bridging the “digital divide.”
- USAID's Office of Democracy and Governance has produced a Case Tracking and Management Guide (September 2001) that speaks to the role of technology in courts.

ENDNOTES

¹ USAID Development Information Services, Donor Coordination: Strategies and Perspectives (January 2004) (www.dec.org/pdf_docs/PNACW251.pdf).

² See WTO, Negotiation, implementation and development: the Doha agenda (www.wto.org/english/tratop_e/dda_e/dda_e.htm).

³ Indeed, the U.S. is the largest single-country donor of TCB assistance. See Office of the United States Trade Representative, U.S. Contributions to Trade Capacity Building: Improving Lives through Trade and Aid (September 2003), located at (www.ustr.gov/assets/Trade_Development/Trade_Capacity_Building/asset_upload_file272_3687.pdf).

⁴ Id.

⁵ See WTO, Decision Adopted by the General Council on 1 August 2004 (WT/L/579), located at www.wto.org/english/tratop_e/dda_e/draft_text_gc_dg_31july04_e.htm.

⁶ The World Bank's Doing Business reports and statistics are posted and updated at <http://rru.worldbank.org/doingbusiness/>.

⁷ World Bank, Doing Business in 2005: Removing Obstacles to Growth 3 (2005) (hereinafter Doing Business in 2005).

⁸ Detailed information about the Millennium Challenge Account is posted and updated at www.mcc.gov.

⁹ More information about PRSPs, including their significance with respect to donor coordination, can be found at www.worldbank.org/poverty/strategies/index.htm.

¹⁰ More information about the MDGs can be found at www.un.org/millenniumgoals.

¹¹ U.N. Millennium Project, Investing in Development: A Practical Plan to Achieve the Millennium Development Goals (January 2005).

¹² See Alvero Herrero and Keith Henderson, The Cost of Resolving Small Business Conflicts: The Case of Peru (Inter-American Development Bank Sustainable Development Department – Best Practices Series) (2004) (www.ifes.org/rule_of_law/Documents/Small%20business/SME%20Peru%20Report%20final%20EN.pdf); Wade Channell et al, Small and Medium

Enterprise Interventions and Gap Analysis (study performed for USAID/Bosnia by BearingPoint Inc.) (May 2004).

¹³ Doing Business in 2005, supra note 7, at 41 (citing Grameen Bank (2004)).

¹⁴ Detailed discussions of the problem of enforcement on a country-specific basis can be found at USAID/ National Center for State Courts, Execution of Civil Judgments in Kosovo (September 2004); Peter Kahn and Keith Henderson, Barriers to the Enforcement of Court Judgments and the Rule of Law (publication of the International Foundation for Election Systems, focusing chiefly on Argentina and Mexico) (Spring 2003); Sandra Elena, Alvero Herrero and Keith Henderson, Barriers to the Enforcement of Court Judgments in Peru - Winning in Court is Only Half the Battle: Perspectives from SMEs and Other Users (publication of the International Foundation for Election Systems) (April 2004).

¹⁵ Doing Business in 2005, supra note 7, at 59.

¹⁶ Id. at 65.

¹⁷ USAID/Office of Democracy and Governance, Guide to Rule of Law Country Analysis (draft, February 2005).

¹⁸ For a baseline review of administrative law systems in Bulgaria, see Government of Bulgaria/UNDP, Comprehensive Review of the Administrative Justice System in Bulgaria (April 2002), located at <http://unpan1.un.org/intradoc/groups/public/documents/UNTC/UNPAN017500.pdf>.

¹⁹ Malcolm Russell-Einhorn and Howard N. Fenton, Using Administrative Law Mechanisms to strengthen USAID Programming: A Guide for USAID Officers (publication of Center for Institutional Reform and the Independent Sector of the University of Maryland, scheduled for publication by USAID's Office of Democracy and Governance in 2005). Most of the discussion of administrative law in this section is drawn directly from this report.

²⁰ See UNDP Programme on Governance in the Arab Region, E-Justice: Toward a Strategic Use of ICT in Judicial Reform (Waleed Malik, 2002) (www.pogar.org/publications/judiciary/wmalik/index.html#intro).

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Appendix B: Glossary of Key Terms and Concepts

Alternative Dispute Resolution (ADR). Methods by which legal conflicts and disputes are resolved privately other than through litigation in the public courts. This usually manifests in the forms of **arbitration, mediation, or conciliation**. ADR typically involves a process somewhat less formal than the traditional court process and includes the designation of a third-party to preside over a hearing or discussion between the parties. The advantages of ADR are speed and cost: it typically (though not always) costs less and is quicker than court litigation. ADR forums are also private. A perceived disadvantage of ADR is that it often involves a level of compromise that persons engaged in litigation do not wish to make.

Arbitration. An ADR process through which parties in a dispute state their views, offer evidence, and agree to let a neutral third party make a decision that will end the dispute. In most cases, once the arbitrator (or panel of arbitrators) reviews the evidence, he or she hands down a binding decision. This is known as **binding arbitration**. An alternative to binding arbitration exists, **non-binding** arbitration, in which the disputing parties put their case before an impartial third party who renders an opinion or recommendation, which the parties may choose to accept or reject.

Bankruptcy Law. Bankruptcy is a system for ensuring the equitable payment of debts when a debtor is no longer able to meet its debt obligations, either by reorganizing the debtor or liquidating the debtor and its assets.

Civil Law. A legal tradition which is the basis of the law in the majority of countries of the world, especially in continental Europe, but also in Japan, Latin America, and most former colonies of continental European countries. In civil law countries, legislation is seen as the primary source of law. Courts thus base their judgments on the provisions of codes and statutes, from which solutions in particular cases are to be derived.

Civil law judges are usually trained and promoted separately from attorneys (whereas common law judges are usually selected from accomplished and reputable attorneys). In general, the judge in a civil law system plays a more active role in determining the facts of a case involving criminal law. Also, civil law systems rely much more on written argument than oral argument.

Collateral Law. See Secured Transactions Law.

Common Law. The system of laws originated and developed in England and based on court decisions, on the doctrines implicit in those decisions, and on customs and usages rather than on codified written laws (although common law systems typically have developed many codes, as well). The distinctive feature of common law is that it represents the law of the courts as expressed in judicial decisions. The grounds for deciding cases are found in precedents provided by past decisions, as contrasted to the civil law system, which is based on statutes and prescribed texts. Besides the system of judicial precedents, other characteristics of common law are trial by jury and the doctrine of the supremacy of the law.

Commercial Dispute Resolution. The process through which courts or other tribunals and services (such as Alternative Dispute Resolution [ADR] mechanisms) resolve commercial disputes, for example those concerning the interpretation and enforcement of contracts, the liquidation or rehabilitation of a business, the settlement of property rights disputes, or general adherence to the commercial law.

Commercial Law. Any one or more of the areas of substantive law defined for the purposes of this Guide to include Bankruptcy, Secured Transactions, Companies, Competition, Contract, Foreign Direct Investment, and International Trade laws, and associated institutions.

Company Law. A set of laws that: (1) sets forth requirements for incorporating a company (i.e., business registration), (2) defines and regulates ownership interests of company shareholders, (3) establishes basic principles or rules of corporate governance, (4) sets limits on the liability of company shareholders, and (5) establishes legal personality for the firm created, providing the legal basis for entering into contracts and accessing to finance.

Competition Law. A legal and regulatory framework that prevents businesses from unreasonably limiting the quality, quantity, and price of goods or services available in the marketplace and seeks to limit anticompetitive government regulation of the marketplace.

Contract Law. A system of creating, interpreting, and enforcing commercial obligations between parties. (Often referred to as the “Commercial Law” or “Law on Obligations” in Civil Code legal systems.)

Corporate Governance. The system by which companies are directed and controlled. Company Law typically requires businesses to delineate the rights and responsibilities of its different participants in their founding documents – including its board(s), managers, shareholders, and other stakeholders – and to spell out the rules and procedures for making decisions on company affairs. This delineation of roles, or system of *Corporate Governance*, establishes the structure through which company objectives are set, the means of attaining those objectives, and how performance will be monitored.

Corruption. The misuse of public office for private gain. Corruption encompasses abuses by government officials such as embezzlement and nepotism, as well as abuses linking public and private actors such as bribery, extortion, influence peddling, and fraud. Corruption arises in both political and bureaucratic offices and can be petty or grand, organized or unorganized. In the private sector, corruption increases the cost of business through the price of bribes themselves, the management cost of

negotiating with officials, and the risk of breached agreements or detection. Ultimately the costs of corruption can either be internalized by the private sector, or passed along to the consumer.

Enforcement. The purpose of enforcement is generally to recover sums of money, but it may also be to have some other kind of duty performed (duty to do something or refrain from doing something). In practice, a person or business seeking enforcement must have an enforceable document (such as a court judgment or a deed). Enforcement for the recovery of sums of money may be in the form of *attachment of goods* (placing goods under the control of the courts and sold at public sale or auction so that the debtor can be paid back from the proceeds); *attachment of bank assets* (the debtor’s account is blocked or seized) and/or the credit balance is seized; *assignment of earnings* (part of the debtor’s wages or salary can be seized and the creditor is paid from it); or *execution against real property* (whereby the debtor is evicted from property, which is confiscated and sold at auction to pay the creditor). There are certain categories of assets and claims that typically cannot be attached, such as clothing, food, certain items of furniture, a part of the salary, so that debtors and their families can still enjoy a reasonable standard of living.

Fragile states. Those countries that can be categorized as “weak”, “frail,” “post-conflict,” or some other appellation indicative of being under significant stress. Stress may be caused by civil conflict, famine, or some cataclysmic event. USAID’s primary objectives for fragile states are stabilization, reform, and economic recovery to provide a foundation for transformational development. Fragile states, which generally include (but are not limited to) those states known as Least Developed Countries (LDCs), need to fend off economic instability through programs that foster job creation and provide a social safety net. Macroeconomic stability, establishment of functioning, competitive markets, and safeguarding of property rights is very important. Examples of fragile states include Ethiopia, Sudan, Niger, Haiti, and Afghanistan.

Foreign Direct Investment. A system of laws, regulations, and institutions that regulates the treatment of direct investment from outside the country

Implementing Institution. The administrative body with primary responsibility for implementation and enforcement of framework and subsidiary laws, regulations, and policies governing one or more of the seven areas of commercial law addressed in this Guide. For example, courts are among the Implementing Institutions for each of the laws discussed in this Guide.

International Trade. A system that governs the cross-border sale of goods and services.

Land Reform. The redistribution of agricultural land, typically by government action. For the world's rural poor, land is a fundamental asset. It is the primary source of income, security, and status. Law and policy is the primary apparatus used to assign and define land rights.

Legal Framework. For the purposes of this Guide, the laws and regulations that a country has in place that serve as the structural basis for the ability of a country to achieve market-based development.

Litigation. A legal proceeding in a court; a judicial contest to determine and enforce legal rights.

Mediation. Method of ADR in which a neutral third party, the mediator, assists two or more parties in order to help them achieve an agreement, with concrete effects, on a matter of common interest. Mediation techniques can be specially tailored to the idiosyncratic needs of the parties. The main fields of application of mediation are business commerce, legal dispute (including such areas as family law and landlord-tenant cases) and diplomacy. A formal mediation agreement may take the form of a contract, which may be enforceable through traditional legal mechanisms.

Most Favored Nation. This principle, found in international trade law, provides that a member's lowest tariff rate must be extended to all members of a trade pact.

National Treatment. This principle, found in international trade law, requires a commitment to treat foreign goods, once they have lawfully entered a country, no differently than goods produced domestically

Notary. A public officer who certifies and attests to the authenticity of writings (such as deeds) and takes affidavits, depositions, and protests of negotiable instruments. The role undertaken by notaries in civil law countries is much greater than in common law countries. Notaries in the former frequently undertake work done in common law countries by the Titles Office and other Government agencies. The qualifications imposed by some civil law countries are often much greater than in common law states.

Real Property Law. A system of laws and regulations that: (1) creates and protects recognized rights in real property (generally land and buildings), (2) taps the asset value of real property through secured lending, and (3) preserves land use rights and tenant rights.

Secured Transactions Law. A system that taps the asset value of personal property, thereby facilitating commercial lending. Under secured transaction regimes, debtors use their property as collateral to secure loans, thereby granting creditors a "security interest" in the property – that is, a right to seize and sell the property in case of default by the debtor.

Small and Medium-sized Enterprises. Enterprises having fewer than 250 employees are typically considered "medium-sized," and those having between 10 and 49 employees are considered "small." (*Micro-enterprises* are enterprises that have fewer than 10 employees.) Donor assistance initiatives intended to promote economic growth in fragile states or transitioning economies have traditionally focused on the private firm, usually SMEs, as a catalyst or "engine" of economic development.

Supporting Institution. Firms, individuals, or activities without which Framework Laws cannot be fully or efficiently implemented or

enforced. Examples include notaries, bailiffs, trustees, banks, consumers groups, business support organizations, professional associations, and other similar ancillary service providers.

Trade Capacity Building. The vast array of potential legal and institutional changes necessary to “open up” a country to trade, including reduced trade barriers (such as import tariffs), significant strengthening of the overall commercial law framework, improved rule of law generally, substantial reform specifically in the arena of customs, and support for the industrial, agricultural and professional sectors to meet international standards of production and service.

Transitioning states. Category of developing country – also in many cases referred to as “emerging markets” – which are reasonably stable. The challenge for donors is how best to achieve far-reaching, fundamental changes in institutional capacity, human capacity, and economic structure so that further economic and social progress can be sustained without foreign aid. Economic growth objectives are central to achieving such a “lift-off” point. Examples of transitioning states are Egypt, Jordan, El Salvador, Croatia, and Romania.

Transparency. The extent to which government and commercial institutions share information about their operations, decision-making processes, financial workings, and

Organization of this Guide

To help achieve the overarching goal of transformational development, this guide addresses commercial law reform as it pertains to nine areas of law covered under the CLIR Methodology:

Company Law and Corporate Governance; Contract Law and Enforcement; Real Property; Secured Transactions; Bankruptcy; Competition Law; Commercial Dispute Resolution; Foreign Direct Investment; and International Trade.

These topics were chosen for their direct bearing – individually and collectively – on a country’s prospects for sustained economic development. In addition to the areas of law covered in this guide, the

CLIR: Nine Building Blocks

- Company Law and Corporate Governance
- Contract Law and Enforcement
- Real Property Law
- Secured Transactions Law
- Bankruptcy Law
- Competition Law
- Commercial Dispute Resolution
- Foreign Direct Investment
- International Trade Law

CLIR Methodology also covers **Commercial Court Administration** and **Financial Crimes** (i.e., anti-money laundering and terrorist financing).

Each chapter in this guide discusses the specific legal topic in three parts: (a) Key Concepts, with an emphasis on the significance of the topic and important issues that will likely arise when it becomes part of an overall program for economic development; (b) Major Guidelines, in particular with respect to the legal framework, implementing institutions, and supporting institutions that must be in place for effective, sustainable implementation; and (c) Additional Guidance, Tools, and Resources that may be of use when designing or implementing a program pertaining to the topic. With respect to the Major Guidelines section of each chapter, this guide follows the structure developed in the CLIR Diagnostic Methodology. In particular, the discussions focus on the following aspects of reform:

Legal Framework: This aspect of reform centers on establishing a system of “black letter law” and regulations that can support sustainable, market-driven economic growth. Discussion in this guide centers on key components of each law and how the law relates to other aspects of a country’s legal system.

Implementing Institutions: The discussion here identifies the chief implementers and enforcers of the law at issue, who generally most often are state

actors. The development professional must then evaluate how well these implementers carry out their duties in terms of efficiency, transparency, and predictability, and whether institutional behaviors create barriers to economic participation and predictability.

Supporting Institutions: This discussion lists the civil society institutions that reflect the deeply rooted laws and institutions that govern economic life.

Social Dynamics/Market for Reform: This discussion is presented through both the Key Concepts and Additional Guidance sections of each chapter. These discussions help the development professional identify and understand how well a legal system responds to users' evolving needs and how receptive key stakeholders are to change. In addition, these discussions identify the forces or factors governing the pace and direction of change.

Finally, this guide includes four appendices that are useful to the development professional engaged in CLIR. Appendix A discusses certain cross-cutting issues in CLIR reform, including (a) the importance of donor coordination; (b) the role of other major U.S. and global development initiatives; (c) special concerns of Small and Medium-Sized Enterprises (SMEs); (d) the relationship between CLIR and development initiatives in democracy and governance; (e) CLIR and legal education; (f) CLIR and administrative law; (g) CLIR and corruption; and (h) management of information and technology. Appendix B is a glossary of key terms and concepts. Appendix C lists

the major national, regional or global institutions referenced one or more times in this guide.

Appendix D presents three Case Studies, which demonstrate the inter-relationship of the various CLIR topics discussed in this guide and which may be used as a learning tool for CLIR program developers and implementers.

The Countries at Issue: Terminology Used Throughout this Guide

Throughout this Guide, reference is made to the type of countries that are served by USAID efforts in commercial legal and institutional reform (CLIR). The terms used here generally reflect those set forth in the USAID White Paper, "U.S. Foreign Aid: Meeting the Challenges of the Twenty-first Century" (January 2004), but are also adjusted to reflect the chief emphasis of this Guide on economic development.

Fragile states are those countries that can be categorized as "weak", "frail," "post-conflict," or some other appellation indicative of being under significant stress and often include LDCs. Stress may be caused by civil conflict, famine, or some cataclysmic event. USAID's primary objectives for fragile states are stabilization, reform, and economic recovery to provide a foundation for transformational development. Fragile states need to fend off economic instability through programs that foster job creation and provide a social safety net. Macroeconomic stability, establishment of functioning competitive markets, and safeguarding of property rights are important considerations. Examples of fragile states include Ethiopia, Sudan, Niger, Haiti, and Afghanistan.

Transitioning states – also in many cases referred to as "emerging markets" – are reasonably stable. The challenge for donors is how best to achieve far-reaching, fundamental changes in institutional capacity, human capacity, and economic structure so that further economic and social progress can be sustained without foreign aid. Economic growth objectives are central to achieving such a "lift-off" point. Examples of transitioning states are Egypt, Jordan, El Salvador, Croatia, and Romania.

Strategic states are designated as such by the National Security Council with input from the State and Defense Departments. Intervention possibilities run the full range of assistance instruments USAID can offer. Economic growth objectives are often central to U.S. strategic interests in such countries. Examples of strategic states are Haiti, Colombia, Ethiopia, Sudan, Pakistan, Afghanistan, Iraq, and Indonesia.

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Appendix C: List of Major Institutions Referenced in this Guide

ACGA	Asian Corporate Governance Association
ADB	Asian Development Bank
CAFTA	Central American Free Trade Agreement
CARICOM	Caribbean Community
EBRD	European Bank for Reconstruction and Development
EC	European Commission (of the European Union)
EU	European Union
IADB	Inter-American Development Bank
IASB	International Accounting Standards Board
ICC	International Chamber of Commerce
IF	Integrated Framework for Technical Assistance to Least Developed Countries
IMF	International Monetary Fund
ITC	United States International Trade Commission
MCC	United States Millennium Challenge Corporation
NEPAD	New Partnership for Africa's Development
OECD	Organization for Economic Cooperation and Development
TDA	United States Trade and Development Agency
UN	United Nations <ul style="list-style-type: none">• United Nations Economic Commission on Africa (UNECA)• United Nations Economic Commission on Europe (UNECE)• United Nations Commission on International Trade Law (UNCITRAL)• United Nations Conference on Trade and Development (UNCTAD)• International Institute for the Unification of Private Law (UNIDROIT)
USAID	United States Agency for International Development <ul style="list-style-type: none">• Bureau of Economic Growth, Agriculture, and Trade (EGAT)• Bureau of Democracy, Conflict, and Humanitarian Assistance (DCHA)<ul style="list-style-type: none">– Office of Democracy and Governance (ODG)• Bureau of Policy and Program Coordination (PPC)• Development Experience Clearinghouse (DEC)

- USDA** United States Department of Agriculture
- Foreign Agriculture Service (FAS)
 - Animal & Plant Health Inspection Service (APHIS)
 - Agricultural Marketing Service (AMS)
 - Agricultural Research Service (ARS)
- USDOC** United States Department of Commerce
- Commercial Law Development Program (CLDP)
 - International Trade Administration (ITA)
 - Patent & Trademark Office (PTO)
 - National Institute of Standards and Technology (NIST)
- USGTN** USAID/Global Trade and Technology Network
- USTR** Office of the United States Trade Representative
- World Bank** The World Bank consists of five closely associated institutions:
- The International Bank for Reconstruction and Development (IBRD);
 - The International Development Association (IDA);
 - The International Finance Corporation (IFC);
 - The Multilateral Investment Guarantee Agency (MIGA);
 - The International Center for the Settlement of Investment Disputes (ICSID).
- WTO** World Trade Organization

Appendix D: Case Studies

Overview

The following Case Studies may be used as a learning tool for local policy makers and implementers in those countries where CLIR programs are envisioned or in place. In contemplating each Case Study, and, indeed, in designing a CLIR program, consideration should be given to how the state of one topic may influence the circumstances of another. The format of each Case Study is as follows:

Facts

The Case Studies anticipate that the commercial legal and institutional environment in a given country will be the product not only of laws on the books, but also of such factors as the country's will and ability to enforce the law, the competing agendas of various state agencies, the country's readiness for certain reforms, the aid environment, and even the influence of certain personalities or institutions.

Assessment

The findings set forth in this portion are those that might be found through the comprehensive analysis promoted by the CLIR Diagnostic Methodology. This portion attempts to isolate specific opportunities and impediments to reform.

Possible Recommendations

This section suggests various approaches that may be taken for the purposes of securing structural change and then creating conditions for sustainable reform that result in genuine, measurable indications of economic development.

The fact situations are not intended to be country specific – although they are drawn from specific situations – but rather might be found in any of the regions where USAID works.

CASE STUDY I: FDI, TRADE, AND COMPETITION

Facts

The Government is pursuing accession to the WTO in hopes of increasing foreign direct investment (FDI) and improving market access for businesses seeking to import goods and services. In support of this effort, the Foreign Investment Agency drafted the Law on the Protection of Foreign Investments (the PFI Law), which was enacted without debate two years ago by the legislature. Even so, there continue to be a number of impediments to making such investments effectively. First, the registration of foreign ventures or companies is not specified in the PFI law. Instead, registration is governed by ad hoc local rules, which themselves are rife with rent-seeking opportunities. The delays and uncertainties of the registration are a major complaint of both domestic and foreign investors. In addition, the Foreign Investment Agency is ineffectual. Though the Agency is technically independent from the Ministry of Economic Development, the Agency often intercedes on behalf of favored investors and is susceptible to cronyism and graft.

Further, there is no concrete law against anti-competitive practices, and government monopolies are well established. Indeed, the government does nothing to discourage fixed prices, believing that these create a level playing field for competitors. Price-fixing has had a particularly negative effect in the area of the export market for cash crops. The lack of pro-competitive, market-oriented trade policies has resulted in preserving long-standing monopolies in the agriculture sector, despite their inefficiencies. These vested interests are often able to influence various government agencies to erect non-tariff barriers against their competitors, particularly by getting the Customs Office to delay processing of competing exporters' paperwork and reject competing imports based on specious findings of phyto-sanitary problems. In addition, the Tax Authority tends to single out new competitors for extensive, disruptive audits. The Foreign Investors' Association, comprised of representatives of non-domestic enterprises, issued a White Paper on these concerns last year, but the Government has not responded. A World Bank team recently underscored each of these issues in a project assessment report.

Assessment

The commercial environment is being weakened by a lack of effective policymaking and policy enforcement, as evidenced by the failure to implement existing laws along with gaps in the legal framework itself. The FDI law is generally sound, but it lacks a few specific provisions needed to increase certainty with respect to rights of foreign companies. This can be fixed through amendments, but improving the law is unlikely to improve investment. Rather, the complaints chiefly have to do with enforcement of contractual obligations and obstructions of access to local markets.

The lack of a regulatory framework for competition means that there are no protections against a wide number of unfair trade practices. New investors – whether foreign or domestic – are unlikely to risk much investment at all unless protected, which means that many will seek monopoly privileges. Some will be successful. For economic development and growth, consideration must be given to a Competition Law. However, enactment of a Competition Law, which necessarily calls for a strong, independent implementation authority and essentially effective court system, may be regarded as premature.

Trade Law seems to be underway and headed in the right direction through the WTO process. This process will provide strong incentives for ensuring that the right laws are put into place, and it also offers an excellent opportunity for technical assistance. Assistance should include aid in developing regulations regarding the operations of the Customs Administration to limit discretionary authority currently being abused. Without solid regulations, other legal changes are likely to be hollow

The weakness of implementing institutions undercuts the capacity of the state to enforce existing laws. The role of the Foreign Investment Agency vis-a-vis the Ministry of Economic Development needs to be clarified publicly with clear support for the Agency. The Agency may also need assistance in understanding how it can advocate changes to the constraints investors have identified – including law and enforcement issues in other agencies and ministries. Likewise, the Ministry of Trade needs assistance in monitoring trade and enforcing Trade Law, which will not simply be covered by the WTO. All of these institutions will need proper orientation about how to handle inappropriate activities involving other authorities, such as the Tax Authority and the Customs Agency.

Supporting institutions have only recently begun to appear. The Bar Association is among the oldest, but it is essentially a licensing agency with mandatory fees that does not understand how to provide services to its members other than lobbying for higher fees. A new officer was just elected, however, who has returned from five years of practicing law in England, where he was heavily involved in legal associations. The law schools do not yet have any curriculum on Competition Law, and Trade Law courses are still based on Marxist ideology about capitalist exploitation, though few students accept that ideology any longer. The Foreign Investors' Association is the best-organized business association there is, with members from the banking, manufacturing, retailing, and telecommunications industry. They understand the issues, but there are not yet any strong local groups who can join with them to voice concerns. An Agricultural Producers' Association has been effective in obtaining bulk supplies for farmers' cooperatives, but has never been involved in advocating reforms.

The commercial environment includes very powerful vested interests. On one side, there are a number of politicians with interests in established local companies who do not wish to see any competition that might lower their own revenues and prestige. On another, there are individuals who want to open some foreign investment opportunities because they will be controlling interests. Large, established businesses regularly meet with these and other government officials to oppose reform trends that threaten their market shares or earnings. Very few in government understand the economic importance of competition, trade and open investment.

There are many constituencies pushing for reform, but they are generally weak. Several government officials believe that these pro-trade changes will bring new jobs while increasing tax revenues. The private sector would also like to see market-oriented changes, but do not have a reasonable means of voicing these interests. The Foreign Investors' Association intends to continue advocating reform, but is sometimes marginalized as foreigners who do not understand local needs. The Bar Association may now be in a position to participate in the reforms, but will need support in restructuring the organization from its current, passive functions into a more active body.

Possible Recommendations

- **FDI:** Reorganize the Foreign Investment Agency and give it the exclusive mandate to manage the foreign company registration process. Plan a consensus-building activity in which FIA members and other directly interested government officials work together to draft an FIA Code of Conduct or other standard-setting document. Initiate an outreach program in which the FIA educates interested companies, organizations and the media about its mandate and scope of responsibilities.
- **Competition:** Evaluate the country's readiness for a Competition Law, including whether it has the capacity to support a fully empowered Competition Authority. Regardless of whether Competition Law is pursued or tabled for the time-being, establish a committee of interested parties to propose an approach and timetable for breaking up government-run monopolies in cash crop exports to preserve efficiency and

cut costs while increasing competition. Develop a Competition Law curriculum both for the law schools and for continuing legal education for judges, attorneys, and other interested professionals.

- **Trade:** Conduct an analysis of the country's economic responsiveness to opportunities to trade, incorporating all categories addressed in the Trade Law chapter of this Guide. Based on the results, trade capacity building measures may include gradually reducing or eliminating export controls, prohibitively high customs duties, and non-tariff barriers with a view to increasing the marketability of processed agricultural goods. In conjunction with other donors or projects, initiate an outreach program in which government officials, the public, the media, and other constituencies are educated about the advantages of WTO accession. Support an inter-ministerial process that promotes good governance and transparency in adhering to the WTO principles can be retained even after they have acceded to the WTO.
- **Cross-Cutting Theme: Corruption:** Establish more transparent management and accounting practices in government agencies so that rent-seeking opportunities can be curbed. Where donor programs engaged specifically in anti-corruption are at work in the country, make an effort to relate the messages of your respective programs and leverage anti-corruption resources and opportunities.

CASE STUDY 2: BANKRUPTCY, SECURED TRANSACTIONS, REAL PROPERTY

Facts

In response to pressure from the banking community and donors, the Republic set up a modern collateral registry system two years ago. The framework law was drafted by a team of law professors, one practitioner, and a lawyer from the Ministry of Finance, with occasional assistance from an expatriate technical advisor who primarily focused the drafting team on the EBRD Checklist for secured transaction systems. The system covers pledges for most movable and intangible property, but requires extensive detail about the collateral being pledged, including itemization of inventory and accounts receivable. Moreover, to pledge accounts receivable, each payor must be notified of the assignment. Registration establishes priority and also legality of the underlying pledge agreement and costs approximately \$60. Although most registrations are completed within an hour, retrieval of the information on debtors is problematic, with the registry officials requiring requestors to prove that they have a right to the information.

Unlike the country's company registry, the pledge registry is not in the courts (which are beset by substantial delays in registration), but in the former office of the central clearinghouse for payments. The clearinghouse function was eliminated three years ago, but the old framework was used to create several different registries. For efficiency purposes, the government also decided to include registration of mortgages as pledges, so that the registry includes claims against buildings and land. Initial response was fairly robust, with substantial filings of real estate mortgages. In addition, early pledge filings for equipment were also robust, but automobile filings were disappointing. Leasing agencies do not even use the registry.

The new Bankruptcy Law, based on a German model, was drafted by the leading local expert on comparative bankruptcy systems, with virtually no assistance. The drafter felt it important to ensure fairness among creditors so that larger institutions cannot take advantage of their greater leverage, and therefore stripped the system of priorities to make all creditors equal. There are still no implementing regulations for the trustees, but practices have developed in which they are appointed by judges without input from the creditors. The Bar Association has effectively argued the trustees must be members of the bar.

Assessment

Both the Bankruptcy and Secured Transactions Laws are essentially sound, based in great part on effective foreign models. They have broken down in several significant areas, however, primarily because the drafters do not understand the purpose or practical implications sufficiently. In the Secured Transactions Law, there are several theoretical problems. First, there is confusion with respect to the distinctions between legality and priority, with the drafters having overstepped commercial need for notice by making registration mandatory for a pledge contract to be legal. Better practices simply require registration to ensure priority, with creditors responsible for protecting their interests.

Second, costs of registration serve as a barrier to SME financing through secured transactions. The costs do not affect higher loans, but are prohibitive for smaller ones, especially if coupled with notarization, which is normal practice in the country. This has affected financing for automobiles. Leasing companies do not register their lease interests, although they are entitled to, because of these costs. Stakeholders involved in real estate are not typically concerned by these costs, but have noted that the drop in mortgages and other real property secured financing is due to poor security of title. The initial surge in registrations came from the 20% of the market that has well settled ownership. Unfortunately, most urban land sales were not registered in the past 10-15 years because of high taxes and transaction costs. As a result, banks are reluctant to take real property as collateral without significant additional assets and guarantees.

Third, failure of the registry to provide information on debtors is extremely serious. This comes in great part from a historical perspective in which government agencies are seen as guardians of information, not providers. Their practices are undercutting the entire reason for registration – providing notice to third parties in order to maintain priorities –because the third parties can no longer get such notice. Although the use of an existing registry network was an excellent idea, and successful elsewhere, management of the change expected of employees was not as well thought out. Employees are confused about the transformation of their employer's mission and expectations of customer service. Clearly more education is needed.

In addition, the differences in priority systems between Bankruptcy and Secured Transactions are fatal to the Secured Transactions system, robbing it of the risk-management tools inherent in secured transactions. This fundamental misunderstanding points to a serious weakness in the system of drafting. Such misconceived ideas could have been prevented by involving the banking and business community in the drafting process. Instead, secured financing is slowing down dramatically.

The selection of Bankruptcy trustees is not based on market requirements, but on vested interests. Creditors do not have a sufficient hand in monitoring or selecting the performance of the trustees, and the courts are too new at this work to provide an alternative. Even worse, the CLIR Assessment uncovered a recent trend for judges to appoint friends and relatives, irrespective of their qualifications.

Possible Recommendations

- **Cross-cutting Issues: Legislative Process:** Establish a notice and input system for legislative process to ensure stakeholder participation in democratic lawmaking. If Parliament is resistant to formal changes, ensure that all legal reform programs funded by USAID include extensive stakeholder feedback activities. CLIR projects, leveraging the know-how and resources of donor-funded legislative reform projects, should work with state institutions to promote understanding of the value of outside input into legislation and to acknowledge and integrate the perspectives of those groups most affected by changes in the law.
- **Secured Transactions Law:** Working with supporting institutions, advocate for change in law and registry practices. The priorities include:
 - Training for registry employees to explain the purpose of the new system, the details of its implementation, and expectations of customer service. In addition, a system of monitoring should be put in place through which users can complain to higher-level ministry officials of performance failures.
 - Reduction of fees to \$10-15 to enable SME borrowers to use the system. This will probably require a solid cost-benefit analysis to convince policymakers that they will not lose money.
 - Amending the law to eliminate provisions annulling unregistered contracts, preferably through establishment of a multi-disciplinary working group.
- **Bankruptcy Law:** Provide high-level technical assistance from Germany to educate the drafter on the economic need for priorities. Although Americans can provide the same information, the professor is unlikely to listen, so it is better to use someone he will immediately accept.
- **Bankruptcy Law:** Assist with drafting implementing regulations for the law, including a system of certifying or licensing trustees based on appropriate qualifications. The Bar Association will resist use of non-lawyers, so it will be important to work with the different associations of accountants, bankers, and foreign investors to counter-balance their influence.

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- **Bankruptcy Practice:** Assist with drafting a handbook for trustees and creditor committees, then providing education to trustees and judges in how to manage and run bankruptcy cases.
- **Real Property:** The lack of adequate title presents serious constraints to development, and is also very expensive to correct. If budget capacity exists, provide technical assistance to update the land registry and cadastre. Otherwise, coordinate with other donors such as the World Bank to provide support in training or legal reform while they undertake the expense of modernization.

CASE STUDY 3: CONTRACTS, COMMERCIAL DISPUTE RESOLUTION, COMPANY LAW

Facts

In the last ten years, the Law on Obligations (Contract Law) has been revised four times in order to add new concepts and contractual tools, such as leasing, franchising, and liquidated damages. Even so, the major concerns of the business community have not been addressed. Specifically, the Law remains overprotective of debtors, permitting judges to rewrite damages and interest rate clauses if they feel that the terms are “unfair.” Several well established business associations have lobbied for new changes, but there is little political will to work on the Law of Obligations again, due to the number of other laws currently under revision and reconsideration.

The business and legal communities are also dissatisfied with performance of the courts. Resolution of even simple commercial cases often takes two years. Even worse, the judgments, when issued, are virtually unenforceable because the bailiffs have no authority to seize property without using the police, and the police do not assist. Illegal self-help has grown, causing concerns about criminal elements. There is much talk about the use of alternative dispute resolution, especially arbitration, which has been presented as an excellent solution to the court crisis. Currently, the tax-funded Chamber of Economy has a Court of Arbitration, which hears 8-10 cases a year. These cases typically involve disputes with between one domestic company and a second company based in a neighboring country, however, rather than two or more domestic business concerns.

Company Law is also in transition, with recent expansion of corporate forms to permit small and medium-sized limited liability companies. For larger companies, new rules of corporate governance have been adopted, with strong support from foreign accounting firms. Business associations are being asked to have their members adopt a new code of business ethics, but there is little understanding or support for this, especially because of the perceived need for maintaining double sets of accounting books to avoid high taxes.

Assessment

The Law on Obligations provides the general foundation for development of complex commercial activity, even though it is flawed. The flaws, however, are permissive, not mandatory; that is, judges *may* set aside contractual clauses, but are not *required* to do so. With no support currently for actual amendment of these provisions, the business and banking communities, together with the local In-House Counsel Association, will need to reorient their efforts to provide education for judges so that they understand the socio-economic impact of rewriting contracts (namely, the higher costs of doing business for the entire country). Likewise, they can look more to self-regulation in setting standards for different sectors of the economy, so that judges feel comfortable agreeing to the contract terms in line with industry standards.

In interviews, a number of judges suggested that the delays in process are due to poor drafting quality of contracts, making many documents virtually unenforceable. They also complain that the lawyers constantly use delay tactics to avoid judgments, and that they have little control over the situation. Research in the Code of Civil Procedure and Court Law, however, shows that there are a number of sanctions available to judges, but that few use them. In addition, several judges outside the capital are known for efficient trial management, suggesting that not all of the problems are due to lawyers or processes. A local professor has further noted that the delay tactics grew during the period of authoritarian government, as the government sought to avoid payment of debts by prolonging the process until the creditors gave up or went bankrupt.

The Company Law has produced a great deal of new registrations of the limited liability companies. The CLIR Diagnostic Assessment team noted, however, that there is a great deal of confusion over the charter documents, with the management of many small companies feeling confused over what should be included.

Frustration with enforcement is giving rise to a great deal of interest in ADR. However, the Chamber of Economy holds a “lock” on most arbitration disputes, and prefers to restrict its list of arbitrators to a tightly knit group of law professors and business leaders who enjoy their access to arbitration fees and consider themselves above continuing legal education or skill training. On the other hand, the use of mediation, which emphasizes negotiation and consensus, is not currently the province of the Chamber. The insurance industry has shown substantial interest in mediation and many lawyers have expressed the desire to receive training in mediation techniques. Without specific statutory language providing for the enforcement of mediation agreements, however, there is uncertainty over the viability of this option.

The Assessment team also noted that companies generally have little or no experience with accounts receivable management or collection techniques, so that they often wait until a crisis point then sue their debtors. In addition, regulations on corporate profits require a company to sue before they can write off bad debts. Foreign accounting firms find that this creates a substantial misrepresentation of balance sheets, because companies carry their receivables indefinitely if they decide not to sue. Local accounting firms complain that they must assist their clients with double sets of books because tax authorities are so inept they do not understand various issues, such as contingent liabilities and depreciation. Consequently, they keep one set of books for the tax authorities and one for the company. Bankers have noted that this is causing problems with creditworthiness, because companies only show them the doctored books, which do not justify large loans or lines of credit, and require substantial collateralization.

Possible Recommendations

- **Commercial Dispute Resolution: Enforcement.** Enforcement problems are negatively affecting the economy, undercutting the importance of contracts, and depressing the demand for arbitration services. A stand-alone program to address enforcement issues should be seriously considered, including:
 - Analysis and re-engineering of the bailiff system;
 - Introduction of market-oriented auctions to improve value and speed;
 - Development of credit information services and credit collection training and services, to enable the private sector to better protect interests and create a culture of accountability.
- **Commercial Dispute Resolution: ADR.** There is demand for ADR, but lack of understanding about how it works and what is required for success. Working with the private sector and courts, it is possible to introduce mediation and in-court settlement negotiations through training. If enforcement issues are also being addressed, include arbitration in the program; otherwise, leave it alone because it will fail without proper enforceability to support it. Statutory changes that remove the exclusive hold over arbitration by the Chamber of Economy and support the enforcement of all agreements arrived at through ADR are also warranted.
- **Commercial Dispute Resolution: Delays.** The courts are in need of modernization and computerization, but these will take up to six years. In the interim, work with judges to teach management skills for better efficiency, including application of existing sanctions to discipline lawyers. Combine this with continuing legal education and public education for lawyers regarding the new judicial practices and their consequences for clients.

- **Contracts: Improved Drafting.** Although judges overstate the extent to which delay is attributable to poor drafting, a program to improve drafting skills will lower the cost of litigation and enforcement. Introduce CLE and law school courses in collaboration with the Bar Association, the Law Schools, the In-House Counsel Association, and various business associations to ensure wide dissemination and to include a wide array of potential users in the program.
- **Company Law: Corporate Documents.** Work with attorneys, notaries and the Company Registry to develop basic forms for new companies to use, including brochures to be handed out at the Company Registry.
- **Company Law: Corporate Governance.** Various opportunities exist to encourage better governance without changing laws, including:
 - Support the use of self-regulation by working with the business community to develop codes of ethical conduct for companies and boards and require adherence to the codes for membership in business associations.
 - Provide market incentives by working with banks to link terms of credit to internal procedures.
 - Educate fiscal agents in business realities and how to interpret accounts properly; have international accounting firms work with local firms to develop the training materials and provide the trainer
- **Cross-Cutting Issues: Corporate Profit Tax.** The failure of the regulations to recognize normal bad-debt write-offs is creating tens of thousands of unnecessary lawsuits, thus overtaxing court resources and wasting millions of dollars in unnecessary legal expenses. Have local business and professional associations work with the Ministry of Finance to develop mutually acceptable standards and practices for writing off debt, with or without litigation. Use the Banking Association and the Foreign Investors' Association to advocate change at the highest governmental levels.

Appendix E: Commercial Law and Microeconomic Reform Legal Subject Area Summaries

INTRODUCTION

To help development practitioners gain a better understanding of the complexities of commercial law reform, USAID commissioned the Commercial Law and Microeconomic Reform: A Practical Guide to Program Implementation (CLIR Guide). Each of the areas of law covered in the CLIR Guide are summarized in this document, and certain key definitions are referenced below. Consult the corresponding area of law in the CLIR Guide for an in-depth treatment of the areas of law in this document.

DEFINITIONS:

Pillar Laws: The legal regimes for Real Property, Contract Law, the business registration aspects of Company Law, and Commercial Dispute Resolution are the four pillars to building a market economy.

Second Tier Laws: This refers to laws that build or supplement the four Pillar Laws, and for purposes of this Summary Guide include Secured Transactions, Bankruptcy, Competition Policy, Foreign Direct Investment, International Trade Law, and the corporate governance aspects of Company Law.

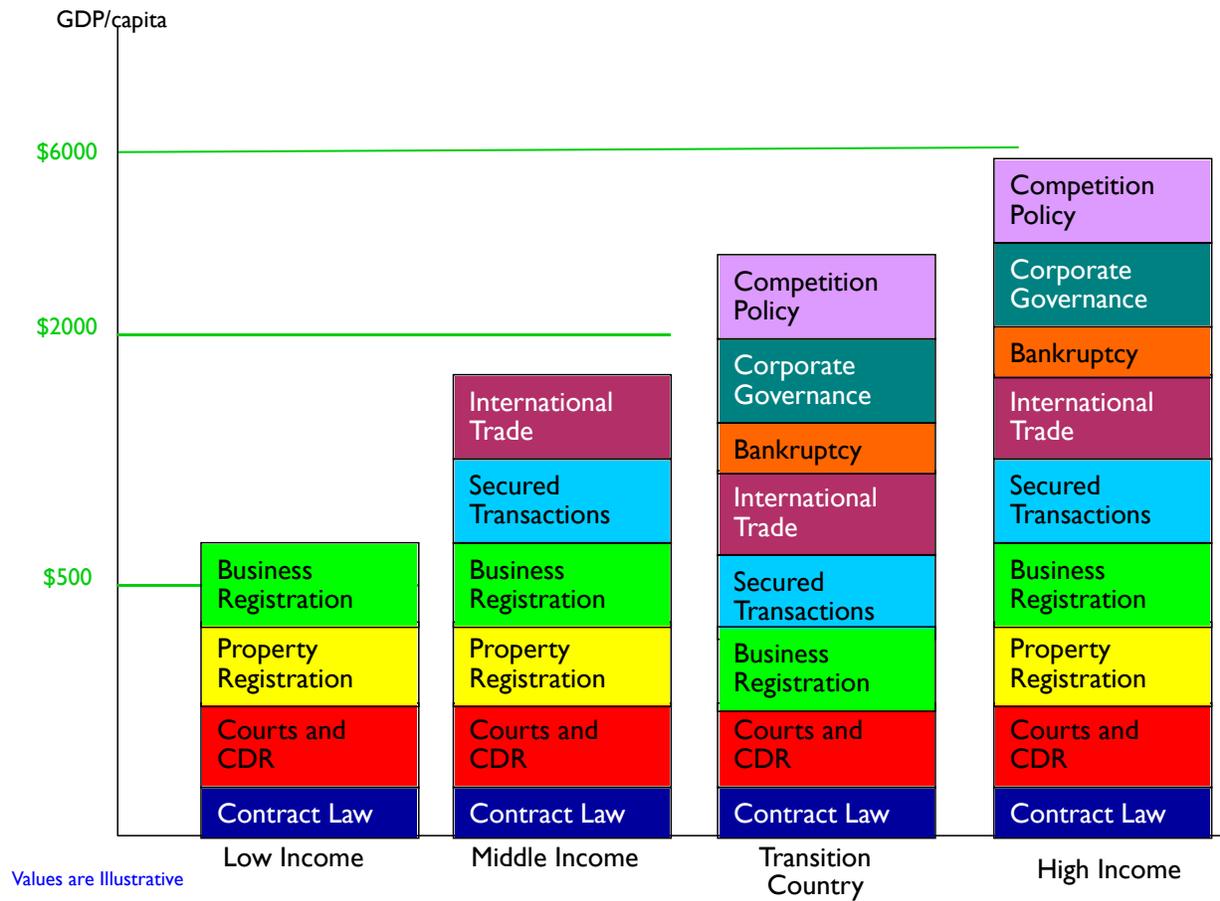
Transition Economy: Any one of a number of former Socialist or Communist states stemming from the collapse of Communism in the 1980s and 1990s.

Fragile State: Those countries that can be labeled “weak”, “frail”, “post-conflict”, or some other appellation indicative of being under significant stress. Stress may be caused by civil conflict, famine, or some cataclysmic event. Fragile states can be further categorized as Failed, Failing, or Recovering. USAID economic growth activities will most likely be implemented in Recovering States, although there may be some interventions that may be beneficial in Failing and Failed States. USAID’s primary objectives for fragile states are stabilization, reform, and economic recovery to provide a foundation for transformational development. Fragile states, which generally include (but are not limited to) those states known as Least Developed Countries (LDCs), need to fend off economic instability through programs that foster job creation and provide a social safety net. Macroeconomic stability, establishment of functioning, competitive markets, and safeguarding of property rights are very important.

Transitioning States: In many cases referred to as “emerging markets”, these countries are reasonably stable. The challenge for donors is how best to achieve far-reaching, fundamental changes in institutional capacity, human capacity, and economic structure so that further economic and social progress can be sustained without foreign aid. Economic growth objectives are central to achieving such a “lift-off” point.

Strategic States: These are designated as such by the National Security Council with input from the State and Defense Departments. Intervention possibilities run the full range of assistance instruments USAID can offer. Economic growth objectives are often central to U.S. strategic interests in such countries.

Commercial Law Reform Typology



Pillar I: Real Property (Including Mortgage Law)

Definition: A system of laws and regulations that: (1) creates and protects recognized rights in real property (generally land and buildings); (2) taps the asset value of real property through secured lending; and (3) preserves land use rights and tenant rights.

Linkages to Economic Growth and Transformational Development:

- **Poverty Reduction:** Development specialists have identified a clear relationship between land tenure (property ownership or ownership-like rights) and the reduction of poverty.
- **Promotes investment in productive assets:** Secure property rights (whether through ownership, leasing, or customary arrangement) encourages rights-holders to maintain and make productive improvements to property.
- **Establishes an ownership class:** Secured lending, through Mortgage Law, allows people to buy homes and land, fostering a sense of independence and economic empowerment.
- **Facilitates access to credit:** Secure, registered property rights enable owners to more easily borrow against equity.

Policy Framework: Real Property Law is a core reform for any developing country. It should precede or take place concurrently with – and always consistently with – reform efforts in **Commercial Dispute Resolution** and **Contract Law**.

Programming Issues: The development professional should carefully consider how best to handle the creation or improvement of **Land Registries** (sometimes called **Land Cadastres** in Civil Code systems), which are necessary for sound, effective judicial enforcement. In some countries, improvements to land may be legitimately—but confusingly—filed in **Pledge Registries** established under **Secured Transactions** Law. It is very important that reform initiatives repair such a situation, so that any liens involving real property (both to land and improvements, like structures, to the land) will be contained in the same registry.

Best Practices and Special Concerns:

The World Bank **Doing Business** Reports (2004-2006) suggest that efficient courts coupled with strong supporting legislation defining the rights of citizens and businesses to their property are the backbone of real property rights. The reports conclude that inexpensive and quick, cheap registry systems are effective means for securing title to property, even when Commercial Dispute Resolution and enforcement mechanisms are weak. Other recommendations include:

- linking and unifying the agencies involved in registering property;
- providing easy and convenient access to the registry; and
- Protecting the legal rights of creditors.

Doing Business cautions that automation and technology are not a panacea. In many countries, particularly poor ones, electronic registration is probably not sustainable yet. If paper records are inaccurate, putting them in a computer will not help. Hence, the focus in such situations should be to focus on improving the efficiency of current services and coverage and accuracy of the registry.

USAID’s **DCHA Bureau** has found that automating key functions in registry systems can make a marked improvement in operational performance. Like *Doing Business*, it recommends that while there is no need to automate all registry locations (such as those in remote towns and villages), it is still important to have central or regional automated records that are periodically updated in order to support ownership transfers. Experience indicates that local or provincial manual or semi-automated systems often require only limited resources to work effectively.

In **Transition Economies**, development and implementation of a sound Real Property Law – concurrent with Company Law and Contract Law reform – is a critical step in establishing a market economy. With respect to **Fragile States**, the breakdown of the existing real property regime is one of the signal indicators of a failing state. Donors should consider ways to strengthen institutions in failing and recovering states. In failed states, donors should seek to preserve or make back-up copies of land registry records, if practicable. In **Recovering States** resolving conflicting claims to land ownership, especially in violent situations, can be a major challenge.

Significant Intersections with other USAID Activities

Real Property Law reform demands an interdisciplinary approach that cuts across different sectoral disciplines in agencies such as USAID. Democracy and governance, economic growth, agriculture, environment, and post-conflict peace-building projects may all require interventions that affect land ownership, tenure, and natural resources management.

ACTIVITY	IMPORTANCE
Agriculture	Secure ownership of real property is essential to agricultural investment as it facilitates access to credit, which can in later stages of development sustain agriculture on a commercial scale.
Credit Access (Includes DCA, Microfinance, and Financial Markets types of activities)	Enables small business and entrepreneurs to pledge their homes and land as collateral, thereby satisfying high collateral requirements for a loan. This can vastly increase the level of financial intermediation and correspondingly there is greater opportunity for credit-facilitating activities.
Rule of Law/ Democracy	High—Securing rights in real property is a paramount ROL issue. Foreclosure under mortgage involves enforcement issues.
Trade & Investment	Without secure property rights, investors are unlikely to make substantial improvements in real property and their access to credit will be limited.
Gender Issues	It is of particular importance that legislation establishes equal rights for women. Nonetheless, customary law and cultural taboos may undermine even sound legislation, restricting women’s access to and control of real property.

Pillar Law II: Contract Law

Definition: A system of creating, interpreting, and enforcing commercial obligations between parties. (Often referred to as the “Commercial Law” or “Law on Obligations” in Civil Code legal systems.)

Linkages to Economic Growth and Transformational Development:

- **Creates the “rules of the road” concerning commercial transactions.** Contract law involves setting rules concerning the most commonplace of transactions, such as sales, leases, negotiable instruments, bank deposits, funds transfers, letters of credit, and warehouse receipts. The U.S. Uniform Commercial Code (UCC) contains hundreds of tailored rules and numerous exceptions. In Civil Law systems, the Commercial Code is the senior law to which all other economic laws are subordinate.
- **Enables transformational development:** A well-functioning contract law regime will support the creation, observance, and enforcement of more complex and longer-term commercial transactions.
- **Reduces market risks: Greater certainty in contract enforcement (including consistent interpretation of Contract Law by the courts) lowers the risk of doing business and expands access to seller and lender finance.**

Policy Framework: The development and implementation of a sound **Contract Law** – along with **Company and Real Property** law reform – are fundamental for establishment of a market economy. Contract law is meaningless without independent, non-biased **Commercial Dispute Resolution** mechanisms that include efficient enforcement mechanisms (typically by marshals, sheriffs, or bailiffs). Institutional aspects of Contract Law – i.e., competent courts and enforcement institutions – help promote **SME development and Foreign Direct Investment**.

Programming Issues: The development professional should address the following in any Contract Law reform activity:

- **Courts and ADR:** Establishment of efficient and fair courts and other dispute resolution mechanisms, like arbitration, mediation, and conciliation. The effectiveness and credibility of ADR is increased when an international affiliation such as the ICC or when the country is a signatory to the New York Convention.
- **Judicial Training:** Court officials and judges typically require training in commercial practices, commercial law, and the needs of business. Effective ADR depends on court acceptance of its out-of-court rulings.
- **Enforcement:** Institutions and mechanisms that address enforcement of contracts are ineffective in many developing countries.
- **Legal Education:** Enhancing the capacity of private sector attorneys (the “bar”) and of law students in areas such as the proper drafting of contracts is highly recommended when commercial legal reform efforts are undertaken.
- **Association Development:** Business and professional associations serve as important drivers of industry-specific contract law reforms.

Best Practices and Special Concerns:

The World Bank Doing Business Reports recommend the use of standardized forms as a way of reforming Contract Laws. Many global and regional organizations, both public and private, have developed standardized forms for international contracts. The Reports also provide a number of recommendations concerning Contract Enforcement, more fully described at the Commercial Dispute Resolution section herein.

Fragile States: Sound and impartial enforcement of contract law is critical for advancing fragile states and transition economies to a transformational development stage. In **Failing States**, a decline in observance and enforcement of the contract law regime will lead to the cessation of all but the simplest kinds of commercial transactions, like barter and one-off cash sales that do not require an enforceable contract.

In **Transition Economies**, particularly post-Socialist economies, initiatives in Contract Law reform will likely affect the development of second tier laws, like bankruptcy, intellectual property rights, competition policy, and trade law. Therefore, care should be made to integrate contract law reform with other donor initiatives in private sector development.

Significant Intersections with other USAID Activities

ACTIVITY	IMPORTANCE
Credit Access (Includes DCA, Microfinance, and Financial Markets types of activities)	Banks will be very reluctant to lend if contract law enforcement is slow, costly, or unpredictable. This stems from the fact that asset recovery would be substantially impeded in the event of default. An improved Contract Law regime will make lending less expensive, increase financial intermediation, and will result in greater opportunity for programming in the country.
Rule of Law/Democracy	Effective Contract Enforcement inhibits arbitrary actions by economic actors and the government that can undermine the Rule of Law.
Trade & Investment	The ability to enforce contracts is fundamental to enabling arms length, impersonal transactions necessary for engaging in international commerce and competing in global markets.

Pillar III: Company Law

(Including Business Registration and Corporate Governance)

Definition: For purposes of this overview, a set of laws that: (1) sets forth requirements for incorporating a company (i.e., business registration); (2) defines and regulates ownership interests of company shareholders; (3) establishes basic principles or rules of corporate governance; (4) sets limits on the liability of company shareholders; and (5) establishes legal personality for the firm created, providing the legal basis for entering into contracts and accessing to finance.

Linkages to Economic Growth and Transformational Development:

- **Encourages entrepreneurialism.** Easing requirements for business registration, combined with sensible business tax and regulatory policies, encourages economic empowerment. Entrepreneurs frequently have the option of choosing a business structure that shields them from personal liability for the company's debts. Company Law thus plays a critical role in market economies by reducing the personal risk involved with starting a business.
- **Facilitates the creation of small and medium size enterprises (SMEs):** Clear, easily accessible, and not unduly burdensome laws, regulations and procedures for business formation promote formation of firms, particularly on the part of entrepreneurs with fewer resources.
- **Formalizes commercial activities within the economy:** This leads to enhanced tax revenues and greater protection for the workforce.
- **Facilitates access to credit:** A formalized legal status that registration provides facilitates access to finance.
- **Promotes investment: The adoption of good Corporate Governance principles creates stronger investment environments.**

Policy Framework: **Company Law** is a fundamental building block for constructing a viable market economy. This puts company law reform work in the same category as Commercial Dispute Resolution (CDR), Real Property, and Contracts. Most countries already have a company law framework, but such laws may be fragmented, overly complex, outdated or otherwise not up to international best practices. A sound company law framework is a prerequisite for meaningful progress on **SME development** and **Capital Markets** and **Bankruptcy laws**.

Corporate Governance initiatives are more appropriate at later stages of development, particularly in **Transition Economies and High Income States** with a critical mass of joint stock companies. Such initiatives should integrate regional and global standards developed by various institutions. Application of such standards is driven by lenders and investors, so that loan officers and others should be trained in Corporate Governance evaluation to activate financial incentives for reform. The development professional should coordinate with **Democracy and Rule of Law programmers to coordinate Criminal and Civil fraud provisions in Corporate Governance laws (that guard against misallocation and misuse of company resources)**.

Programming Issues: The development professional should consider several programming opportunities when developing a Company Law project. Work on a **Company Registry** (comprising information on registered businesses) can sometimes be beneficially combined with simultaneous development of registries for Real Property, Secured Transactions (i.e., collateral registries for movable and other types of personal

property), and Intellectual Property. Legal areas closely linked to Company Law are **Contract Law**, **Commercial Dispute Resolution**, **Privatization Law**, Competition **Policy**, **Labor Policy** (workforce management, labor standards, pensions), and **Tax Policy**.

Best Practices and Special Concerns:

The World Bank Doing Business Reports (2004-2006) contain a treasure trove of policy recommendations. With respect to business registration, Doing Business recommends:

- Creating a one-stop shop for registering a business, with an automatic approval system (“silent consent”) in order to sharply limit the discretion of government officials;
- Eliminating the involvement of judges and notaries from the registration process;
- Easing filing requirements, including zero or next-to-zero capital base requirements, elimination of newspaper publication requirements, and introducing the use of standardized forms.
- Introduction of temporary business licenses and eliminate the renewal of licenses
- Consolidating the numbers and types of taxes with which business must comply, and keeping company rates moderate.
- Reducing special exemptions and privileges

Significant Intersections with other USAID Activities

ACTIVITY	IMPORTANCE
Rule of Law/Democracy	Registries are usually located in courts or the Ministry of Justice. Regulatory actions to enforce laws in this area require a sophisticated administrative law regime and a robust enforcement and prosecutorial capacity. In addition, it is important to note that formal registry can expose SMEs to higher levels of bribe-seeking activity if such forms of administrative corruption have not already been addressed and if the discretion of registering officials is not limited.
Trade & Investment	Good corporate governance and easy business entry regulations can be beneficial in promoting both foreign and domestic investment.
Gender Issues	Attention should be paid as to whether there are any impediments (due to custom, bias, or formal procedures) that may inhibit women’s freedom to register a business.

Pillar IV: Commercial Dispute Resolution (CDR)

Definition: The process through which courts or other tribunals and services (such as Alternative Dispute Resolution [ADR] mechanisms) resolve commercial disputes, for example those concerning the interpretation and enforcement of contracts, the liquidation or rehabilitation of a business, the settlement of property rights disputes, or general adherence to the commercial law.

Linkages to Economic Growth and Transformational Development:

- **Reduces conflict and violence:** An impartial and accessible judicial system promotes the peaceful settlement of disputes.
- **Promotes faith and confidence in the commercial system:** Vigorous CDR systems to enable a wider variety of business transactions.
- **Enhances commerce:** Knowing in advance that agreements will be enforced in case a party reneges on an agreement will make all parties to a contract more likely to invest in longer-term and more complicated relationships.
- **Fosters legitimacy in governance.**
- **Discourages fraud:** Rapid, predictable and cheap CDR discourages parties from entering contracts they do not believe they can fulfill.

Policy Framework: In terms of sequencing, development, and implementation, **CDR** is a fundamental building block for constructing a viable market economy. Without CDR, marketplace transactions will be limited to sales and barter when parties don't know one another (are not "connected"). CDR is rendered meaningless without certainty of efficient enforcement by court clerks, sheriff, bailiffs, or private enforcement agencies. **Alternate Dispute Resolution** (ADR) can be developed through such mechanisms as arbitration, mediations, and conciliation, but ADR should be viewed as an alternative to courts and not a substitute for them, and must be supported by the court system.

Programming Issues: With respect to **Court Reform**, development professionals should carefully consider the whether they have found cooperative and willing partners in the government to enhance and improve the court system so that it will become an impartial, efficient institution. Projects may contain any of the following kinds of activities in their workplans:

- **Court personnel:** Training in court administration.
- **Enforcement of judgments:** Training of bailiffs, sheriffs, and other collection agents.
- **Case management:** Ensures that cases can be tracked through the court system, enhancing consistency and responsiveness.
- **Receivables Management and Collection:** Widespread use of receivables management and collections creates a culture of accountability and payment, thus avoiding excessive reliance on courts and outside arbiters to resolve delinquencies and disputes.

Best Practices and Special Concerns:

The World Bank Doing Business Reports (2004-2006) identify nine types of reform that have been shown to improve commercial dispute resolution:

- Establishing information systems in the courts;

- Taking transactions that are not disputes, such as business registration, out of the hands of judges;
- Reducing procedural complexity by reducing the amount of time, number of steps, and cost it takes to enforce a judgment;
- Eliminating the requirement for “legal justification” of the complaint, which prevails in Civil Law countries;
- Establishing small-claims courts, which are typically cheaper and quicker to use than regular courts;
- Establishing specialized commercial courts, which generally entail procedural simplification aimed at “mass production”;
- Introducing case management, through which one judge oversees a case from inception through resolution;
- Reducing delays in deciding cases by limiting opportunities to abuse appeals; and
- Providing better incentives for enforcement, often through privatizing the enforcement process.

USAID best practices: Democracy & Governance programs have engaged various other methods toward strengthening the environment for resolving commercial disputes, including:

- Emphasizing prevention of disputes among private actors through better risk-assessment, the use of contracts, and improved collection practices, as well as more private-sector involvement in the legal reform process;
- Promoting judicial professionalism, including judicial ethics, judicial leadership, judicial institution-building, and training;
- Creating and supporting avenues for Alternative Dispute Resolution as a viable alternative to traditional litigation;
- Developing improved and more accessible information resources in commercial law and dispute resolution;
- Privatize or delegate court functions such as repossession, auction, and service of processes; and
- Facilitate public access to court records and rulings, in order to reduce opportunities for corruption.

Significant Intersections with other USAID Activities

ACTIVITY	IMPORTANCE
Credit Access (Includes DCA, Microfinance, and Financial Markets types of activities)	Similar to contract enforcement, effective dispute resolution is critical for increasing financial intermediation. Interest rate spreads will be lowered if the risk and cost of contract enforcement and CDR is lowered. This allows more enterprises to afford loans.
Enterprise Development	Stable, swift, and predictable court enforcement of commercial disputes is essential for stable growth. Small claims courts may enhance access to justice.
Rule of Law/ Democracy	ROL projects are involved heavily in courts and ADR.
Trade & Investment	Stable and predictable court enforcement is crucial for FDI and Trade. Courts enforce WTO concepts like “national treatment” and appeal of executive branch decisions/rulemaking. Trade and Investment liberalization that is not broadly understood or supported by key sectors of society can easily unravel in the event of an economic crisis, like that which occurred in Argentina.
Gender Issues	Courts enforce equal rights provisions and can remedy discriminatory treatment by government and/or private sector.

SECOND TIER LAWS:

A. Bankruptcy Law (Also called “Insolvency Law”)

Definition: Bankruptcy is a system for ensuring the equitable payment of debts when a debtor is no longer able to meet its debt obligations, either by reorganizing the debtor or liquidating the debtor and its assets.

Linkages to Economic Growth and Transformational Development:

- **Forestalls financial sector hemorrhaging:** Bankrupt enterprises usually owe large debts to numerous creditors—including banking institutions and the government treasury—that increase with time, and can rob both viable private sector firms and the public sector of scarce capital.
- **Protects Debtors:** Bankruptcy protection permits debtors to meet or relieve their own debt burdens should they become overextended. Thus, Bankruptcy may afford a safety net to debtors who cannot recover by enabling them to begin anew, promoting entrepreneurship
- **Protects Creditors:** Bankruptcy provides certainty of assistance in collecting debts from troubled debtors. This is especially true for small and medium sized enterprises and for foreign investment.
- **Puts assets back into productive economic use:** Bankruptcy Law imposes the discipline of restructuring if an enterprise is potentially commercially viable. Regarding liquidation, this is done typically only when an enterprise has no market value as a going concern. Liquidation can be economically beneficial, as sale and redistribution will place assets into productive use, rather than leaving them under-utilized or unused.
- **Debt restructuring:** Bankruptcy law can provide for a fair, orderly disposition of debts. If a troubled company begins to pay insiders or hide or dispose of assets, bankruptcy can provide a process for recovering diverted assets for the benefit of the company’s other creditors.
- **Increases access to finance:** By segregating pledged assets from the general pool of assets available to satisfy claims, Bankruptcy Law lowers the risk of loss to secured lenders and increases lending for asset based finance. By providing a clear ranking of unsecured claimants, clarifies relative credit risk, lowering “uncertainty” or worst case premiums. As Bankruptcy law lowers the risk of non-payment, lenders are more willing to provide reasonable access to capital at affordable rates.
- **Reduces conflicts:** By forcing creditors to collaborate within a court supervised framework, prevents “spoilers”, reduces conflict and speeds agreement on equitable resolution.
- **Competitiveness:** Competitiveness declines if a country’s private sector is littered with an excess of bankrupt, but still operating, firms. Profitable firms often find it difficult to compete with bankrupt firms because of the inherent subsidy that failure to pay obligations can provide to a bankrupt firm that is allowed to continue to operate. In addition, lenders and other creditors operate more efficiently because disputes between competing creditors are more transparently resolved.

Policy Framework: In terms of sequencing, development, and implementation, a sound Bankruptcy Law can only work when a well-functioning **Court System** is in place. Bankruptcy law reforms should be made compatible with the legal regimes for **Secured Transactions, Mortgage, Company Law & Corporate Governance, Contract Law and Commercial Dispute Resolution.**

Programming Issues: The development professional should consider several programming opportunities when developing a Bankruptcy Law project, such as:

- creation of specialized courts,
- training of judicial experts, trustees, auditors, assessors (or valuation experts), and the legal profession;
- Review of liability of Directors and Officers (Corporate Governance)
- Review of Secured Transactions priorities, especially with respect to the rights of secured creditors.
- Enhancement of enforcement capacity

Best Practices and Special Concerns:

The World Bank Doing Business Reports (2004-2006) find that good bankruptcy regimes have the following features:

- Allowance for continuous operation of viable business;
- Simplify liquidation procedures and provide for efficient summary proceedings;
- Involve stakeholders in the insolvency process, including establish creditors’ committees;
- Include judicial training in commercial litigation matters;
- Put in place an improved foreclosure process; and
- Pay bankruptcy administrators on the outcome of bankruptcy based on market proceeds.

Recovering States and **Transition States** are typically littered with the hollowed out shells of firms that were once productive. Many of these firms were looted by directors and officers who used gaps in corporate governance and fraud regimes to appropriate corporate assets for personal benefit. Bankruptcy law reform may be able to accomplish a normalization of industrial assets and intellectual capital so that assets may be put back into productive use.

Special Concerns: Bankruptcy is sometimes misunderstood as a system that will remove or reduce the political consequences of firing thousands of workers. Bankruptcy judges may create tremendous delays in the process to avoid popular blame for the terminations, eventually clogging the entire legal system.

Significant Intersections with other USAID Activities

ACTIVITY	IMPORTANCE
Agriculture	A creditor’s ability to take possession of the land of a defaulted borrower is an important determinant of the quantity of credit available to the sector.
Credit Access (Includes DCA, Microfinance, and Financial Markets types of activities)	DCA: A sound bankruptcy regime will make credit extension less costly by ensuring higher debt/payback recovery rates. This will reduce interest rate spreads because lenders will have greater assurance of collecting from an insolvent borrower. Lower rates increase the number of borrowers who can afford loans and this creates additional investment opportunities. Bankruptcy law is much more relevant for loans to large corporations than loans to the medium size enterprises, which are the typical borrowers under DCA-backed loans.
Enterprise Development	Bankruptcy Law can also encourage risk taking on the part of entrepreneurs by allowing them to limit their personal liability in the event that a business fails.
Labor	Bankrupt enterprises frequently can not, or do not, honor commitments, nor pay salaries, to their workers.
Rule of Law/ Democracy	Coordination with ROL activities is warranted. Labor programs in the country may be relevant. Ongoing donor activities with bar associations, law faculties, and judicial training institutes under ROL programs should be taken into consideration.
Gender Issues	Bankruptcy law may help to define/create deeper financial markets and insurance markets for the poor, and particularly for poor women.

B. Competition Law and Policy

Definition: A legal and regulatory framework that prevents businesses from unreasonably limiting the quality, quantity, and price of goods or services available in the marketplace and seeks to limit anticompetitive government regulation of the marketplace.

At its most basic level, Competition Law prohibits conduct by a single firm that maintains or enhances its market power. In addition, many competition laws prohibit mergers or acquisitions that would substantially lessen competition or create a monopoly. Competition law enforcement attacks price-fixing or market-division cartels and other anticompetitive conduct by dominant firms to maintain or increase their market power and to exclude new competition as well as restricts mergers that may lead to dominance or collusion.

Linkages to Economic Growth and Transformational Development:

- **Enhances competition:** Conduct that undermines competition among businesses stifles innovation, decreases growth in productivity and efficiency, and hurts consumers through less choice or higher prices.
- **Gives capitalism a good name:** Competition laws, when properly applied, help to ensure that the benefits that flow from applying market economy principles are not thwarted by incumbent monopolies or cartels.
- **Broader participation in the economy:** Effective competition policies open participation in entrepreneurial activities to segments of society that have been historically excluded.
- **Competitiveness:** Vigorous domestic competition leads to greater competitiveness internationally. Conversely, where domestic competition is artificially limited, domestic firms are less likely to develop the competitive edge that will enable them to compete in the global market place.
- **Encourages innovation: Competition policy allows for a greater availability of improvements in infrastructure industries such as telecommunications and energy.**

Policy Framework: In order for there to be an effective Competition Policy, there must be a strong, powerful administrative authority capable of taking on politically powerful firms and advocating within the government on behalf of policies favoring free competition over regulation. Strong systems of **Commercial Dispute Resolution** and the existence of political support for open competition are also needed. Hence, Competition policy projects are more appropriate in **Middle Income Countries**; i.e., countries with a transformational development agenda. Competition Policy is closely linked with **Consumer Protection, Company Law** (affects potential entry of competition), and Bankruptcy Law (affects exit of competitors).

Programming Issues: Development professionals should carefully consider the political and policy environment when considering implementing a Competition Policy. Too rapid a relaxation of local industry protections may produce substantial job losses from competition without reallocation of human resources to other productive sectors, increasing long-term unemployment burdens that may partially offset gains from price reductions. Well-intentioned regulations by government agencies can unintentionally undercut broader government policy favoring competition

Best Practices and Special Concerns:

A general global consensus is emerging over the necessary components of a classic Competition Law which is best suited to support a developing country's emergence into the world economy. **The U.S. Federal Trade Commission** and the **U.S. Department of Justice, Antitrust Division**, have assisted dozens of developing

countries around the world in implementing a Competition policy. FTC and DOJ frequently consult with country counterparts and USAID missions concerning development. FTC and DOJ services may be accessed through a Participating Agency Partnership Agreement.

Projects should not be initiated in **Fragile States**, which typically do not have enough resources to support the effective development and administration of competition policy. Rather, building capacity through new criminal laws regarding fraud and coercion may be more appropriate, as well as adopting other pro-competition strategies.

Since 1990, **Transition Economies** (transitioning from planned to free markets) find it difficult to distinguish between legitimate hard-fought competitive behavior and behavior that undermines the competitive process as a whole. Old habits favoring intervention in the market by government regulators can unintentionally undercut broader new government policies favoring competition. In addition, former state-owned firms, recently privatized, often enjoy cozy relationships with government regulators. The Ukrainian and Russian experiences show that states often protect bankrupt enterprises to avoid social disturbances

Trade Capacity Building: Free Trade Agreements, such as the Central American Free Trade Agreement, frequently require competition policy reviews and infrastructure.

Significant Intersections with other USAID Activities

ACTIVITY	IMPORTANCE
Agriculture	Monopsonies in the purchase of agricultural produce, either officially sanctioned or unofficially tolerated, can be extremely prejudicial to agricultural producers and the development of the sector as a whole.
Credit Access	A good competition law will increase the number of potential borrowers.
Enterprise Development	Competition law can remove barriers to firms that wish to enter markets that have been traditionally characterized by monopolistic or oligopolistic structures.
Rule of Law/Democracy	Intersection with criminal law means courts and prosecutors need to have capacity to adjudicate and enforce these laws. Corruption and collusion are factors in the ability of the state to play a 'referee' role
Trade & Investment	Competition policy can remove privately imposed barriers to trade that complement trade agreements' removal of public barriers to trade. It can also influence removal of public barriers imposed by governments at the behest of favored competitors.
Gender Issues	May potentially reduce market failure that affects women sellers in global value chains.

C. Foreign Direct Investment (FDI)

Definition: A system of laws, regulations, and institutions that regulates the treatment of direct investment from outside the country.

Linkages to Economic Growth and Transformational Development:

- **Makes investments safer for foreigners:** An FDI regime assures foreign investors that their investments will be safeguarded and provides further assurances in case conflicts arise. International trade agreements, like those of the WTO, typically call for National Treatment, so that foreign investors are equally well as domestic investors.
- **Transformative development:** Research findings by USAID indicate that FDI is catalytic in that it brings new technologies, institutions, and organizational models to developing countries.

Policy Framework: FDI can best be understood as a device which explicitly seeks to reassure foreign investors as to the safety of their investments in a particular country. Hence, advanced high-income countries have less need for a separate FDI law than recovering, low-income, and transition countries. Typical FDI frameworks contain provisions for the following items:

- Protection of property and investments from government expropriation;
- Reduction or elimination of any burdensome or discriminatory licenses, permits, approvals for foreign investors; and
- Hastened procedures for dispute resolution.

A country should have a basic framework for **Contract Law** and for **Commercial Dispute Resolution**. Even when the law does work well, local political reality may act as a barrier to FDI without further guarantees, such as an agreement with **Overseas Private Investment Corporation (OPIC)**. In countries with a chaotic legal environment (like recovering states), an FDI law can help foreigners sort out legal tangles and uncertainties.

Programming Issues: An excessive emphasis on foreigner rights without concomitant protection of local investors can increase social tensions and local resentment against foreign ownership. Failure to address the general investment climate through solely focusing on FDI can short-circuit the crucial growth and development provided by domestic investment. In addition, many countries have used tax holidays to entice foreign investment – but this may be counter-productive if investors believe that a subsequent entrant may get a better deal.

Best Practices and Special Concerns:

The World Bank Doing Business Reports (2004-2006) recommend the following ways to improve the protection of foreign and domestic investors in firms incorporated in a particular country.

- notifying investors of directors' interests in business deals;
- requiring approval by disinterested directors or investors for related party transactions;
- eliminating loopholes in rules requiring shareholder approval; and
- helping investors bring lawsuits (where courts are strong).

EGAT best practice includes **coalition building**. FDI concerns are often best presented by actual investors through bi-lateral chambers of commerce and investor associations that more fully understand actual investment constraints.

A coalition in support of FDI should include allies from inside and outside the official institutions of the government, such as politicians, executive branch officials, business and civic leaders, professional associations, universities, and others. Donors can establish and support coalitions through the advent and facilitation of new institutions such as national competitiveness councils, commercial law roundtables, and public information campaigns.

FDI is a **Global Issue**, as particular country regimes may be shaped by multilateral trade agreements (i.e., of the **World Trade Organization**) and bilateral agreements (e.g., between the United States and the counterpart country through Bilateral Investment Treaties (BITs) and Trade and Investment Framework Agreements [TIFAs]).

Significant Intersections with other USAID Activities

ACTIVITY	IMPORTANCE
Enterprise Development	Foreign Direct Investment has a catalytic effect, particularly for human resource development and the introduction of new technologies to a developing economy.
Labor	Provides job opportunities, training, can eventually enhance labor bargaining power, and often begins to bring local labor standards closer to the international norm.
Rule of Law/Democracy	De facto 'treatment' of foreign investors is carried out by government officials and courts, and the extent to which they are governed by laws is critical to the foreign investor. Judges are often complicit in stripping foreign investors of their assets. On the other hand, there are cases where foreign direct investors gain inordinate privileges if they are well-connected to local officials or they are seen as crucial to the national economy by the government.
Gender Issues	FDI may encourage the development of industries and sectors that are female intensive. The terms and conditions of employment in these sectors is of particularly special concern.

D. International Trade Law

Definition: A system that governs the cross-border sale of goods and services.

Linkages to Economic Growth and Transformational Development:

- **Reduces poverty by stimulates economic growth:** World Bank research¹ demonstrates that countries that liberalize their trade regimes grow faster than those that do not.
- **Makes an economy more productive and competitive by allowing specialization:** Trade Law reform generally involves accession to and compliance with trade agreements which serve to reduce tariffs, remove trade barriers, and consolidate markets. This liberalization exposes domestic firms to international price signals, pressuring them to find ways of enhancing productivity and to finding new markets abroad.
- **Levels the playing field:** Membership in international trade agreements is based on the principles of non-discrimination – the Most Favored Nation (MFN) principle provides that a member’s lowest tariff rate must be extended to all members of a trade pact, and the principle of National Treatment requires a commitment to treat foreign goods, once they have lawfully entered a country, no differently from goods produced domestically.

Policy Framework: Trade is regulated by international trade bodies, like the **World Trade Organization** (WTO) and through regional frameworks, like CAFTA, ASEAN, and CARICOM. **Trade capacity building** (TCB) can be categorized as a **global, strategic, transnational issue**. TCB can have direct bearing on a country’s willingness and ability to enter into bilateral and multilateral trade liberalization negotiations.

USAID’s **Strategy for Building Trade Capacity in the Developing World** sets forth the Agency’s position on the relationship between trade and development; the conceptual framework for engagement in TCB; and the plan for increasing the capacity to deliver more – and more effective – TCB assistance. The Strategy aims to promote tangible improvements in the effectiveness of developing countries’ commercial laws and institutions, and, over time, improvements in the quantity and quality of individual developing country’s exports, imports, and foreign investment.

Programming Issues: The development professional should address the following in any International Trade Law reform activity:

- **Customs law**, particularly with respect to the compatibility with regional and international standards;
- **Commercial Dispute Resolution** and the capability of the court system to competently decide trade disputes;
- Corruption and Transparency through **Administrative Law** reform;
- Development of **Public-Private Dialogues** (through so-called “Pro” Committees); and
- Harmonization with agreements on **Intellectual Property Rights, Product Standards, and Food Safety issues**.

Best Practices and Special Concerns:

The Doing Business Report (2006) proposes several regulatory and transport solutions to international trade barriers on goods, including electronic filings of customs clearance and trade documentation, Customs agencies using a risk assessment policy for inspections, and promoting harmonized regional customs reforms and transport rules.

Note on Microeconomic Reform: The impetus behind the World Bank’s Doing Business Reports was to discern why many countries which conducted macroeconomic liberalization policies, including trade liberalization, failed to register any improvement in economic growth. The conclusion, buttressed by the findings of the Bank, is that macroeconomic liberalization will fail unless countries also liberalize their domestic legal and regulatory regimes (which have come to be defined as “**Microeconomic Reform**”). Microeconomic reform appears to be a necessary step in enabling domestic businesses to respond to opportunities in the global marketplace

Fragile states often suffer from a fundamental lack of “supply-side competitiveness”, i.e., an absence of basic infrastructure, little if any agricultural surplus, and a weak to nonexistent manufacturing base, and limited human capital. For these countries, such conditions must be tackled as a prerequisite for achieving the benefits of trade in the long run.

In **Transition economies** the central challenge is to remove or reduce trade restraints, such as unnecessary regulations, inadequate legal structures, security problems, regional inconsistencies in law and practice, poor technology, and corruption.

Significant Intersections with other USAID Activities

ACTIVITY	IMPORTANCE
Agriculture	Market liberalization resulting from bilateral, regional, and multilateral trade agreements offer new opportunities for export for economies with internationally competitive agricultural sectors. It can also cause significant economic and social displacement if non-competitive sectors are suddenly exposed to international competition without sufficient preparation or plans to assist displaced workers.
Credit Access (Includes DCA, Microfinance, and Financial Markets types of activities)	A good international trade regime can increase the number of commercially viable enterprises, thereby creating additional borrowers. More good businesses lead to more financial intermediation and opportunity for commercial lending.
Enterprise Development	Access to foreign markets can spur the creation of enterprises by enhancing the potential size of the market for a product or service. Such access can also increase the productivity of enterprises through access to foreign technology and inputs. Such access often increases quality and reduces costs in the domestic market and may make it possible to compete internationally in sectors here-to-fore out of reach.
Labor	Significant dislocation can occur in protected industries and in their base of domestic suppliers. Measures to ameliorate the shock of foreign competition (such as worker retraining and relocation) should be considered if significant domestic backlash can be expected.
Rule of Law/ Democracy	WTO agreements mandate transparency in rule-making and decision making. These are reforms typically conducted through Administrative Law reform, in which the DCHA Bureau has particular expertise.
Trade & Investment	A sound International Trade Law regime decreases the costs and uncertainty of importing goods for final sale. It also facilitates intra-company trade, thereby encouraging local investments for both the domestic and international market.
Gender Issues	Although trade openness is recognized as a contributor to economic growth, recent studies have also demonstrated that trade openness may need to be augmented by complementary policies and programs in order to ensure that the benefits of freer trade reach the poor, particularly traditionally excluded social groups and women. The timing and sequencing of reforms are important considerations as are the implementation of alternative livelihood strategies for workers displaced by trade-induced changes, social safety nets, and workforce retraining and skills development

E. Secured Transactions Law (Also known as “Collateral Law” or “Law on Pledges”)

Definition: A system that taps the asset value of personal property, thereby facilitating commercial lending. Under secured transaction regimes, debtors use their property as collateral to secure loans, thereby granting creditors a “security interest” in the property – that is, a right to seize and sell the property in case of default by the debtor.

Linkages to Economic Growth and Transformational Development:

- **Facilitates access to credit:** Sound systems of Secured Transactions make it easier for individuals and companies to obtain credit and on better terms.
- **Protects creditors:** Secured Transactions Law reduces the risk of loss as a result of default by the debtor by allowing creditors to have recourse to the property secured. This “second way out” enables lenders to justify lower risk premiums, less restrictive credit terms, and expanded lending.
- **Benefits debtors:** The ability to use personal property as collateral for a non-possessory loan allows individuals and companies who may not own real property, or who otherwise lack meaningful access to credit, to obtain credit on preferential terms.

Policy Framework: In terms of sequencing, development, and implementation, development professionals should consider **coordinated registry development**. Development of a Collateral Registry should take place with clear understanding of how a country’s other registries – such as Real Property, Securities, and Patent registries – are organized and function. Many donor bodies prefer to create “all-in-one” registry regimes. However, if a country’s land or real property registry is problematic, it should not be allowed to slow down the development of other pledge registries.

Secured Transactions law should be closely coordinated with **Bankruptcy Law**. Conflicting priority schemes in bankruptcy and enforcement laws can eviscerate secured transaction laws. Bankruptcy and Secured Transactions should be approached as two parts of the same system. In addition, care should be taken to make changes, if necessary, to the **Contract Law regime**.

Implementing and supporting institutions will require capacity building. Not to be overlooked are Judges and the court system, the training and development of support professions, like Assessors/Valuation Experts, and Repossession Agents, and the development of institutions like Credit Information Bureaus and Collection Agencies.

Best Practices and Special Concerns:

The World Bank Doing Business Reports (2004-2006) find that effective secured transactions laws eliminate legal obstacles to sharing credit information, focus public registries on supervision, give secured creditors priority to collateral, and introduce summary enforcement proceedings. Collateral registries should be cheap, efficient, and require a “notice-only” filing system. Specific recommendations concerning the secured transactions legal regime follow:

- Information sharing among private credit bureaus should be encouraged—with positive as well as negative information being shared;
- The law should define the specific and complementary roles of public registries and private credit bureaus;

- Courts should be made more efficient to enforce the rights of creditors, especially unsecured lenders;
- Expanding the providers of credit data to include trade creditors, retailers and utilities increases the power to predict default and expands credit;
- Creation of a universal security instrument covering all assets and debt, so that potential borrowers with any kind of collateral will no longer miss out on loans.

In **Recovering** and **Post-conflict States**, the ability to repay debts and the authority of courts to enforce contracts and security agreements will likely be reduced following major cataclysms like war, civil conflict, and natural disaster. Governments and donor organizations will be challenged in such circumstances as to how to get the local economy “moving” again, in spite of major economic dislocations.

Significant Intersections with other USAID Activities

ACTIVITY	IMPORTANCE
Credit Access (Includes DCA, Microfinance, and Financial Markets types of activities)	<p>DCA: Weak or nonexistent secured transactions regimes are an impediment to financial intermediation. DCA activities have primarily focused on Micro-, Small-, and Medium-size enterprises for which real property is a more relevant form of collateral than inventory, receivables or movable property. Therefore, secured transactions law is important for increasing financial intermediation and DCA opportunities, it is less important than contract enforcement and real property law and mortgage law.</p> <p>Microfinance: Activities typically uses unsecured loans.</p>
Rule of Law/Democracy	Registry functions often reside within the court system so coordination with ROL programs is warranted. Efforts to remove these functions from courts are usually resisted.
Trade & Investment	Trade is frequently financed through merchandise and inventories secured as collateral.
Gender Issues	Facilitates credit to entrepreneurs including women. Where women have secure property rights to assets that they can use as collateral, care needs to be taken to ensure an appropriate risk assessment is undertaken. Women, and particularly poor women (and men), may not be able to use certain types of property as collateral if the risk of loss or business failure is too high.

(Footnotes)

¹ David Dollar and Aart Kraay, Trade, Growth, and Poverty, Finance and Development (September 2001), available at <http://www.worldbank.org/research/growth/pdffiles/Trade5.pdf>.

