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LAW, LEGAL INSTITUTIONS, AND DEVELOPMENT: LESSONS OF THE 1990S FOR PROPERTY RIGHTS, SECURED TRANSACTIONS, BUSINESS REGISTRATION, AND CONTRACT ENFORCEMENT

By Heywood W. Fleisig and Nuria de la Peña

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All views, interpretations, recommendations, and conclusions expressed in this paper are those of the authors and not necessarily those of the Center for the Economic Analysis of Law or of the World Bank, its executive directors, or the countries they represent.

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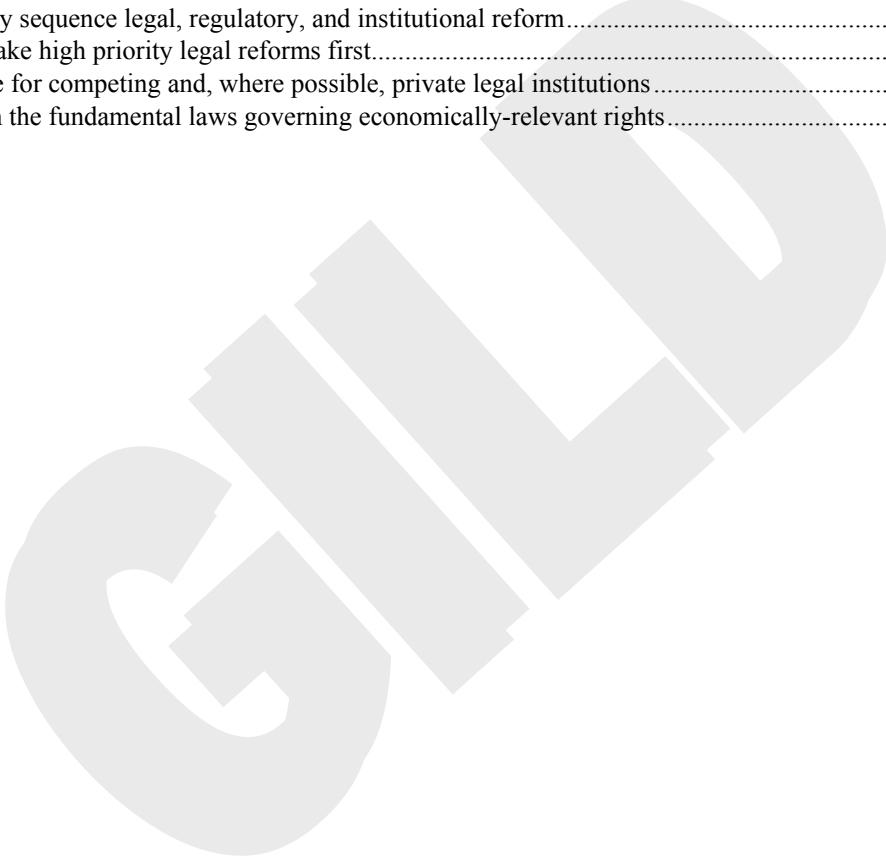
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I. Introduction and Background

In every country, markets rest partly on a foundation of law and partly on a non-legal foundation of extra-legal and, sometimes, illegal, customs and usage. These legal and non-legal foundations directly affect the operation of rural financial institutions. They also affect the status of other economic agents - individuals, farmers, and businesses. Sometimes these are clients of financial institutions, sometimes in the key case of non-bank financial intermediaries they are competitors, and sometimes they are both.

Non-legal institutions can work well. One fertilizer dealer in Bangladesh sold fertilizer on credit to about one thousand farmers for a total amount of credit of \$200,000 to \$500,000. This entire portfolio was backed by a handshake and the knowledge of farmers that if they didn't pay, they would never again get credit from the dealer or from his few competitors. Nor did this dealer look to the legal system for backup. When pressed on whether he would take a (hypothetical) non-paying client to court, he replied, "What? I have enough trouble. He didn't pay me. Why would I go to court?"¹

However, non-legal institutions work better when they have the backing of an effective legal system. The successful fertilizer dealer himself had no access to credit, because his enormous portfolio of loans with nearly a 100% repayment rate could not serve as collateral for a loan under Bangladesh law. Even if this portfolio could, he himself, as an individual proprietor, could not use Bangladesh's secured transactions system, which was limited to corporations (the "company charge"). Nor could he expand territory easily because for clients he did not know personally he could not take their future crop as collateral for a loan. He could, in principle, take a mortgage on their land but in most cases they were renting or did not have proper title. However, even where they had proper title, the high costs mandated under the mortgage law made such small properties worthless as collateral. These same barriers to expansion, however, prevented competing fertilizer dealers from entering his market. Therefore, he had market power over both the implicit interest rate on his loans and the price charged for fertilizer. The result? Narrow, fragmented, and uncompetitive markets. The cause? Definition and implementation of a system of legal rights not suited to competitive markets and the provision of finance –key elements in economic growth.

Non-legal solutions have power in local situations where personal relationships can replace formal law and enforcement. Their weakness lies in their collapse outside that local orbit. These geographic and associational limits on non-legal solutions undermine the central function of the financial market - bringing those with savings together with those with the best investments. Those with the best investments may not always be the saver's neighbors, relatives, or members of the same religious sect, caste, or tribe.

This paper discusses analogous legal problems in several areas that affect markets: - bank, non-bank, and non-financial lenders; their clients; business operators seeking to enforce contracts. The paper first discusses the legal framework for property rights, first, those dealing with ownership, and use of property. The issues include land rights, land titling, cadasters, and access to credit. Then it follows with property rights dealing with security interests. These

¹ Bangladesh: Creating a Legal and Regulatory Framework to Promote Access to Credit in Agriculture, by Heywood W. Fleisig, CEAL processed, May 1996.

include secured transactions, which govern taking collateral, covering laws of mortgage, pledge, and, for common law countries, the charge and hire purchase. Then it turns to contract enforcement, entry and exist of institutions from financial markets. Following specific lessons listed in separate discussions, it concludes with a discussion of the lessons of the 1990s.

Time and resources did not permit a review of all relevant areas. For some key omissions, we have briefly noted the importance of the issue and noted specifically that the paper will not treat it further. The overarching lesson of the 1990s? Law has a broad and deep bearing on development but it is a vast area and it is easy to miss the target entirely.

II. Property Rights in Real Estate

Property rights issues in developing countries can be divided into two main groups that match the main economic issues. The first deals with the rights concerning the ownership, use and disposition of property. The applicable laws can differ substantially with the type of property. The main groups include laws that relate to real estate property, personal property (typically fixtures, movables and intangibles), and intellectual property.² Of these property rights, this section will focus on property rights in real estate.

The second main group of property rights comprises security interests in property. These property rights permit taking property (including property in which others have ownership rights) and selling it to pay an obligation, such as a loan. We discuss security interests issues for all real and personal property in the next chapter.

- **Property Rights that deal with the ownership, use and disposition of property**
 - Real estate (e.g., land law)
 - Personal Property (e.g., laws on possession, warehouse bailment, seizure, Intellectual Property)
- **Property Rights that deal with security interests in property (see section II)**
 - Against Real Estate (e.g., mortgage laws, financial trust laws)
 - Against Personal Property (e.g., pledge laws, chattel mortgage laws, sales with retention or reversion of title law, financial leasing law, security interests in personal property laws)

In a developed country, real estate represents about two-thirds of the country's tangible capital stock. About half of this real estate is residential; about half is industrial and commercial property.³ Clearly, defining rights to this wealth is fundamental. The Bank has focused on fee simple title. That focus ignores most of the richness of rights to real estate. Similarly, simply transposing industrial country institutions to create and monitor land rights in developing countries has a high failure rate. Rarely will such institutions address the economically essential elements of these rights in a way that conforms to the constraints of each developing country's institutional framework.

Functioning markets require clear definition of legal rights to the use of land -- particularly for the exchange of land rights and their use as collateral. . Despite their popularity in World Bank projects, land titling and cadasters are neither necessary nor sufficient conditions for using land rights as collateral and, thereby, improving access to credit. Success depends,

² This paper will discuss rights in real estate property but not rights in personal or intellectual property.

³ These figures represent only tangible capital. Including intangible capital would raise them.

rather, on clearly defined land rights and a system for secured transactions that can use those rights that the law defines.⁴

Property rights in real estate can involve many institutions: a title registry, a real estate registry, a cadaster, a system of taxation, a framework for eviction, and institutions that monitor the use of land rights for natural resources or energy.

A. Different Property Rights and Interests in Real Estate

Some commonly-known property rights in real estate include:

Fee Simple, a freehold state of virtually infinite duration and of absolute inheritance, free of any condition, limitations, or restriction to particular heirs. Also called fee simple absolute.⁵

In common law countries, ownership of real property may be limited by future interests (e.g., fee simple conditional, fee simple defeasible, fee simple determinable).

Fee tail, not possible under Civil Law, is a conveyance created by a deed or will to a person “and the heirs of his body.” A fee tail establishes a fixed line of inheritable succession and cuts off the regular succession of heirs at law.⁶ It is a limited state in that inheritance is through lineal descent only, which, if exclusively through males, is called fee tail male, while exclusively through females is called fee tail female. If the family line runs out (failure of issue) the fee reverts to the grantor or his successors in interest.⁷

In common law, other interests in property ownership exist in the form of easements. An easement is a right created by an express or an implied agreement, of one owner of land, to make lawful and beneficial use of the land of another. It is an inchoate privilege and therefore not a fee or a state.⁸ Easement appurtenant is one that requires a dominant state to which the benefits of the easement attaches or appertains. Passes with the dominant state to all subsequent grantees and it is inheritable. Other types of easement include easement by prescription, easement in gross, easement of necessity, equitable easement, implied easement, affirmative easement, negative easement, public easement, reciprocal easement. Civil Code countries also permit similar rights to use land.

In most countries, the property law also provides for rights of way, and long-term leases (or usufructs in Civil Code countries).

In addition, interests in land may be held indirectly as when land is held by cooperatives,

⁴ The best work on land titling recognizes this distinction. Unfortunately, these points have not shown up in the projects reviewed for this paper. For examples reflecting this understanding see Klaus Deininger, “A World Bank Policy Research Report Land Policies For Growth And Poverty Reduction,” (Washington, DC: The World Bank, 2003 and David Palmer and John McLaughlin, “Land Registration and Development”, ITC Journal, May 5, 1996. For an interesting discussion of the completeness of land rights and of the ability to use property as collateral, see Karla Hoff and Andrew Lyon, “The Optimal Sequencing of Land and Credit Market Reforms in Developing Countries: A Theoretical Perspective”, IRIS working paper 39, (College Park Maryland: IRIS, January 1993). Hoff and Lyon note that the inconsistency between the land rights and the system for taking collateral may be so great that it is more economically efficient to use other forms of collateral. We agree with this finding. This paper is concerned with the feasibility of improving property rights to real estate and to collateral to reduce this disparity and better permit land to serve as collateral.

⁵ 78 P. 2d 905, 907, 908, Law Dictionary, Barrons, at p. 149.

⁶ 243 P. 2d 1030.

⁷ Idem, at p. 149.

⁸ Idem above, at p. 149.

corporations and associations that, in turn, have with long-term contracts for land-use rights with the members or shareholders. There is also property conveyed with different state deeds conveying different rights.

Finally, there are future rights in these land rights, such as when the elements for claiming land ownership are known and will accrue in the future. The laws of Civil Code countries often limit future property rights, so that, for example, future property may not be transferred or mortgaged as collateral for loans.

Even this list is not exhaustive. Therefore, the fee simple ownership of titled land is not the only possible interest in land, or the even, necessarily, the most important land right.

B. Title to Real Estate

In general, a real estate “title” refers to the legal document that creates a property right, such as the conveyance document. When the government transfers land to private ownership, a titling system may additionally refer to a state certification of that ownership right. Many countries use titling. However, most legal systems define different rights in property, including ownership, without necessarily referring to a title. For example, in Vanuatu, Papua New Guinea Samoa, Bolivia and France occupants can demonstrate that they “own” real estate without having a title document.

The more land rights that the law covers, the more these rights can be traded and used as collateral for loans. Advanced economies have most of these types of ownership arrangements. For example, the United States is popularly seen as the heartland of “fee-simple” titled ownership. However, more than 25% of the land in the United States belongs to the federal government -- closer to 50% in the state of California, the third largest economy in the world. Farmers, miners, and businesses use this land under a wide variety of leases and use rights granted by agreements with the Federal government. Much of the land under Wall Street is owned by religious and non-profit institutions. They rent that land to the commercial entities that erect buildings and, in turn, rent them to those who occupy it. Large blocks of US land under the control of Native Americans are administered under traditional systems.

Land is leased all over the world. Much of the land in the city of London is owned by the British royal family, which, like South Pacific customary tribes, does not alienate its land; the entire city of Hong Kong was built on land leased from the government of China. The “owners” of rights to this land may not alienate it because it is their policy; or they may not alienate it because the terms under which they inherited or otherwise obtained the land prevent them from alienating it. Nonetheless, well-developed legal systems permit an active market in land rights and such land rights routinely serve as collateral.

In the next chapter, when we examine the laws that govern taking real estate as collateral, it is of great importance to remember that many other important property rights in real estate exist beside a present, fee simple absolute (e.g., long-term leases, future rights, use rights). The laws on secured transactions of many countries, however, do not permit other property rights serve as collateral.

C. Elements of Property Rights in Real Estate

A recent authoritative review of land issues stated that “the way in which land rights are defined, households and entrepreneurs can obtain ownership or possession of it, and conflicts pertaining to it are resolved through formal or informal means will have far-reaching social and

economic effects. The implications not only influence the structure of governance at the local level, but also affect (a) households' ability to produce for their subsistence and to generate a marketable surplus, (b) their social and economic status and often their collective identity, (c) their incentive to invest and to use land in a sustainable manner, and (d) their ability to self-insure and/or to access financial markets." ("A World Bank Policy Research Report Land Policies For Growth And Poverty Reduction," By Klaus Deininger, The World Bank, 2003).

What remains in advancing this economic research, is a clear understanding of the legal provisions that define these land rights and create secure tenure; and, as is discussed in the next section, of the legal provisions that support the use of real estate rights as collateral.

Four elements underpin every property right: creation, priority, publicity, and enforcement. Each element contains, in turn, difficult issues that affect the economic value of property rights.

- **Creation:**

The law must define and create property rights and must permit clear and low costs methods and procedures for transferring land between parties and at death.

Key issues: How can legal provisions set out a clear definition and scope of different property rights? What legal provisions determine the transactions costs for transferring land during the life of the owner and at the owner's death? What legal features could lower the costs of these transfers? How can legal provisions give greater security to low-cost natural description of land boundaries?

- **Priority:**

The law must set logical and clear priorities among the different property rights and must set a time of publicity from which a right will prevail against other claimants to the same property.

Key Issues: How can the law clearly set out the ranking of priority of claims in real estate? Why is important that the law based priority from the time of publicity? How it should do so? How can legal provisions automatically "clean up" imperfect land rights?

- **Publicity:**

The law must provide a practical, effective and sustainable system for publicizing these land rights

Key Issues: What legal provisions set out the institutional framework for making public the interests in real estate by filing in the real estate registry? What best possible laws are necessary to lower the costs and increase security in the filing system? What legal provisions can improve the institutional performance of the registry by setting up private and competitively run registries?

- **Enforcement:**

The law must set out a workable system for enforcing these rights, including enforcement by using force to evict unlawful occupants.

Key issues: What legal provisions are possible to set up expedited and low costs systems for resolving disputes and use force to enforce them? What options exist to privatize enforcement?

Without a clear analysis of these legal issues, misdirection abounds. For example, the above-cited World Bank report states

"An indicator of limited credibility of leases is that even where there is strong, effective demand for credit, financial institutions will not accept long-term leases as collateral."

However, this problems has a clear legal root in many countries: Most French Civil Code countries in Latin America, including Argentina, Bolivia, Nicaragua and Guatemala, contain a provision in the mortgage law that specifically prohibits the use of a lease or an usufruct right

(long term lease) as collateral for a loan.

A lease does not lack credibility as a land tenure device. Rather, it lacks credibility as a security device. In these countries, rational lenders do not accept leases as collateral because it is illegal to do so. Because using a lease as collateral lacks the sanction of law, lenders cannot use the state and judiciary to enforce collection. Nor, under those circumstances, can banks describe a loan so secured as "well-secured" to a competent bank examiner. In the laws of these countries, only presently accrued fee simple absolute property rights can serve as the objects of security under a mortgage. Not even future titles can serve as collateral. When such a legal feature produces an unsatisfactory economic outcome, reformers must change the law, not the belief system of lenders.

World Bank projects in the 1990s mainly focused on titling land and, later, registering titles in the real estate registry. In terms of the foregoing schema, that means projects focused on aspects of creation and publicity. Projects typically did not address the legal problems in priority conflicts and in enforcement.

Moreover, the projects only partially addressed problems in creation. Many problems exist in establishing formal property rights in real estate. The Bank projects focused on the state issuance of titles -- a state creation of private property rights -- but neglected others. For example, they ignored expensive legal requirements for transferring land by sale or inheritance.

Finally, the projects only partially addressed the problem of publicity. The projects supported real estate registries. However, they ignored changing the laws that govern registries, so antiquated registration rules and inefficient state and monopolistic registries remained unchanged.

This chapter discusses these four elements of property rights in real estate.

D. Creation: Defining Clear Interests In Real Estate

Most legal systems permit many different interests in land. Each interest requires careful definition. For example, a conveyance of a fee simple interest in a sales contract requires a law that clearly defines how to create the fee simple land right and a description of what that fee simple land right encompasses. World Bank projects often insist on systems that require transferring land without impediment - fee simple absolute title. Such a Procrustean stance can create enormous political problems in systems where such ownership is politically or socially objectionable. Prohibitions against alienation occur commonly in traditional cultures in Africa, Latin America and the South Pacific as well as in most transitional economies that stress long-term use rights and state-owned property or cooperative ownership. The Bank's rigid stance in support of fee-simple title also misses the opportunity to better define and concretize other land rights, paying particular attention to the terms of transferability, certainty, and use as collateral. Such refinement could improve the economic value of these land rights in ways more harmonious with the other social values of the residents.

In the analysis by the Instituto Libertad y Democracia in Egypt, Hernando de Soto shows that: 25% of Egyptians live on agricultural land whereupon both law and the constitution forbids construction; Another substantial fraction lives in the upper (illegal) floors of nominally two-storied public housing. Altogether, 92% of all land and buildings is held extra-legally. About \$245 billion in Egyptian real estate cannot be mortgaged because it is not legally titled, an amount forty times greater than all bilateral aid to Egypt and fifty times greater than all World

Bank loans. Filing a mortgage requires 207 bureaucratic steps and takes 17 staff-years to complete.⁹

1. Lowering costs of creation

In most developing countries, expensive legal requirements, such as notary deeds, block farmers from legally acquiring and transferring land rights or using them as collateral for loans. These high costs arise from laws that set up monopolistic and state supervised systems of notaries, lawyers and other public employees that, by law, intervene in the legal creation of land rights with innumerable procedures that have no clear public policy benefit. Many World Bank projects, for example, in Latin America and the Caribbean have dealt with land issues. Typically, though, they do not change the laws that mandate these high costs. For example, a project in Guatemala includes in its objectives a legal framework for land markets to function,¹⁰ but no activity was actually dedicated to reforming the Civil Code chapter on property rights. Guatemala, to date, has one of the most expensive notarial systems in the region. While these issues require further legal research and analysis of the present situation, the broad outlines are clear. Because of these high costs of transferring property to other parties and heirs, as the years go by, more and more existing property will become informal. IN a textbook case of unsustainable reform, much recently-titled land will become informal again as people cannot follow the many legal requirements and afford the legally imposed fees.¹¹

As demonstrated in the pioneering work of Hernando de Soto, informal land tenancy can be overcome. Many projects have adopted this technique, worked directly with the local system. By settling all boundary claims at once, they overcome some legal restrictions. A Bank project in Peru further points out that

“...apart from a series of projects in Thailand, the Bank has few proven success stories. Conventional systems of titling and registration (involving expensive cadastral surveys and the modernization of existing agencies, for instance) have proven costly and ineffective in tackling the pervasive problem of informal ownership. On the other hand, titling and registration systems that proceed area by area, that are based on information held by the local community, and that settle all ownership claims simultaneously have proven effective in formalizing ownership. Bank experience also suggests that a prior condition for developing land markets is to establish policies which eliminate the major market distortions, in particular laws allowing freedom to transact and the removal of taxes and subsidies that distort land values.”¹²

While it represents a step in the right direction, the Bank's Peru project notably does not go on to propose changes in these legal impediments or, beyond its broad description, even

⁹ Source: http://www.ild.org.pe/posters/egypt/egypt_poster_1.htm

¹⁰ Land Fund Project P054462, 23 IBRD/IDA, Guatemala, Active 1/7/1999, Project Information Document, at p. 2

¹¹ “Billions of dollars are spent each year on a huge array of activities related to titling and registering property in developing countries, ranging from aerial photography through ground surveying to the introduction of sophisticated computer technology. These efforts, however, have largely failed to address the fundamental problem associated with property formalization – the actual transformation of informal into formal property. Even when formal titles have been issued and registered, many of the property rights soon revert to informality as subsequent sales, inheritances, and gifts are not documented in the registry. As much as 90 of rural and 50 of urban property rights in developing countries are not protected by formal property titles.” Land Registration and Development, David Palmer and John McLaughlin, ITC Journal, May 5, 1996, at p. 1.

¹² Urban Property Rights Project P039086 38 IBRD/IDA Peru, Active 8/6/1998.

propose to identify them. A next development step must make sure that all legal restrictions are revised (Peru's civil code and notary law, for example, has not been reformed yet).

Moreover, projects must make sure that the reform is sustainable over time, by also addressing the problems that may impede legal land tenancy in the long term. Principally, successory proceedings govern inheritance rights in developing countries. These apply to all land transfers, obviously necessary when the owner of title dies. However, when the registered owner dies, transfer of title to the heir can involve extremely costly judicial steps. The consequence is unsustainable reform. In Bolivia, much land already titled and registered with donor support

Box 1. Can Developing Countries Afford Property Rights?

The World Bank funded reform of the movable property laws and registries for all of Romania came in at under \$700,000. The World Bank funded reform of immovable property registry for only the district of Bucharest, one of 41 districts, cost \$26 million and reportedly remains incomplete. Pro-rated, that means a cost of more than \$1 billion to formalize Romanian real estate, about 4% of Romanian GDP. Imagine someone proposing a \$320 billion project for the United States. Movable property amounts to about 1/3 of the national capital stock; immovable property amounts to about 2/3 of the stock. Why the difference in costs? Poor project design that leaves obsolete laws unchanged. Can countries afford property rights at these rates?

under the agrarian reform comes back to the informal market at least every generation because farmers cannot bear the expense of following all the legal steps set out by the Bolivian Civil Code required for transferring the land by inheritance. Most land projects missed a key point of reform by completely avoiding reforming these laws. World Bank projects come in at astronomical prices (Box 1).

- **Lessons Learned**

- **Lower the cost of creating rights in real estate**

Sustainable reform of rights in real estate requires a sharp reduction in the cost of creating those rights

- E. Priority: Establishing a Clear Ranking of Priority of Interests in Land**

Without clear rules for ranking the priority of interests in real estate, no land market can function properly. Land may have great value as a productive asset, but that value cannot be realized if a purchaser cannot tell who has other rights to the property. It is common in developing countries to hear of owners who must purchase the real estate twice because the owner has also sold the property to another person and the law does not provide for which purchase interest will prevail. Such legal muddiness creates great risk in land rights. While the importance of this may seem basic, most land reform projects assume that the priority rules in custom, the civil code, or the land laws are clear. They assume that they all apply the known rule, "first in time, first in right", which assigns priority to the first to register in the real estate registry. However, most developing countries lack priority rules, provide for unclear priority rules, or have conflicting laws that defeat the land right priority.

Developing country courts are awash in land-use right cases that dispute unclear legal principles in the courts. Peruvian Civil Code, for example, opens the door for challenging a first to register priority rule under the grounds of bad faith. In Romania, property taxes rank first regardless of registration, and can show up, "unexpectedly" at any time. In several South Pacific countries, such as Vanuatu, Papua New Guinea and Samoa, the law endorses the application of

customary rules but it is very unclear what the applicable customs will say about conflicting priority claims. Many mortgage laws are silent on the question of a second security interest, creating uncertainty around the possible development of a market in security interests of second or lower priority.¹³

F. Publicity: Problems In Publicizing Interests In Land, The Registry Of Real Estate And The Cadaster

For security in property rights, the law provides for an institutional system to make public any interests in real estate. In most countries, the real estate registry does this. The key registry functions necessary to property rights in land is the element of publicity -- making public the existence of a property right against third parties. Typically, contract law will bind the grantor (typically seller) and grantee (typically buyer) in the transaction. The public policy issues arise in determining the relation of the grantor and grantee to all other possible claimants ("third parties"). This element of making property rights publicly known to everybody, permitting them to know the moment in time of the ranking of priority against other claimants, is the only element a registry provides that is essential for a property right in real estate and for real estate market.

The registry may also perform other services aside from the property right objective. For example, in some systems, a "registered title" may have a strong government guarantee, as it does in New Zealand, Australia, and some Canadian provinces. The law may provide for automatic cleaning of title defects, as in most Civil Code, countries where a third party purchaser for value (after two transactions) takes free of defects. Or the law may provide a weak government guarantee in the registration and permit restrictions to land ownership that can be claimed many transactions later in time, as in most states of the United States. In those states, lenders typically require additional assurance of the quality of the title; they require that borrowers purchase title insurance. The fees for this registration are typically high.

Moreover, although the land is permanently in the same place, typically any new right in real estate, such as a new owner under a sale must register his or her real estate right in the registry to set up a ranking of priority against other claimants to the same property. This, of course, occurs at least as often as the owner dies and bequeaths the land to another person.

Many World Bank projects have focused on the publicity system and supported the real estate registry together with the cadaster. Several concerns, however, arise in their analysis of the legal framework that underlies the cadaster and the registry.

1. *The cadaster*

The cadaster is a state institution that maps property. Before cadasters existed, private parties created maps that described the physical natural boundaries of their property. Laws recognized those boundaries. Most property laws have chapters on property rights and do not mention cadasters. Such private mapping still goes on; it is cheap.

A state cadaster is more expensive than a private map because it establishes a uniform quality of map. That map quality may be economically excessive for many properties. The cadaster also undertakes many functions other than describing the physical boundaries of a

¹³ See also, "Trabas Legales al Acceso al Crédito en Peru" book by the UNIVERSIDAD PERUANA DE CIENCIAS APLICADAS, Lima, Peru, (2000) <http://infodev.upc.edu.pe/fondo-editorial/libros/00trabas/>.

property. A cadaster may also set out a mosaic map of all property, or may set out the properties improvements, topography, soil types, zoning, tax status, to name a few. The government may need this information to learn which property is still under public domain, or how to tax property, or impose environmental regulations. However these features should stand alone, based on their own benefits. Property rights themselves do not depend on these other functions of the cadaster. Property rights depend only on the boundary description of property.

Under most circumstances, the cadaster assists the ‘government’ in learning of the natural boundaries of private property rights. The private occupants of this property already know these boundaries. On some occasions, as when the Netherlands first distributed land reclaimed from the North Sea, or when the United States, Canada, Australia, and New Zealand undertook to distribute large blocks of land seized from the original inhabitants, cadasters helped establish the original deed from the state. Typically, however, in developing countries and countries in transitions, the occupants of the property have a clear idea of the location of their boundaries. And if they do not, they must go to court to settle their claims. Under those circumstances, the cadaster adds little value to private parties’ mapping or physical natural description of their property rights boundary.

Therefore, these projects add a second expensive state cadastral mapping system to the existing description of the boundary of property rights in real estate. Even under the assumption that state titles will be issued, these are often granted to existing occupants, who may undertake the boundary description of their claim by private means.

For example, occupied land can be titled by incorporating in the title, or purchase document, a description of its natural boundaries as set out by the private occupants. Further useful efforts to avoid subsequent conflicts may incorporate the consent of the neighboring land occupants¹⁴. These, in a way, are “private” systems for mapping land. Just this suffices to satisfy private parties in a market economy about the physical scope of a property right. Just this, in a market economy, suffices for property rights in real estate to have economic value.

One of the most advanced land markets in the world, that of the United States, is supported by laws that give greatest legal force to natural descriptions of land boundaries as set out by the private parties in the land purchase document (title deed). This natural description prevails, by law, over any other description, including cadastral maps, or any other more modern description technology. Many land deeds in the United States today include only natural boundary descriptions or an attached hand-drawn map of the property. Nonetheless, these maps support billions of dollars in asset-back securitization transactions.

In this approach, expensive state cadastral mapping systems become desirable only under some particular conditions. First, when the state grants titles to unoccupied state land. In such cases, boundaries will need to be set out for the first time – so that the government knows what it is giving away. Second, when the government pursues objectives other than strengthening property rights. More expensive cadastral mapping systems may be useful in achieving other objectives in land use management, the preservation of the environment, or assessments for real estate taxation.

Moreover, good project analysis requires separating these costs and returns. The cheaper systems for establishing property rights should be evaluated against the large benefits from

¹⁴ A technique used successfully in Hernando de Soto’s real estate titling project in Peru.

property rights in land while the more expensive optional features of the cadaster should be evaluated against the additional benefits envisioned from the non-property rights benefits of the cadaster.¹⁵

Modern cadastral mapping systems take a long time and are extremely expensive. Many questions arise in the design of these projects:

Is it a good use of government or Bank resources to support expensive, state-run, cadasters, in place of cheaper systems that could produce the same improvement in the framework for property rights? Is it better to cover a fraction of the real estate or of the land rights with an expensive cadastral mapping system than use a cheaper registration system that relies on natural description of land boundaries and covers more land or more land-use rights? Why does the Bank promote laws that change satisfactory current laws that require only physical mappings and call for requiring cadastral mapping to achieve legal registration for publicity?

What is the evidence that the non-property rights purposes of cadasters represent an effective use of bank resources? What are the priorities of the other uses? What is their impact on development?

Even if the non-property rights aspects of cadasters can stand on their own because of their additional benefits, why design projects in ways that by requiring a cadaster actually delays simpler and cheaper activities for a workable property rights system that could begin by using private natural boundaries descriptions? Has the promotion of cadasters superceded property rights as the objective of these projects?

If the cadaster is supported because it achieves other important objectives, why continue its institutional setup as a state monopoly? Why not privatize these functions under a legal framework to provide competitive private supply and, therefore, better and cheaper services?

Contrary to these well-established legal principles, many projects ostensibly aimed at rights to real estate have focused more in the cadaster than in the problems in the property rights framework. For example, the Real Estate Registration Modernization Project (P055304 15 IBRD/IDA Slovenia Active 6/22/1999) description states:

“The project would consist of the following 6 components: (i) Core Cadastre including orthophoto mapping, cadastral mapping improvement, linkages to the land registry, information technology and information management coordination, and a Buildings Register; (ii) Legal Cadastre (Land Registration Integration) would provide: on-going systems development, registration process streamlining, land records strategy development and modernization, and training; measures to address the backlogs; linkages to the cadastre, and apartment registration; (iii) Agriculture Land Use Monitoring System established to support Slovenia's possible future participation in the CAP and other programs of the EU; (iv) Real Estate Tax System development for the development of a recurrent real estate property tax system including real estate valuation; (v) Legal Framework Completion Support to improve the legal framework for land registration; apartment registration, mortgage registration; and (vi) Project Management

¹⁵ This is presented as a point of general intellectual guidance, as none of the projects examined actually contain any formal analysis of the project.

Support to fund a coordination unit, and implementation units in each agency, TA, and training requirements.”¹⁶.

The land market of the United States, arguably one of the most advanced land markets in the world, rests on a legal framework that gives priority to natural descriptions of land boundaries as set out by the private parties in the conveyance document or government title deed. This natural description prevails by law over any other description, including those of cadastral maps or any other more modern description technology. Many land deeds in the United States today include only natural boundary descriptions or an attached hand-drawn map of the property. Yet, they support billions of dollars in asset-back securitization transactions.

2. The real estate registry

The law often designates the real estate registry as the place to make public the existence of a property right in real estate. Laws that deal with the ranking of priority of claims in real estate often provide that from the time of publicity by filing in the real estate registry, the holder of a property right has priority against other claimants to the same property.

Anticipating a later discussion, note that the laws and institutions for the ranking of priority in the rights to the real estate can be completely separate and different from the laws and institutions that govern the ranking of priority of security interests against the real estate -- typically loans secured by the real estate. The economics of property rights in collateral do not require a real estate registry for creating security interests against real estate. Rights against real estate require that people have a clear, unambiguous and publicly accessible system for establishing a ranking of priority in real estate. For this, notice of this interest in real estate must appear in a place where parties can easily search and determine their priority. In some countries different registries do this. So, for example, in Washington DC, rights for fee simple real estate ownership are filed in the DC real estate registry; but rights to cooperative units are filed in the private books of the cooperative while public notice of security interests in those rights appears in the security interests filing archive; rights to use and occupy Federal land, which might be physically adjacent to the cooperative and fee simple property governed by other rights, are filed in different Federal registries. In New Brunswick, security interests against both fixed and movable property are filed in a single security interests registry.

The registry problems discussed below (III.F) for security interests will also apply to the registration of other interests in real estate. We set out here some public policy considerations specific to the issue of land rights.

(1) Problems in the underlying real estate registry laws

In developing countries, several laws underlie the system of publicity. These laws determine what information must be filed, how it must be filed, and the requirements for documents needed before registration. These legal provisions set out many requirements whose costs outweigh their benefits. For example,

- ❖ *Filing the “entire sales agreement” instead of filing only a “notice” of the existence of the transaction.*
- ❖ *Filing only in paper with original signatures.*

¹⁶ Real Estate Registration Modernization Project (P055304 15 IBRD/IDA Slovenia Active 6/22/1999)

- ❖ *Requiring documents certified as genuine by a notary or a judge.*
- ❖ *Requiring that the registry officials make annotations in many different books.*
- ❖ *Requiring expensive registry certifications for undertaking many transactions.*
- ❖ *Limit public access to the registry.*
- ❖ *Requiring that a copy of the document be transcribed by hand into the notary's ledger*

Bank projects never undertake an economic analysis of these laws. . Consequently, they wind up automating many unnecessary legal requirements. Computerizing nonsensical requirements doesn't make those requirements less costly or burdensome. Indeed, such systems may aggravate issues by raising the certainty that all clients have completed the nonsensical requirements. Registry reforms in these projects result in superficially modern real estate registry offices that still confront Bolivian citizens and the government with high costs that block efficient transactions.

(2) Private or public operation?

Governments of developing countries face chronic governance problems. They often cannot staff even central government functions with honest and industrious staff. Despite these limitations, the laws of most developing countries provide for a real estate registry administered by the government. Moreover, the state typically operates the registry as a monopoly. This legal framework, dictating a state-run monopoly, produces registry service that is expensive, corrupt, uncertain, and, typically, not offering ready public access.

Bank projects almost never address the legal roots of this institutional problem. Rather, they continue channeling funds to these failing institutions and support their expansion. In so doing, they have addressed none of the problems of weak and inconsistent incentives of government registry operators. In this, these projects guarantee a lack of sustainability

With the exception of the path breaking Internet-based and privately operated notice filing system for security interests supported by the World Bank in Romania, World Bank projects in the 1990s on real estate registries have, based on those inspected, financed improvements only in these state-run and monopolistic registries. No efforts appear to have been made to privatize either the real estate registries or the cadasters.

These projects often claim their efforts have brought security, preserved old records with computer systems, and reduced backlogs. However, they come up against fundamental institution-building problems in these countries – government employees have poor incentives and government-run institutions typically provide poor service at high prices, especially when the law grants them a monopoly. The new World Bank-funded equipment just replaces earlier donor-supplied equipment lying in disrepair around these offices. Without resolving these incentive and competition issues, why should we be more sanguine about these reforms? How sustainable are these reforms in monopoly registries administered by the government? In Bolivia, for example, all real estate registry offices today are slow, expensive, and uncertain; corruption is pervasive; and registry officers, contrary to the law, continue to deny the public full public access to all registry records.¹⁷ This situation continues even after two land administration projects by the World Bank, two by the IDB and one large project component by USAID that have all included funds for real estate registry offices in several jurisdictions. Privatization

¹⁷ Lack of public access limits the private sector from copying registry information and selling it as a service.

provides an obvious route past these problems, but privatization must be designed into the legal framework for the registration process. The law must set out a framework for incentives that permit the private sector to provide these services in a competitive framework.

(3) Should the real estate registry file the mortgages in developing countries?

A second and separate issue, however, arises in where lenders will file the security interest against the titled property. Most mortgage laws specify that the security interest be filed in the same registry as the title. This is a practice, not a logical necessity. However, many problems arise in depending on filing registries for the security interest function. First, in many countries, the titling registries don't work, work badly, or have no clear timetable for their establishment. Second, obviously if only a mortgage can be filed against titled land, what security device applies to other land rights? Where do lenders file notices of those security interests? Finally, titling registries are typically local and not national. When financial centers are distant from such areas, the costs of search rise and only local lenders will be able to check. That adversely affects many financial transactions: it makes it expensive for borrowers in major financial centers to use rural land located collateral, and limits competition in financial services in distant areas.

As discussed later in the secured transactions section, a better strategy would avoid the restrictions of title/registry systems in deciding how to publicize security interests (another property right) in real estate. Most projects delay reforms in the registration of mortgages and other security interests in real estate until the registry of real estate is reformed, since they narrowly envision that these security interests must necessarily be filed with the title.¹⁸ Instead, efforts could be placed in creating a single national filing archive for notices of security interests and other interests in real estate. Such a filing archive would not contain the underlying documentation concerning transfer and ownership but, rather, would only carry notices of such rights and transactions. As a technical matter, this would be a simple database and each entry would have a few digital entries. Such an archive for a relatively large country could be operated out of a modern desktop computer and be available on the Internet for a nominal charge.

Separating the notice filing archive from the underlying registries division permits the coexistence of different individual registries of land-use rights, even administered by different government agencies. It also permits these registries to develop at different speeds, which may be appropriate given possible differences in importance and difference in the difficulty of the tasks that they face. Of course this notice can include data linked to any other registry - for example the notice in the filing archive can include a reference to the cadastral identification number. However, it is not necessary that it contain such a number for it to be a valid notice of a valid interest in real estate.

This separation between the notice filing archive and the title registry would permit beginning the process of lending secured by real estate rights even while the titling process continues separately in a title registry.¹⁹

- **Lessons learned**

- **Minimize the role of cadasters in land reform**

¹⁸ World Bank real estate projects in Romania set out such framework.

¹⁹ See Ukraine: Draft Law on Secured Transactions and Rights in Property, with commentaries, prepared for the World Bank, ECCA, CEAL processed 2002.

A cadaster performs several useful purposes: zoning, tax collection, and land use planning. However, the World Bank and policymakers must balance these useful features against their costs and the reality that most developing countries do not tax land. The typical land titling/cadastral project spends far more on cadastral mapping than is necessary to introduce the minimum framework for rights in real estate. A cadastral system is necessary neither for the operation of a mortgage market nor for establishing land-use rights, including fee simple ownership. Cadasters should be restricted to cases where the government is breaking up hitherto unoccupied land. They should not replicate readily available and legally valid physical boundary descriptions.

➤ **Reform economically unsound registry laws**

From the point of view of the underlying economic and legal logic of a registry of real estate rights, the registry must give public notice of the existence of rights. Most registry laws embellish this central function with expensive, extraneous and largely valueless "certifications". At the same time, they undercut the main function of the real estate registry by making it difficult for the public to access the information therein.

A reformed registry legal framework could call for a registry that is simple (e.g., under a notice filing system), but must be current and easily accessible. Instead of supporting further automation of inefficient registry practices, the Bank could support the study and revisions of the registry laws and regulations. It could see whether it succeeded by gathering data on the cost of registration before and after the reform, something suggested in no Bank project examined.

➤ **Support private operation**

Most analyses in project documents seems to assume that because the existing law says so, because European and US registries are set out this way too, and because registries carry out a public purpose, they must be run by a state monopoly. This seems just a misconception.

Undeniably, a real estate registry administered by the private sector in a competitive framework would be different from the registries specified in the laws of every other industrial country; contrary to the common law practices and contrary to the Civil Codes of most countries . . . However, unless the Bank supports imaginative solutions to the constraints presented by poor governance, developing countries will have to wait an undetermined length of time to develop civic institutions of the quality of the industrial countries. The Bank offers little value-added if its projects only propose, robot-like, to emulate existing industrial country practices without considering how to achieve the same economic objectives under the constraints facing developing countries.

Effective reform of the real estate registries in developing countries will only take place if the laws that provide for a state and monopolistic administration of the real estate registry are amended to provide instead for a private and competitive administration. A registry's public purpose does not prevent private operation. Rather, it requires a legal framework that leads private competitive operators to offer registry services that meet the public policy objectives.

Instead of continuing to fund the existing system, the Bank could support the development of laws that provide for these changes to the underlying registry framework, including development of the necessary amendments to the Civil Code. It could look beyond industrial country models to private and semi-private solutions developed in Romania and Colombia. This is not an easy legal reform component and will need to be set out in a comprehensive manner, including economic assessment and analysis, dissemination and training, public awareness and support to congressional representatives. However, it is the only plausible strategy for escaping the recurring cycle of periodic donor replacement of decrepit registry equipment that provides the window dressing for reform but none of the changes in incentives required for sustainable operation.

➤ **File mortgages in the security interests archive, not the real estate registry**

Jump start the use of real estate as collateral by setting up a simple notice filing system for security interests that applies to all security interests, including the mortgage. De-link the slower development of property rights in land from the potentially fast development of the use of well-define rights in land to serve as collateral.

(4) Next Steps

The Bank has undertaken no proper evaluation of the effectiveness of its work in real estate registration. A key problem in the analysis of the real estate registry lies in the lack of evidence of outcomes of past projects. Information about such outcomes, however, could be readily incorporated in the Bank's work by collecting the costs of publicity (time and money of all steps for registration, including legal requirement before filing) after the reform. An acceptable reform should lower the cost of registration, relative to income, to a point not greater than the same statistic for the United States. Indeed, possibly the target should be lower than this statistic for the United States, because the US system is itself very inefficient and carries the heavy weight of many outdated procedures. Enforcing Interests in Land

Enforcing interests in rights to real estate face the same problems in the eviction and sale of real estate that will be discussed below for security interests. As security agreements are consensual, disputes about them are subject to consensual dispute resolution discussed below. Non-consensual real estate disputes, such as trespassing damages and boundary disputes, will face the same judicial court problems as other non-consensual claims. Non-consensual disputes, however, are beyond the scope of this paper.

III. Property Rights in Collateral (Secured Transactions)

One key property right lies in the right to use property as collateral for loans. An efficient system of secured transactions improves access to credit: lower interest rates, larger loans relative to cash flow, longer periods to repay. It also reduces poverty and reduces wealth disparities, because secured transactions for movable property leads improves by more access to credit by the poor and by micro and small enterprises compared to those with large assets in real estate. For land, good reform permits using small and rural holdings of real estate as collateral. Treatment of portfolios as movable property makes inexpensive and feasible most portfolio diversification and securitization. Programs in the financial and banking sector and SME sectors do not reflect these legal issues. Filing archives typically are transplanted industrial country institutions, reflecting their own history of political problems and rent seeking and do not address institutional constraints in developing countries.

A. Private Finance

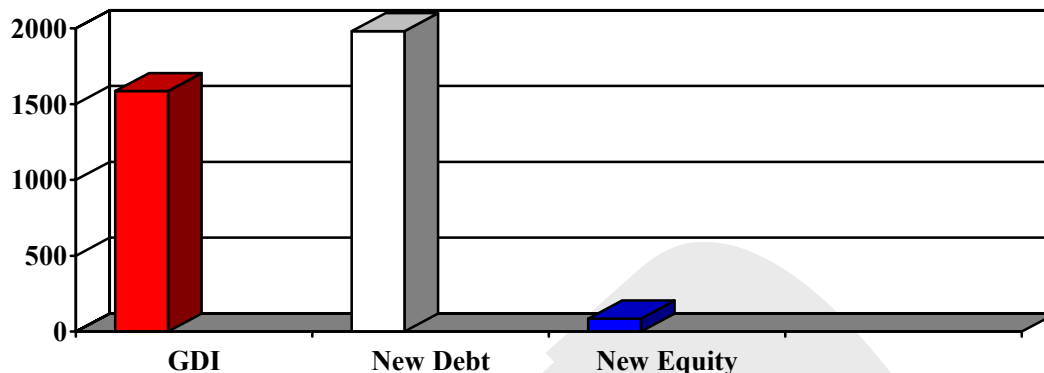
In 2001, developing country GDP amounted to about \$6 trillion. Based on past performance, just keeping pace with industrial country per capital incomes requires that these countries invest about \$1.2 trillion annually. Where will that money come from? Multilateral development banks and the IMF supplied, net new lending of about \$18 billion in 2001; aid agencies supplied even less. Donors represent less than the rounding error on developing country investment needs.

What about the public development banks in developing countries? MDBs have spent the past ten years putting these banks out of business, after their long history of making uncollectible and often unproductive loans.

Financing this investment will require private funds. If financed privately, will it be in equities or debt? That is hard to judge given the primitive state of developing country equity markets. However, the United States has one of the most advanced systems in the world for

organizing equity markets. There, in 2000, new equity issues amounted to less than 5% of new lending.

US Gross Domestic Investment, New Debt, New Equity (2001)

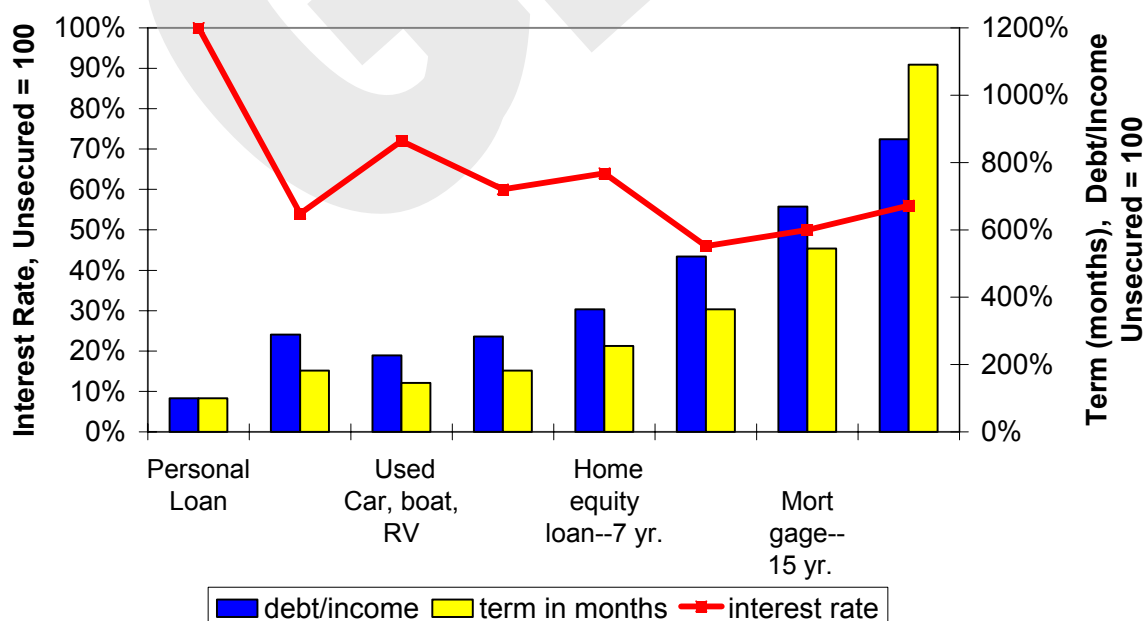


Financing investment will require private funds, therefore, and private funds mean debt. For private lending to play the necessary role, private lenders need a fundamental assurance about one thing: that the borrower will pay. A country's legal framework for debt collection provides that assurance.

B. The Economic Gain from Secured Lending

A legal framework that permits offering property as collateral for a loan offers broad benefits in reducing debt collection risk. In systems where borrowers can offer a broad range of property as collateral, they get larger loans, at lower interest rates, repayable over longer periods

Loan Terms with Different Collateral -- Unsecured = 100%



of time. The theory behind this is complex,²⁰ but examples abound. The credit unions of the World Bank, the Inter-American Development Bank, the International Monetary Fund and the Federal Reserve all offer much better loans terms when a borrower offers collateral. Compared to a loan backed only by a signature, a borrower offering real estate as collateral could expect to get a loan nine times larger, repayable over a period of time eleven times longer, at an interest rate about 50% lower than if the borrower. For a loan secured by movable property, the borrower would get loan terms somewhere between those for unsecured loans and those secured by real estate. Washington commercial lenders follow the same practice.

When the law permits effective use of collateral, the risk from lending falls. Lenders react by offering more credit at the same or better terms. More credit at lower interest rates permits higher rates of investment and more capital per worker, leading to much higher incomes. Seventy percent of bank loans in the United States are secured; at the same time, credit relative to GNP in the United States is about ten times higher than in most developing countries. Farmers and business operators borrow routinely at interest rates about 600 basis points higher than the government-borrowing rate, a fraction of the spread facing their counterparts in most developing countries.

C. Experience in Developing Countries

With few exceptions, farmers and business operators in developing countries get little advantage from offering property as collateral for loans.

Graphic (Argentina example)(forthcoming)

Why does this experience in developing countries differ so much from that of industrial countries? This section of the paper discusses how poor laws and legal institutions in developing countries provide no economic incentives for lenders in developing countries to give better loan terms when borrowers offer most property -- both movable and real estate -- as collateral for loans. This chapter sets out those features.

1. *Basic economic elements of a secured transactions legal framework*

The fundamental economic feature of collateral and the distinguishing trait of a secured lending system (a lending system that uses collateral) lies in granting priority to a lender or credit seller in collecting against some property of the debtor. A security interest is "a right of satisfaction" from the property - the "collateral" -- to which the security interest is attached. If the debtor defaults, the collateral can be sold or exchanged, and the security interest of the secured creditor will be satisfied (paid) ahead of the general claims of unsecured creditors. Moreover, the security interest of a secured creditor will be satisfied in the order of its priority among the other secured creditors that have a security interest against that same collateral. Without a security interest, a creditor is "unsecured". An unsecured creditor has only a general claim against a debtor's property - a claim that gives that creditor no better right to payment than any other unsecured creditor. In modern credit systems, such as those of the United States, Canada, New Zealand, or Romania, unsecured and secured lending coexist in a fruitful and mutually

²⁰ For a discussion of credit rationing in a developing country context, see Karla Hoff and Joseph Stiglitz "Introduction: Imperfect Information and Rural Credit Markets -- Puzzles and Perspectives" in The World Bank Economic Review Vol. 4, No. 1 (Washington, DC: The World Bank, 1990), pp. 235 -250. As the authors note, using collateral is one way that lenders surmount informational asymmetries and enforcement problems that produce credit rationing. See pp. 242-243.

reinforcing manner. However, when a legal system supports only unsecured lending, creditors will lend less to any given borrower, for shorter periods of time, and at higher interest rates.

In both Civil Code and Common Law countries, secured transactions are a subset of the general legal area of "property rights", also known as "real rights" or "derechos reales," in Spanish Civil Code jurisdictions. Often, legal frameworks in developing countries ostensibly let creditors enter into a secured loan by creating a security interest against a debtor's property. For Civil Code countries, the Civil Code and, perhaps, one of more laws on pledge and mortgage might provide the conceptual legal basis for security interests, known as a "real guarantees" or *garantías reales*, in Spanish. For common law countries, the company charge and some version of "hire purchase", and chattel mortgage, might, similarly, provide such a legal basis.

Moreover, the logical possibility under the law of such a security interest cannot alone secure the economic benefits of a secured lending system. Rather, the legal system must meet some key requirements:²¹

* **Creation:** the process by which the creditor establishes a security interest in property (the collateral) -- must cover all economically important property, transactions, and agents; the law must permit creation at a low cost relative to the value of the transaction.

* **Priority:** the process by which the lender establishes the priority of the security interest against all other claims in property -- must provide for unambiguous ranking of priority rules; must protect the secured party from hidden claims of third parties, including other secured creditors, unsecured creditors, a trustee in bankruptcy, some purchasers of the collateral, labor claims, and government tax claims.

* **Publicity (Registration):** the legal process that makes public the ranking of priority of the security interest -- must permit a potential lender to establish a ranking of priority in collateral by filing a notice of the security interest in a publicly available archive (registry), and must also permit a potential lender to easily search the archive to determine quickly and inexpensively whether other claims exist against a borrower's property.

* **Enforcement:** the process by which, upon the debtor's default, the creditor will seize collateral or evict tenants from real estate serving as collateral, and sell the collateral to satisfy the secured claim -- must take place quickly relative to the economic life of the property, and cost little relative to the value of the transaction secured with such property.

The legal frameworks for secured transactions in most developing countries do not pass these key economic tests.²²

These economic benchmarks contrast with the typical World Bank matrix. Consider, for example, the benchmarks for an Indonesia adjustment operation in 1999. A new law on secured

²¹ Draws on Professor John A. Spanogle, Proposed Polish Charges Act (1992).

²² Moreover, with only one unit of capital backing twelve units of loans, loan losses that may seem reasonable to the non-specialist can have grave consequences for a bank. At this level of leverage, if only one loan in twelve goes bad, a bank has lost all of its capital and is technically bankrupt." William Armstrong, THE IMPORTANCE OF IMPROVING THE MECHANISMS FOR SECURITY INTERESTS IN CENTRAL AMERICA, Inter-American Development Bank, Presentación en el Taller Regional: "Desarrollando la Economía Rural de Puebla a Panamá" Banco Interamericano de Desarrollo, Guatemala, 5 - 7 de March 2001. For this reason, the research on secured transactions concludes that securing loans with collateral, in order to quickly recover the funds lent, has great bearing in the country's financial sector stability.

transactions has just been passed;²³ Box 4, Corporate Restructuring and Governance, states: “...Policy Action: 4. Submit to Parliament secured transactions law. Target Date: Done.” However, the law actually passed did not meet these needed economic benchmarks for an effective law of secured transactions. As in other legal areas, a matrix of objectives could be better tailored, instead, by referring to the economic benchmarks of the law, rather than to the passage of a certain “type” of law. Indonesia's legal system still sets out a deficient framework for secured transactions that impairs lender's ability to collect loans, severely limits access to credit and economic growth, and increases financial fragility.

In Albania, Kyrgyz Republic and Moldova²⁴ new laws have been adopted in the area of secured transactions. The bank reports argued that these laws show no economic impact because “it will take time for institutional capacity to develop and demonstrate that the environment provides adequate protection for creditors.”²⁵ This is nonsense. An effective reform should have an immediate impact. The review of these laws outside the Bank, however, shows that they lack key economic features. These defects include neglecting broad classes property in what can serve as collateral for loans, failing to establish registries that can function privately, competitively, and inexpensively; and failing to establish enforcement systems that are fast and inexpensive.²⁶

We discuss the importance of these economic benchmarks below.

D. Creation: Problems

Several problems arise in creating security interests in developing countries. These features increase risk, raise transactions costs, and reduce the value of property as collateral:

Unreformed countries usually have a fragmented system for creating security interests -- several different laws govern secured transactions. As a first approximation, legal systems in developing countries can be divided into Common Law and Civil Code systems. Most former British colonies follow a Common Law system, most former European colonies follow a Civil Code system, and countries that were never colonies adopted one code or another for their own historical reasons. Within the Civil Code tradition, for secured transactions, there are three important basic models: French, German, and Dutch.

In Civil Code countries, typically the law(s) on pledge will govern creation of the pledge (security interests in movable property), a mortgage law will govern the creation of the mortgage (security interests in titled real estate). Nearly all Civil Code and Common law countries will have a law on mortgage. Civil Code countries often also have a law on pledge for property that

²³ Indonesia: Structural Performance Criteria and Benchmarks. Table 2. Structural Performance Criteria and Benchmarks, July-September, 1999, Box 2. Loan Recovery Strategy for the Largest Nonperforming Borrowers of IBRA's AMC, and Each of the 7 State Banks and the 12 IBRA Banks 1998-1999. at <http://lnweb18.worldbank.org/eap/eap.nsf/Attachments/LOI-072299.pdf> Loan: \$31.5m Corporate Restructuring Technical Assistance Loan approved in 3/99.

²⁴ Case Studies from Albania, Azerbaijan, Kyrgyz Republic and Moldova, Khaled Sherif, Michael Borish, George Clarke, Edited by, Paul J. Siegelbaum The World Bank Structural Adjustment in the Transition.

²⁵ Case Studies from Albania, Azerbaijan, Kyrgyz Republic and Moldova (above). This study presents recommendations on how countries that have struggled with the transition process in the areas of private and financial sector development might be able to shift gears and more rapidly achieve objectives. This study focuses on Albania, Azerbaijan, the Kyrgyz Republic and Moldova (referred to in this study as the “subject countries”), which were selected because they are united by a number of characteristics that have severely impaired their ability to overcome structural and institutional obstacles to realize sustainable growth and poverty reduction.

²⁶ UNIDROIT Convention of International Interests in Mobile Equipment, background reports at www.unidroit.org.

remains in the hands of the creditor (the "possessory" pledge used, for example, by a pawnshop or a warehouse), a law on pledge for property that remains in the hands of the borrower (the non-possessory pledge). They may further divide pledges into those that apply to commercial entities, and set out in the Commercial Code (the Commercial Pledge) and those applying to non-commercial entities and set out in the Civil Code (the Civil Pledge). Other laws may apply to particular commodities or goods: examples include ships, airplanes, fishing boats, cattle, or industrial property. Common Law developing countries (all former British colonies) will typically have the company Charge, from the different versions of the British Companies Act, applying to security interests in the property of corporations. They will normally have a version of a Hire Purchase Act, a device similar to a financial lease or a conditional sale.

1. Gaps in coverage

Taken together, these laws might superficially indicate that much property might serve as an object of security. However, the opposite is true. Gaps in coverage of transactions and transactions limit using secured transactions in rural credit. (See Box 27, 28). Nor can more laws "fill" these gaps. Just logical prevents naming all numbers between 1 and 2, so logic prevents fragmented laws, each listing only a set of transactions and property, from covering cover all possible transactions and all property that can serve as collateral for loans.

Box: Gaps in Coverage

Under the Nicaraguan commercial pledge, movable property cannot secure a loan unless the property is being purchased on credit. This effectively rules out third party financing or the refinancing of equipment already owned.

Mexican law often limits who can use a certain security device. An equipment dealer in Puebla could not use financial leasing to sell equipment on credit. Mexican law permits leasing only by authorized leasing companies. In 1999 in India, the company charge was the only floating non-possessory security interest. A "company", however, refers only to a corporation, not to individual or non-corporate borrowers. At a single stroke, Indian law deprives all small farmers, businesses, and microenterprises of the ability to use their equipment and inventory of movable property as collateral for loans

2. Limits to inventory financing

Moreover, many laws on secured transactions laws, such as pledge laws, restrict the use of general descriptions of collateral (see Box 3).²⁹ Sometimes this will not matter, as when a lender does want such a detailed description of the collateral - for example, a rare painting or a prize breeding bull. But sometimes a lender will want a general or generic description of the collateral (for example, "100 head of cattle", "all inventory in a store", "all crops in a field").

²⁷ De la Peña / Fleisig, "Nicaragua: Draft Law on Security Interests in Personal Property and Commentaries," CEAL (1998); and Nicaragua: Options for Filing Security Interests in Personal Property and Nicaragua: How Problems in the Framework for Secured Transactions Limit Access to Credit, CEAL (1998) and Pacific Basin Research Abstracts, Federal Reserve Bank of San Francisco (1998).

²⁸ See "Secured Transactions Law Reform in Asia: Unleashing the Potential of Collateral," prepared by Nuria de la Peña and Heywood Fleisig, Center for the Economic Analysis of Law, and Philip A. Wellons, Program on International Financial Systems, Harvard Law School, for the Asian Development Bank and published in Law and Policy Reform at the Asian Development Bank 2000 -- Volume II, Asian Development Bank, Office of the General Counsel, Manila, Philippines; and also available at http://www.adb.org/Documents/Others/Law_ADB/lpr_2000_2.asp?p=lawdevt.

²⁹ This restrictive view arises from the original concept of a pledge as a limited type of security interest. Moreover, the pledge provisions evolved from, and followed, real estate rules that required a strict identification of real estate offered as collateral.

When the law demands specific descriptions, it can make collection more difficult. Sometimes specific descriptions present more difficulties for the lenders and supervisors if the borrower defaults. Counting 100 head of cattle is easier than inspecting the tattoos on each cow; counting twenty refrigerators on the floor of the store is easier than checking the serial numbers on every refrigerator. Seizing "any inventory" available is easier than identifying specific pieces of inventory. In finance, requirements for specific description can cripple transactions. Even when the law permits using the future crop as collateral for loans, for example, most farmers cannot state, in advance, how much they will harvest or exactly describe future crop quality.³⁰ Whether the law effectively permits a general description requires careful checking. Sometimes the law itself will permit a general description needed for inventory collateral. However, this concept is then not present in the other laws that govern registration and enforcement (see box).³¹

Box 2. Other Restrictions on General Description:

In Argentina and Guatemala, the registry law requires a specific description for filing the security interest. In Indonesia, the law requires that the judge state specifically what the lender will seize in a collateral recovery action. Therefore, the provision of the pledge law concerning "general description" cannot be used. These restrictions on general descriptions limit the use of floating security interests for financing inventory, future crop, and securitizing portfolios. They make it impossible to draft security agreements secured by the inventory of a store AND by its accounts receivables. They limit account receivable financing to fund microlenders. These limits have no obvious justification in public policy.

3. Weak continuation of the security interest

The legal provisions for creation also determine the strength of the security interest and the ease of its enforcement -- crucial issues for creditors. For example, if the debtor sells a crop given as collateral, will the law provide that the security interest continue in proceeds in whatever form those proceeds take? Would those proceeds include those derived from future accounts receivable contracts on the sale of such crop? Does the creditor also get a claim in subsequent dispositions? Suppose the contracts are further assigned. For example, suppose the debtor sells the crop to another purchaser and then buys a tractor with the funds. Does the creditor's security interest automatically continue in the tractor as proceeds of the crop offered originally as collateral? Or must the debtor return to court for a court lien? Moreover, if the debtor returns to court, will the court lien have the same priority as the first security interest? Suppose a bank files a lien on all of the debtor's property. Will the original creditor still collect against the tractor with the original ranking of priority the creditor had in the crop? Unreformed law typically specifies none of these principles and makes no provision for the continuation of the security interests in proceeds of collateral.³² These rights are crucial practical considerations

³⁰ Nuria de la Peña and Heywood Fleisig, "Marco Legal e Institucional de Garantías Reales Mobiliarias en Países de la Región"; Presentación en el Taller Regional: "Desarrollando la Economía Rural de Puebla a Panamá" Banco Interamericano de Desarrollo, Guatemala, 5 - 7 de Marzo, 2001, Revista de BANCOS Y EMPRESAS en Ed. Depalma, Argentina (Revista No. 3), 2001.

³¹ For example, in Argentina and Guatemala, the registry law requires a specific description for filing the security interest. In Indonesia, the law requires that the judge state specifically what is to be seized in a collateral recovery action. Therefore, the provision of the law concerning "general description" cannot be used. These restrictions on general descriptions limit the use of floating security interests financing inventory and securitizing portfolios. They make it impossible to draft security agreements secured by the inventory of a store AND its accounts receivables. These limits have no obvious justification in public policy.

³² Some legal problems arise from discrepancies within the framework for secured transactions; others arise from conflicts between the framework for secured transactions and other important objectives of the developing country's legal system. This problem, common in unreformed systems, such as those in Bolivia, Guatemala, Honduras, Nicaragua, Peru, and Ukraine, limits the economic benefits that arise from using collateral. Creditors know they bear the costs of revisiting courts to reinstate their security interests, that the time involved will increase the risk of total

for prospective lenders and credit sellers.

- **Lessons Learned**

- **Follow a functional approach**

A well-drafted system for creating security interests lies at the heart of an effective law. The best reforms integrate all functionally identical security devices (leasing, trust, pledges, mortgages, hire purchase, and assignment of rights) into one comprehensive legal framework and filing registry system. This broader concept - a functional approach -- organizes security interests along the lines of what actually serves as an instrument of security. That permits including broad coverage of all property, transactions and lenders. The law should not restrict descriptions of collateral. To permit and facilitate inventory financing, the law should permit parties to choose a security interest against "generally described" collateral and not require that the security agreement, or later, the court order for seizure, specifically identify the collateral. The law should permit continuation in proceeds and set out clear rules for tracing proceeds; these should supercede old narrow constructs of "fruits and products". As with all good drafting, the new law must rule as inapplicable or derogate all procedural and other rules that conflict with this principle. In those derogations, it must address the other public policy issues that arise when amending those laws. It must also add enforcement rules consistent with this principle

- **Overrule notaries laws**

The World Bank's reforms will have a larger economic impact if the bank were to support projects that derogate notaries' laws. Notary requirements here and in real estate transactions not only add substantial costs to the use of security interests and other interests in real estate, but they provide no additional benefit that outweighs such cost.

- **Let all land rights serve as collateral**

The elements of a financing system for land rights were set out earlier, where the main issues in creation, priority, publicity and enforcement of security interests were discussed for both movable property and real estate. This section concerns the strategic issue of whether reform should depend on a mortgage and trust law versus a broader security interest law in which a broader array of land rights could serve collateral. The difference could not be more stark. Most residents in developing countries cannot use co-tenancies, leased, or cooperatively owned land as collateral, even when titled.

loss, and that the threat of loss of priority defeats much of the economic advantage from collateral. These problems explain why the system of security interests in unreformed systems is weaker than in reformed systems. Some unreformed laws do provide under the general Civil Code principles that a pledge will continue in "fruits and products". However, "fruits and products" includes only one exchange of the original collateral; e.g. the cash from selling the pledged crop. It does not, as do modern concepts of proceeds, extend to subsequent dispositions. In the example above, had the farmer purchased a tractor with the cash obtained from the sale of the pledged crop, the creditor secured by the original crop would not have an automatic claim against that tractor. Moreover, upon court granting such a judgment lien against the tractor, the priority of that lien would date from the time it was filed, not from the time of the original security interest in the crop. In short, even if the court re-establishes a security interest in the farmer's property, that security interest has a lower priority. See *idem* footnote 6 de la Peña, Fleisig, Wellons, "Secured Transactions Law Reform in Asia: Unleashing the Potential of Collateral," at table V.1 and para. 125.

Box 3. Land Titling is not Enough

In Peru, improvements in land titling were not accompanied by a reform of the mortgage law. A recent study found that though titled land offered substantial benefits, it did not improve access to credit by using land as collateral. Land, as collateral, requires a functioning system of secured transactions.

In addition to the secured transactions problems mentioned above, the security interest laws in developing countries do not include all possible land rights as collateral. In Peru, for example, an usufruct of land, a long term lease, cannot be the object of security.

By contrast, owners of land rights in industrial countries can readily use them as collateral for a loan even though the interest in land they have is not a "titled" fee simple. Owners of shares in cooperative housing units such as the Watergate apartment complex transfer them and get external financing for purchases of valuable and elegant housing. At the same time, much World Bank effort is expended in stamping out exactly the same co-ownership and co-tenancy land rights in transitional and traditional economies on the grounds of their "unworkability". Nonetheless, banks and lenders readily finance building and construction on this land and investments inside these buildings. The key lies in flexible and complete secured transaction laws that readily permit a broad array of interests in land to serve as collateral for loans. Most unreformed jurisdictions, however, only provide for restricted mortgage and trust laws that narrow the possible collateral to only presently titled fee simple land.

➤ **Refocus land titling projects toward reforming all land use rights and using these rights as collateral for loans**

World Bank efforts focus on fee simple titling and cadasters. They ignore the broad range of land rights actually in use. Codifying these land rights could make rural land markets more liquid in ways that were politically and socially more acceptable. Existing titling projects typically ignore the mechanism by which

land rights, including fee simple title, become usable as collateral.

Consequently, these projects do not expand access to credit. These projects should be refocused on the broad set of land rights and fixing the legal system so that more land rights can serve as collateral.

E. Priority: Problems

Priority plays a key role in a secured

transactions system: it establishes the order in which the enforcement procedure will satisfy claims against the property serving as collateral. The creditor with the first priority will have its claim satisfied, on sale of the collateral, before a creditor with second priority. Unsecured systems have no system of priority.

For lenders, establishing their priority against the collateral is crucial: even valuable property cannot serve as collateral if a lender cannot determine the value of other claims secured by that property that have a higher priority than the claim that the lender contemplates. For example, a future wheat crop with a minimum value of \$10,000 may be excellent collateral for a

Box 4. Land as Collateral in A System Based on the Mortgage or Trust Law

Many donors support reforming some version of a trust or mortgage law, often based on American practice. Under unreformed civil code and common law practices, the instrument of the mortgage or the trust, requires title to the land. These security instruments are filed in the same registry that registers title to the land, and their priority is determined by the time of filing in that registry. Therefore, property that is not titled cannot possibly serve as collateral under these laws, as the lender would have no physical place under law to file and obtain priority.

This is not a major problem in countries such as the United States. The United States has a well-developed framework of secured transactions and well-developed non-titled land rights. The latter legal framework permits financing by taking as collateral land rights other than titled land, such as leases and cooperative shares. However, in developing countries where much land is not titled, choosing a title/mortgage or trust system will provide no additional access to credit. Despite this, donors press ahead with mortgage and trust laws in countries like Egypt and Ukraine where more than 90% of the land is not titled and could not, under a mortgage or trust law, serve as collateral.

\$6000 loan if no prior claims exist. However, the same crop will be less adequate collateral for a smaller \$5000 loan if a prior claim for \$7,000 exists.

Priority problems attack the heart of a legal system for secured transaction because they present insurmountable difficulties in determining the value of the property as collateral. Where conflicts of priority exist, secured financing will not take place at all.³³

The law specifies how priority is established. Two basic systems have evolved: one establishes priority by possession, used only for movable property; the other establishes priority by publicity or registration, used for both movable property and real estate.³⁴ Most unreformed legal frameworks for taking collateral do not establish this priority structure in a clear and logical way. Rather, they set out ineffective systems or present unresolved inconsistencies. For example, the law may not state that the time of registration sets the time of priority, but rather use another less verifiable standard, such as date of creation (Russia). The law may be ambiguous about what priority system applies to what goods, permitting different pledge laws to apply to different products with no clear distinctions between these products.³⁵ The result? Searching the registry

³³ In default, loans without priority will become portfolios of uncollectible loans. Indeed, a secured loan by definition cannot have a conflict of priority. Without resolution of priority, even a loan that the law defines as a secured loan is, in economic terms, unsecured.

³⁴ One of the first systems of priority, still used in most countries, uses the possessory pledge and establishes priority by possession. In this system -- used by pawnshops and warehouses -- the debtor gives possession of the collateral to the creditor. Since the possession of the collateral by the first creditor cannot easily be hidden from subsequent creditors, the law grants priority to collect to the creditor that has possession of the collateral. However, under the system of priority by possession, a debtor cannot use the collateral until the loan is paid. Such a system can work for pawnshops or warehouses holding goods in storage. However, it has major economic disadvantages for debtors who seek to use their collateral for economic ends -- e.g. the future crop, production and harvesting equipment, or raw materials that they hold for the very purpose of transforming them in production processes, and land.

The non-possessory priority system was developed to address these problems with the possessory pledge. This system permits the borrower to retain possession of the goods or real estate offered as collateral. Crucial to the operation of this system, the non-possessory system sets out the rules for assigning priority among different claimants to the collateral. It also establishes some process by which the claimants make the priority of their claims public. The most successful and advanced systems (discussed below) assign priority by the time of filing in a public registry. Central in such a system of priority, however, is a law that develops the logic of the system well enough so that conflicts and inconsistencies do not prevent the creditor from being able to gain commercial value from the collateral.

³⁵ The law may specify that priority is set by date and time, but not by date, permitting two security interests filed on the same day to have uncertain priority against each other. The law on pledge may give priority to the first to file a pledge on the future crop, while the law on warehouses gives priority to the holder of the warehouse receipt, leaving legally undetermined the priority of lenders in a crucial transaction where a farmer harvests a pledged crop and moves it to a warehouse. The law on pledge may give priority to the first to file in a registry for a security interest against a portfolio, but the law on assignment of rights may give priority to the first to notify a debtor of a transfer of accounts, leaving the priority status of refinancing of microlenders and dealer portfolios legally ambiguous. The laws on pledge may give priority to the financier of a new generator or grain drier, but the law on mortgage may give priority against that generator the holder of the existing first trust. Finally, badly drafted bankruptcy laws overturn the priority of secured lenders compared to unsecured creditors such as the state (taxes), the bankruptcy court (fees), and workers (unpaid wages). Such a feature largely destroys the usefulness of a secured lending system, because it makes collateral useless at precisely the time of liquidity stress that firms need collateral to support their search for financing. For example, most former socialist republics, with the exception of Romania, and all Latin American and Caribbean countries provide conflicting priority rights for the claims of the trustee in bankruptcy, labor dues, and taxes due, vis a vis a secured party. These discrepancies increase risk; and this in turn reduces lending and increases interest rates. In Ukraine, for example, see Law on Leases, Art. 13, which requires registering a lease agreement only for title goods, e.g., cars, and does not govern priority of the lease against registered pledges at the State Registry. See also Law on Pledge, art. 1, which does not include in its scope of application any transfer

filing mandated in the law on pledge or the Company Registry, a creditor would still not learn about other major senior rights against collateral. A registry reform alone cannot solve this problem.

- **Lessons Learned**

- **Use a functional approach to solve conflicting priorities**

Technical excellence in a registry system cannot compensate for inconsistent logic in priority rules. To assure a uniform ranking of priority and eliminate the risk of hidden creditors, priority rules should appear in one law and apply to any and all other interests in property, regardless of their form, entered into for purposes of security. Such a priority structure would cover all present types of security interests, including financial leases, consignments, and sales with retention of title, among others. It would also cover any future hybrid secured transactions that business and finance operators in the reforming country might develop in the future. This framework would not replace the existing special instruments. However, it would operate above them and impose a common system of priority. This would minimize the risk of hidden creditors that could be granted priority rights under a separate law.

- **Resolve all other priority conflicts**

All other priority conflicts must be resolved in the law, including homestead claims, tax liens, and any other non-security sources of claims that conflict with those of the creditor. In this resolution, relevant public policy issues must be addressed (e.g., new homestead law, new tax law that meet public policy objectives without violating priority)

- **Fix the legal framework for microfinance**

Microfinance lenders would be much more viable if their borrowers could use their portfolios of loans as collateral for refinancing their operations. If microlenders could take collateral as well as give unsecured loans, this could increase average loan sizes and lower unit costs of operations. Microlenders who could use their portfolios of loans as collateral could refinance with formal sector lenders at low interest rates.

However, the laws of most developing countries do not set out the ranking of priority of assignees and secured creditors in accounts receivable from the time of filing in a public registry. Rather they set priority from the time of transfer of each individual account. This means that the underlying legal features of accounts receivable financing in developing countries requires that the microlender transfer each small loan to the microlender's creditor.

This feature raises costs in account receivable financing. First, it increases the default rate of the receivables once account debtors learn of the assignment or security. Second, while the laws of developing countries often permit transferring each individual account, this usually requires an expensive notarial deed for each account. Finally, because receivables can only be entirely assigned, they become indivisible collateral (a receivable can only be transferred in its entirety or not at all). Consequently, subsequent lower priority lenders cannot use the same portfolio as collateral. These legal problems create great risk, even though many simulated transactions are often used in these countries to avoid the expenses of transferring each individual account to the secured creditor.

Yet no microfinance World Bank project has issued a position paper on what legal reforms are desirable for microfinance. To the contrary, microfinance projects often advocate state run refinancing operations that undercut long-term viability and indicate that the World Bank itself may not understand the key role played by law in making these institutions viable. The bizarre consequence? Bank projects leave untouched the legal barriers facing microfinance.

of account receivables and other credit rights, leases, sale agreements with retention or reversion of title, warehouse receipts, consignment of goods, and simulated transactions for purposes of security. Peruvian, Argentine, Bolivian, Honduras, Thailand, or China's laws include similar problems.

F. Publicity (Registries): Problems

If the law follows the best practice system of setting priority by making a public filing, that first-to-file publicity system requires that the law designate the place in which to file the security interest. How well that system works determines, as a practical matter, whether the lender can discover prior security interests or claims against the property in question, as well as ascertain its own ranking of priority versus that of other creditors.

a) Registry versus notice filing archive

Within a framework of making public a security interest, however, sharp differences exist between an approach that uses a registry of the entire security agreement with a broad government guarantee and one that uses a notice filing archive. In a registration system, a lender registers the entire security agreement or a lengthy abstract of it. Typically, registry staff also undertakes some check of legal correctness of the security agreement. In system of notice filing, the lender files only a "notice" of the existence of the security interest. The notice filing archive takes responsibility only for correctly entering the information provided by the lender in the notice and for maintaining the database and public access to it.

A registration system costs more: the costs of filing the entire agreement are greater and are not standard; checking is complex and time consuming. At the same time, the state guarantee has little value because the state does not guarantee against error. Moreover, because so much information is filed, both filers and administrators have incentives to restrict public access. This defeats the purpose of the filing system: making public such data.

The much less costly,³⁶ notice-filing system requires only that creditors file a notice of the existence of the security agreement. This notice contains the smallest amount of information necessary to permit third parties to learn that the creditor has created a security interest in certain property. Such a notice might include the names and domiciles of the parties, and a description of the collateral. Because the law requires simple and standardized information, simple databases can readily store it and make it public over the Web. Potential lenders can check existing security interests and other encumbrances on property by searching the filing system themselves.³⁷

2. Lessons Learned

A quick review of project databases shows that registry reform projects pay little attention to the underlying legal requirements of what type of registry or notice system is in

³⁶ A filing notice might contain 14 fields and occupy a space of 15 kilobytes. The same notice scanned as a picture image would require 30 kb to 60 kb depending on the technique used. The underlying security agreement, however, would be many times larger. As underlying security agreements must vary with the nature of the transaction and the type of collateral, they do not follow a standard format. Consequently, they must be scanned in. At a minimal resolution of 150 dpi, such a document would require about 100 kbs per page. Even a streamlined loan agreement would have two to four pages, representing a file of 200 kb to 400 kb. But loans contracts can run on for hundreds of pages. The speed of electronic access is directly proportional to the size of the file: accessing the streamlined version of the text would require 15 to 30 times more time to download. A 100-page loan agreement would require about an hour - more than 600 times more time than the notice of this agreement. Add these times up for looking at a portfolio of 1000 loans in a securitization and the incompatibility of modern financial techniques with the registering the entire contract becomes apparent. The United States of America and most Canadian provinces have adopted this filing system, so has Romania. Creditors obtain information directly from the database where security interests are electronically filed.

³⁷ Where lenders find notices filed, they can ask borrowers for evidence of the relevant security agreements or for authorization from the borrower to gather information directly from the debtor's other creditors.

place. They make no mention of such substantive laws that need to be changed to accommodate less extensive registration requirements. Sometimes projects aim at registry reform alone and have no legal component. In other projects, the legal components are separated from the technical components and undertaken by different consultants. The result? The law does not change features that block progressive technology and the law is not informed by new technical possibilities.

For example, most real estate registry reform projects presume that there is nothing wrong with a country's laws if they require that a copy of the entire mortgage deed be filed in the registry. They then proceed to support a real estate registry that will file these entire security agreements.³⁸ Differences in costs and sustainability are enormous: the Internet based Romania notice filing archive supported by the World Bank cost under \$500 thousand. Using rented servers and web-based programs, its monthly operating costs are about \$150, a cost easily sustainable by its private NGO operators. A real estate registry that files and verifies entire documents could cost millions. Private operators cannot sustain such costs. Indeed, even for the governments themselves, once World Bank funding ends, these systems typically collapse again in endless backlog and out-of-date computer equipment. In a government-funded project, the real estate registry of Santa Cruz, Bolivia presents a clear example of these problems. A World Bank supported for the larger system of registration of deeds is silent on whether it will reform the law first to change the registration function to a notice filing system before purchasing equipment. An IADB project for reforming title registries in Mexico specifically excludes this possibility. A Bank-supported project Armenia has been quick in financing the purchasing of computer systems before reforming the laws (Title Registration Project P057560 8 IBRD/IDA Armenia Active 10/13/1998).]

Box 5. Backward Systems: State-operated Paper-based Systems

Donor funded projects in Indonesia and Vietnam actually introduced state-operated paper-based systems for their secured transactions filing archives. It is difficult to imagine what possible excuse could justify such backward systems in such large countries when Internet-based systems are available.

a) Private versus public operation

In Ecuador, Jamaica, Peru, Bolivia, or Romania (pre-reform), as one approaches a registry street address, finding the entrance is easy: just follow the long line of people outside on the sidewalk. These lines are the unsurprising consequences of government-run monopolistic registries. Even where filing fees could cover efficient operation, public officials face constant temptation to divert these funds to other purposes and leave the registry starved for funds. They face strong political pressure to hire politically connected staff; equipment budgets suffer. A consortium of private operators can run filing archives. Where private operators compete, or represent broad based interest groups, such archives can run very well (see Box). These private operators could include associations, such as the association of banks, chamber of commerce, and association of lawyers. This approach has been followed in Romania and Colombia with great success. Canada has experimented with monopoly private franchise with less success. The United States has kept a state-operated core with many private points of entry. All these systems work better than traditional state-operated systems

³⁸ See, for example, projects at <http://www.property-registration.org/Project-list.htm>.

Box 6. Registries: Private or Public Operation?

Across the world, filing systems operate in very different ways. In most of the United States, state governments operate the filing systems. They file notices and often authorize private persons, such as attorneys and banks, to file notices on their own. In some Canadian territories, provincial registries subcontract essential activities in building up and operating filing systems to private companies. In Argentina, the government licenses private persons to operate the pledge filing system; giving them exclusive rights to certain territories and regulating them. In Romania, the new Law on Security Interest grants the right to administer the filing system to a Consortium of private persons that compete among themselves. In Colombia, chambers of commerce, sanctioned by the government but run by their business-operator members, operate the filing systems for businesses and for the commercial pledge.

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- **Lessons Learned**
- **Create a Single National Filing Archive for Notices of Security Interest**

Owners of movable property may want to move it from one jurisdiction to another. A national filing archive makes it easy for lenders in any area to know whether collateral is pledged. Security interests in land rights can also be filed in this archive, a crucial development for land rights other than fee simple title to which the mortgage applies. Finally, security interests in titled property can be filed in this registry. It avoids holding lending hostage to the process of rebuilding all the real estate registries and gives remote lenders good access to information about land as collateral. (see below)

➤ **Private Operation**

Based on economic logic and experience, we would expect better performance from private competitive supply than from state owned monopolist supply; we would expect competitive state supply and private monopolistic supply to providing service somewhere in between. Changing a monopolistic state-run system to a competitive registry service requires changing the substantive registry law and drafting extensive regulations. Training, computer software, and equipment for these registries - familiar World Bank nostrums -- will not improve this poor service. An effective publicity system requires that the law must uniquely designate the place in which notice is filed. When that place is a state monopoly, the danger always exists that the administering agency will use this monopoly power in collecting fees to fund its other activities. Placing a heavy tax on lending transactions to fund unrelated activities of the ministry that should be funded from general tax revenues is not socially efficient. To avoid this, even when the roll of the government is narrowed to supervising, the law must specify a cap on the fees charged, so that total revenues never exceed the amount based on the cost of operating the registry archive and supervising it.

A brief review of World Bank registry projects underway reveals no substantial change in this approach.

➤ **Filing security interests and other interests in land**

The most advanced laws on secured transactions could provide for filing in the notice filing archive notices of both security interests and notices for any other interests in land, including land-use rights and real estate fee-simple title. That expanded filing archive would encompass an "archive of security interests and rights in property." Such an approach circumvents delays arising from slow, expensive, and politically contentious land titling and real estate property registration systems. Rather, it would provide a quick filing system for security interests and other interests in real estate.³⁹ This strategy, which permits accepting a broad range of land rights as collateral, will accelerate the development of land rights as collateral with commensurate social gain. Titling projects can continue focusing on granting titles while other land rights can be filed where the government prefers. Possessors of such rights will file a notice of such a land right in the security interest filing archive. That will perfect the land use right, including the title, against all subsequent security interests or interests of other subsequent claimants.

³⁹ Under the priority issues above, the priority rule "from the time of filing a notice" must also apply to all "interest" or "claims" in real estate. Then, for example, any sale, lease for more than one year, usufruct, grant, transfer or other interest in real estate could file a "notice" to obtain priority vis-a-vis all claimants. Such a system can be quickly expanded to include non-traditional land-use rights whether devised by traditional communities, economies in transition, or industrial country governments. In this approach, property-titling projects, although desirable on other grounds, would not be a necessary feature for creating security interests in real estate. Lenders themselves could determine how much and what kind of security of tenure they require for a mortgage.

G. Enforcement: Problems

Can the creditor, in the event of default by the debtor, repossess or evict and then sell the property that the debtor gave as collateral? Any rational lender or credit seller will focus on the value of collateral after the costs of sale and seizure, not its nominal market value. Lenders who face slow and expensive enforcement will simply adjust downward the size of the loan relative to the value of collateral realized after the costs of sale and seizure, not its market value before these actions are taken.

Few lenders or credit sellers in developing countries, with the exception of sellers of cars, and some goods crops produced in monopolistic or monopolistic contexts, such as sugar in Central America, fertilizer dealers in Bangladesh, or dairy dealers in Uruguay, believed such a condition was met. Rather, they believed that costs of enforcement would absorb up to half the value of the collateral. They believed that collection would take a long time, during which the collateral would deteriorate and that interest would not accumulate during the enforcement period. As a result, the loan plus accumulated interest would greatly exceed the value of the collateral.

For movable property, such as crops and account receivables, the problem of rapid enforcement can be crucial. Movable property typically depreciates more rapidly than real estate: a period of collection and sale of one to three years makes most movable property useless as collateral. Inventories of bread, fruit or vegetables last a few days; dry pasta and accounts receivable might last 30 to 60 days. Even storable agricultural commodities will depreciate rapidly without proper care. But proper care may be a difficult task under court supervision and unrealistic to expect of the defaulting debtor. For other equipment, one to three years may represent a substantial fraction of its economic life -- a computer loses about one-half of its street value in three years. Only rarely can movable collateral withstand one to three years of collection time and emerge at the end of the process with enough value to make a difference to a lender.

Enforcement has two steps: repossession (for movable property) or eviction (for real estate), and sale.

1. *Limits to repossession of movable property*

Laws in unreformed countries typically require court permission for repossession of collateral. Some poorly drafted reforms appear to give broad leeway to private parties, permitting voluntary agreement an inexpensive means of repossessing collateral.⁴⁰ Such laws might state that only if such a private agreement does not exist will the slower traditional rules for repossession apply, rules that require repossession according to the decision of the court, arbitration court or action of a notary. However, often such voluntary rapid repossession agreements only apply when the debtor and creditor both agree at the time of enforcement. Lenders will consider such a possibility of trivial importance. Lenders don't worry about debtors who voluntarily surrender

Box 7. Time for Repossession

In El Salvador, lawsuits to repossess and sell collateral take anywhere from one to ten years. Lenders take movable property as collateral only from borrowers that own real estate or are otherwise demonstrably wealthy.

Each day for a year, an Uruguayan bank lawyer drove past a piece of her bank's leased equipment, sitting abandoned in an open field, slowly turning to rust. The debtor had fled to Brazil. However, the court required a year to rule that the debtor had disappeared and issue a court order for seizure and sale.

In Peru, lawyers interviewed reported no eviction process faster than one year under the mortgage law. Recently enacted trust laws left the crucial eviction process unreformed in the procedural codes. Now, even under the recently-enacted trust law, lawyers estimated a minimum of 8 months to evict a debtor.

⁴⁰ See, for example, the Ukrainian Law on Pledge art. 20.

their collateral. Lenders worry about debtors who refuse to surrender their collateral. Under most unreformed laws, should the debtor dispute collection, repossession would require a full and lengthy judicial process. Why? Because unreformed laws do not grant creditors a right of self-help repossession; do not permit speedy use of state-controlled force; and require numerous steps in taking possession of collateral.

2. *Limits to eviction from real estate*⁴¹

Repossessing real estate collateral involves evicting the occupants,⁴² who upon default become automatically tenants, typically non-paying. Evicting the occupants of real estate taken as collateral usually requires several lengthy and expensive steps.⁴³ In Ukraine, for example, Pursuant to the Civil Procedural Code of Ukraine of July 18, 1963, a total term in which the court shall prepare the hearings on the eviction request shall not exceed 20 days from the date of filing a claim. The court hearings shall be conducted and the judgment shall be rendered within 15 days.⁴⁴ In practice, the court procedure may exceed this term by several months, since the judge has a right to make extensions of the procedure and the courts are usually overloaded with cases. After the judgment for eviction is obtained, the general term for the enforcement of judgment on eviction is 2 months from the date when the Officer receives the execution document.⁴⁵ However, in practice, because the Officer has the right to halt the eviction proceedings, the procedure may also exceed two months. In slowing down the eviction procedure, the debtor may appeal against the judgment on eviction. In this case, the eviction shall be suspended and the judgment shall not become subject to enforcement until the court of appeal reviews it.⁴⁶

⁴¹ Of course, sometimes the nature of the collateral is such that repossession and sale are economically useless – as with taking a plot of land completely surrounded by the borrower’s relatives. Where no market can be devised for the property, then it will be worth less as collateral and lenders will lend less against it. At the limit, lenders are free to give no weight to such collateral. For a review of these cases in developing country context see Karla Hoff and Andrew Lyon, “The Optimal Sequencing of Land and Credit Market Reforms in Developing Countries: A Theoretical Perspective”, IRIS working paper 39, (College Park Maryland: IRIS, January 1993). Also, the papers presented in “A Symposium Issue on Imperfect Information and Rural Credit Markets”, The World Bank Economic Review Vol. 4, No. 1 (Washington, DC: The World Bank, 1990).

⁴² Eviction and sale of property without appropriate debtor protection (see below) can have disastrous results. See Rachel Kranton and Anand Swamy “The Hazards of Piecemeal Reform: British Civil Courts and the Credit Market in Colonial India,” *Journal of Development Economics*, 58 (1), February 1999, pp. 1-24.

⁴³ These may include obtaining a court judgment and a writ of execution. Typically, the law will set time limits on each stage of this process; however, most unreformed codes of civil procedure permit many appeals. Often, other laws apply to eviction: for example, some countries will not evict families with young children. Sometimes tightly scheduled eviction proceedings are suspended and restarted: sometimes the judge does this because of an overcrowded court calendar, sometimes on any appeal by the debtor/tenant. Some laws permit a wide range of grounds for postponing eviction including business trips, hospital treatment, and vacations. In Peru, an attorney for lenders recently interviewed, reported at least one year to evict tenants from real estate, and further delays if tenants appealed. Peruvians have recently begun using the trust under a recently passed trust law. However, the attorney explained how the trust law does not solve this problem. The slow eviction time cannot be avoided under a trust instrument, since eviction requires the use of force to break and enter the premises, it necessarily requires judicial action under the constitution of Peru as well as in most other countries. Trust laws do not govern the procedural rules for such judicial eviction process. Rather, the subject is governed by the code of civil procedure and rules of the courts, and is affected by the enormous problem of malfunctioning in the judiciary.

⁴⁴ Articles 146 and 148 of the Procedural Code.

⁴⁵ Section 1 of Article 25 of the Enforcement Law.

⁴⁶ Section 3 of Article 329 of the Procedural Code.

3. Limits to the sale of collateral

Once the collateral is repossessed, it must be sold. Most unreformed laws provide for a complex sale procedure. This might include an appraisal of the property, a court administered auction, a provision for revaluation of the property if it fails to sell at the appraised value. Each of these steps costs money, requires additional trips to court for each step, and takes time. Some laws require this procedure even if the creditor could arrange a private sale at a price acceptable to the debtor. Unreformed laws typically do not permit a creditor-controlled sale or a strict foreclosure (transferring ownership of the collateral to the secured party). Sometimes poorly drafted laws permit a creditor to administer the sale but do not permit the creditor to transfer title without a judicially supervised sale. Consequently, a creditor must always use a judicially-supervised sale for titled property such as real estate or automobiles.

4. Homestead and exempt property protection

In addition to the problems in the enforcement procedure set out above, all civilized countries laws restrict creditors' rights in seizing the property of a debtor. All laws so far examined by CEAL, including those of both industrial and developing countries, contain "homestead" and "exempt property" protection provisions providing that a creditor cannot seize certain property. Just as societies have learned that creditor's true interests do not lie in enslaving, imprisoning, dismembering, or killing defaulting debtors, they have also learned that no public policy purpose is served by sending debtors into the world destitute. All countries have limits to debt collection procedures. No law yet inspected permits taking the bed, shoes, or clothes of the debtor.

The provisions set out in Ukraine and Bolivian laws for example, list a wide range of goods and are clearly motivated by concern and compassion for the impoverished debtor. However, these provisions must be drawn very carefully: the debtor cannot use as collateral whatever is on that list. That typically means that people cannot buy these items on credit. So, for example, when the Bolivian mining law stated that the miner's tools could never be seized, it doomed Bolivian miners to fifty years during which equipment could not be purchased on credit. Similar provisions preventing seizing the tools of a worker can cripple programs to provide formal sector credit to the poor and micro-enterprises. What dealer would sell these goods on credit, what lender would extend credit to purchase them, if the law plainly says they could not repossess and sell these items in the event of nonpayment?

When well drafted, these same homestead and exempt property provisions can achieve their intended effect without such a great reduction in access to credit and its attendant economic cost.

5. Problems in bankruptcy laws

Though sometimes grouped together under the rubric of "debtor-creditor" laws, bankruptcy and secured lending serve different economic purposes and social ends: Bankruptcy cancels debt collection. Bankruptcy replaces other penalty systems for defaulting debtors, including debtors' prison, slavery, dismemberment, transportation, and death. Secured lending, on the other hand, facilitates debt collection. It works by improving security and information. Borrowers can then more readily prove their creditworthiness. Lenders can make loans with less risk and collect them more easily.

a) The gain from bankruptcy law

The original gain from bankruptcy arose from ending practices perceived as socially damaging. An imprisoned debtor not only produced nothing and required feeding. Originally, bankruptcy had no direct effect on the position of the secured lender: the secured lender's first recourse was to the collateral for the loan. Only if that collateral was insufficient did the bankruptcy system apply to the deficiency balance -- a debt balance exceeding that realized from the sale of the collateral. Several unreformed bankruptcy laws in Latin America will still reflect this economically efficient isolation of secured loans from bankruptcy, such as the Honduras Commercial Code.

b) Problems in bankruptcy laws

Some bankruptcy laws have given priority to some unsecured claims over secured claims. These laws permit using the proceeds from selling the collateral to satisfy unsecured claims before those of the secured lender. For example, bankruptcy laws in Argentina, Mexico and India give priority over the claims of the secured lender to the fees of bankruptcy lawyers, taxes, unpaid wages of workers, tort claims, subcontractors, and costs of the bankruptcy court.

Evaluating the social value of these provisions involves complex issues in productive efficiency and troubling issues of fairness about which reasonable people might reasonably disagree. Fortunately, it is possible to bypass most of these issues. Other methods exist for achieving these same ends that would not damage the framework for secured lending or reduce the benefits that it confers. Debts to the state could be collected in the same framework as other secured loans if the state merely filed a lien in the debtor's property at the time that the debt to the state was created. Unpaid claims of workers could be protected by a floating lien equal to the unpaid claims. Tort claims could better be provided by requiring insurance by the firm in question. Subcontractors, like workers, could file liens when the debtor's obligation was created. Attorney's fees and the costs of bankruptcy would have priority only from the time of bankruptcy, thereby minimizing incurring social costs for dissolving firms with no net assets left.

Much of the impetus of bankruptcy reform arises from the donor-supported efforts to spread U.S. Chapter 11 business reorganization measures to developing countries. Do developing countries gain from introducing such procedures that aim at judicially-administered methods of preserving the ongoing value of the firm? Such procedures can damage the credit system, as they nearly must always require a stay in execution of the secured creditor's rights. Such a stay presents the risk that these rights will be diminished in the course of the reorganization proceedings.

This issue merits further investigation. Nonetheless, in the reorganization of firms, the evidence from developed countries indicates little social gain from a stay in execution of secured claims. Indeed, most studies have difficulty finding any gain from reorganization proceedings at all.

The economic gain from secured lending is large; it is distributed over a wide group of rich and poor citizens. This large and widely distributed gain justifies extreme caution in abridging the system. Addressing the serious issues raised by adherents of limiting the rights of secured creditors requires a broad reform of a wide range of laws, concerning tax collection, workers rights, and coverage of risk to the citizens at large. However, that broad range of reforms would, without question, promote public welfare better than would limit the rights of

secured creditors without passing the suggested reforms elsewhere. On the difficult question of judicially administered reorganizations, further study is necessary. However, based on the existing studies, no involuntary delay in the exercise of the rights of secured creditors can be justified.

6. *Legal strategy in non-judicial enforcement*⁴⁷

In several countries, the repossession of collateral takes almost two years.⁴⁸ The economic consequences of this limited access to credit are discussed at length in several reports.⁴⁹ An improved framework for secured transactions is essential for increasing the flow of credit. It permits access to credit by those who lack the more readily acceptable guarantees of real estate. Recognizing this, during the 1990s, the World Bank, the European Bank for Reconstruction and Development, and the Inter-American Development Bank have undertaken projects in several countries to improve the framework for secured transactions. This section draws on the experience in such projects in Argentina,⁵⁰ Bangladesh,⁵¹ Bulgaria,⁵² Bolivia,⁵³ El Salvador,⁵⁴ Guatemala, Honduras,⁵⁵ Mexico,⁵⁶ Peru,⁵⁷ and Uruguay.⁵⁸ It presents options for

⁴⁷ The following section draws on "Options for Improving Repossession of Collateral in Latin America," by Nuria de la Peña and Graciela Rodríguez Ferrand [October 1996: CEAL, processed].

⁴⁸ See, Argentina: How Problems in its Framework on Secured Transactions Limit Access to Credit, by Heywood Fleisig and Nuria de la Peña (CEAL 1996) (hereinafter "Argentina "); How Legal Restrictions on Collateral Limit Access to Credit in Bolivia, by Heywood Fleisig, Juan Carlos Aguilar, and Nuria de la Peña (The International Lawyer, Vol., Spring 1997(hereinafter "Bolivia"); How Legal Restrictions on Collateral Limit Access to Credit In Uruguay, Heywood Fleisig and Nuria de la Peña (CEAL, 1996) (hereinafter "Uruguay").

⁴⁹ See, Argentina, Ch. I; Bolivia Ch. II; and Uruguay, Ch. I.

⁵⁰ Work undertaken under the general supervision of Mr. Stephen Schonberger, LA3ER, IBRD. Further background set out in Fleisig, Heywood and de la Peña, Nuria, "Argentina: How Problems in the Framework for Secured Transactions Limit Access to Credit in Agriculture" [September 1995: The World Bank, processed]; and Bacchiocchi, Gianluca G.; Dick, Astrid A., and Loeb, Gabriel J., "Maximizing Social Surplus within the Politically Constrained Argentinean Registry System by Increasing Efficiency and Distributional Equity between Registries and Customers", [May 1994: The World Bank, processed].

⁵¹ Work undertaken under the general supervision of Mr. Madhur Gautam, SA1AN, IBRD and described in more detail in Fleisig, Heywood, "Bangladesh: Creating a Legal and Regulatory Framework to Promote Access to Credit in Agriculture," [November 1995: The World Bank, forthcoming, processed].

⁵² Work undertaken under the general supervision of Zeljko Bogetic (EC1CO), IBRD. Background work done in collaboration with the Europe Bank for Reconstruction and Development and appearing in Fleisig, Heywood; Simpson, John, and Röver, Jan-Hendrik, "The Framework for Secured Transactions in Bulgaria: Economic and Legal Issues" [October 1995: EBRD & IBRD, forthcoming, processed].

⁵³ Work undertaken under the general supervision of Vicente Fretes-Cibils (LA3C1), Susana Knautd (LA3NR), Jonathan Parker (LA3NR) and William Shaw (AF2C0). Background material appears in Fleisig, Heywood and de la Peña, Nuria, "Bolivia: Creating a Legal and Regulatory Framework to Promote Access to Credit in Agriculture," [September 1995: The World Bank, processed]; Fleisig, Heywood; de la Peña, Nuria and Aguilar, Juan Carlos "Bolivia: Creating a Legal and Regulatory Framework to Promote Access to Credit for the Poor," [July 1995: The World Bank, processed]; and Fleisig, Heywood; Aguilar, Juan Carlos and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Bolivia" [December 1994: The World Bank, 13873-BO].

⁵⁴ Work recently initiated under the general supervision of Mark Dutz, Daniel Crisafulli, and Roberto Panzardi (LA2PS), IBRD.

⁵⁵ Work originated by Ms. Graciela Lituma (LA1NR) and now being carried forward under the general supervision of Ms. Silvia V. Castro (LA2NR). Background information appears in de la Peña, Nuria, "Honduras Draft Secured Transactions Law" ("Régimen General de las Garantías Reales Mobiliarias") [March 1994: The Central Bank of Honduras, processed]; de la Peña, Nuria, "Diagnóstico Sobre el Sistema Prendario de Honduras: Su Impacto en el Acceso al Crédito," [December 1993: The Central Bank of Honduras, processed]

⁵⁶ Work undertaken under the general supervision of Michael O'Donnell (IADB).

⁵⁷ Work now being initiated under the general supervision of Surajit Goswami (LA3NR).

expediting the process of repossessing movable property that serves as collateral. It suggests new procedures for non-judicial repossession and sale that would enable creditors to repossess and sell quickly, before the collateral has depreciated in value.

Concern always arises about the constitutionality of these proposals. A full and comprehensive treatment of constitutionality of this reform varies from country to country and is beyond the scope of this paper. We discuss here constitutionality in the context of the legal systems of Latin American Civil Code countries in general; and in some cases, in three countries: Argentina, Bolivia and Uruguay. The ideas, however, are applicable to the legal systems of other Civil Code countries, in particular, to countries, which are contemplating modernization of their laws on financing of movable property. Many of the general points also apply to common law countries. Indeed, the ideas presented also have strong bearing on the reform of security interests laws in the industrial countries of Europe and Japan. .

Changing the laws to expedite repossession of collateral gives rise to important legal issues. Should creditors be allowed to take the collateral without the need of court intervention? May they use physical force against debtors who refuse to surrender collateral? Constitutional law, criminal law, and public policy considerations impose limitations on desirable legal mechanisms, which provide for faster repossession. This section first examines these limitations. It then divides the proposed procedures into those that do not require court intervention and those that do.

7. *Relevant legal issues in repossessing collateral*

Shortening the time for repossessing collateral involves two steps: (1) the creation of procedures by which creditors may seize collateral and (2) the modification of existing procedures by which debtors may defend their interests in collateral. Reforms of these procedures often raise public policy and constitutional issues. Competent legal reform addresses these issues in the diagnostic study and in the commentaries to draft laws. These issues vary from country to country. What is certain is that lawyers in the country will be concerned about how these issues are treated in the law.

This section addresses some of these issues in public policy and constitutionality. It draws on a sample of CEAL work in some developing countries. In the nature of the question, a general answer would be beyond the scope of this paper.

a) *Due process – does repossession without a court take property without due process of law?*

Most due process clauses in Latin American⁵⁸ constitutions state that no one may be deprived of property without a court hearing. On the face of it, this clause would seem to conflict with a law that permits creditors to repossess collateral before seeking a court order.

However, many countries that introduced private repossession and sale faced such constitutional questions, including Canada and the United States. Two key elements underlay the

⁵⁸ Work initiated by Jonathan Parker (LA3NR) and carried forward under the general supervision of Mariluz Cortes (LA1PS). The details appear in Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay" [May 1994: The World Bank, processed].

⁵⁹ A full treatment of constitutionality is beyond the scope of this paper. This section draws on CEAL's Latin American work and gives an example of the breadth of issues that should be considered in the diagnostic paper to give useful advice to borrowing member countries about the constitutionality of the proposed reforms.

courts' favorable disposition of the constitutionality question. First, for almost no country is the constitutional issue one sided. Citizens, as debtors and owners of property, have a right to due process before either property is taken. However, citizens, as owners of property, have the right to freely dispose of that property under the same constitution. Finally, citizens as lenders and possessors of real rights in security interests in property in which others have property rights, also have constitutional support for these rights. As such, it is a conflict among rights, not a simple one-sided decision. Second, in balancing these rights, the courts will typically consider the material public interest: that is, the gain to the public from different balances. In this connection, interesting early US court cases heard evidence on the how changing collection rules would affect access to credit and the interest rates paid by the poor.⁶⁰

For example, in the 1970's, the Wisconsin state legislature considered legislation that would require court intervention in the repossession of motor vehicles. However, legislators argued that such changes would affect consumers adversely because judicializing repossession would increase creditors' costs.⁶¹ These costs would be passed on to consumers in the form of increased finance charges (including possible increases in the required down payment) and thus, would restrict credit availability. Moreover, such restrictions would have a disproportionate impact upon the poor.⁶² In Wisconsin, the decision-makers concluded that while judicialization provided some benefits in terms of protecting the debtor against possible overreaching by creditors, such benefits would be outweighed by higher collection costs.

In a similar California case, Johnson undertook a painstaking cost-benefit analysis on self-help repossession in California. Although this study was limited to one state and one type of financing, it covered a sample of secured transactions that are representative of other secured financing transactions in the United States and other countries with similar societal values and socio-economic structure. He concluded the following: (1) a requirement of a pre-repossession hearing would substantially increase creditor's costs, and (2) these additional costs of "constitutionalized" repossession would represent an incremental burden to high risk borrowers, reflected in the form of increased interest rates and reduced availability of credit to such

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⁶¹ Grau and Whitford argue that judicializing repossession will increase creditors' collection costs. They predict that these extra costs would result from increases in delinquency rates, in the time between initial delinquency and repossession, and in the direct costs of repossession (due largely to attorney's fees). Of course, these costs would be passed on to consumers. See Charles Grau and William Whitford, The Impact of Judicializing Repossession: The Wisconsin Consumer Act Revisited, 1978 Wis. L. Rev. 983.

This hypothesis on costs and benefits of judicialized repossession was tested by assessing the impact of the Wisconsin Consumer Act on credit availability, delinquency rates, and repossession rates for automobile lending. Data was available for only the first two years of the Act's operation. The hypothesis tested whether the incidence of repossession would decline when repossession is judicialized. If it did not decline, as predicted, there existed strong evidence that creditors did not partially substitute workouts for repossession. Also, a reduction in the credit extended to the marginally creditworthy should result in a lowering of delinquency and repossession rates. Data about credit availability may help determine the extent to which any reduction in these rates should be attributed simply to restricted credit availability. If reduction in delinquency and repossession rates cannot be plausibly attributed to restricted credit availability, the hypothesis that judicialized repossession causes greater reliance on workouts and less on repossession appears more probable. The available evidence suggests that there was indeed a reduction in credit availability between 1972 and 1977 (the Wisconsin Consumer Act became effective March 1, 1973) which accounts for the reduction in repossession and delinquency rates, compared with increases elsewhere.

⁶² A earlier, theoretical study on the effects of repossession reform concluded that the critics have probably overestimated the impact. But, both the study and the critics of the study agreed that any increase in collection costs can result in restricted credit availability and increased finance charges.

borrowers.⁶³

b) Protecting debtors against violence.

An entirely separate issue is whether a particular procedure would incite violence between a creditor and a debtor. This issue is to be distinguished from the due process issue, which involves a conflict with the constitution - the issue of violence involves public policy. In other words, the relevant due process concern involves deprivation of property without a court hearing. The relevant public policy concern⁶⁴ is whether that procedure would invite a breach of the peace.⁶⁵

c) Constitutional protection against violence.

The Argentine, Bolivian and Uruguayan Constitutions do not contain specific provisions addressing the public policy concern with laws that could potentially invite a breach of the peace. However, the constitutions of these countries seek to foster peace. Thus, although there are no specific constitutional provisions against laws that foster violence, this paper considers that laws that incite violence could be held unconstitutional under a traditional constitutional analysis, and that such laws would not be accepted by society. Accordingly, the proposed repossession procedures in modern secured transactions laws are designed to not breach of the peace or foster violence, and several incentives are included to induce an amicable repossession of collateral.

d) Larceny, trespass, and other crimes.

Laws governing larceny, trespass, invasion of private property, and other crimes against property include definitions, which may seemingly conflict with a creditor's repossession rights. Addressing this problem requires careful legal drafting of the repossession procedures and, eventually, amending certain provisions in the criminal and criminal procedure codes that may conflict with these repossession provisions.⁶⁶

Suppose a country's laws on larceny, trespass or invasion of private property laws presuppose that an individual has illegally or unjustifiably taken away property that does not belong to him. In that event, procedures that "legitimate" (or validate) self-help repossession will not require modification of the definition of such criminal offenses. The creditor's right arising from the security interest would make the action legitimate. Indeed, the existing criminal law provisions would even place an incentive on creditors to be certain that they have a "legitimate" right to take the collateral,⁶⁷ by for example, making sure that the debtor is in default and that they do not breach the peace. Such incentives may be built into the procedure as specific

⁶³ The Johnson study was based on eight banks and finance companies reporting 46,000 auto repossession in southern California during 1971. Prof. Johnson estimated that this figure represented approximately 75% of all the self-help auto repossessions in 1971. He also estimated that in California in 1971, 62% of the debtors voluntarily surrendered their cars upon creditor's demand, also noting that in most cases of repossession the debtor was actually in default. See Johnson, *supra*.

⁶⁴ The constitution does not expressly recognize this public policy concern but, under traditional constitutional analysis, one must consider this issue.

⁶⁵ A breach of the peace is a violation or disturbance of the public tranquillity and order. The offense of breaking or disturbing the public peace by any riotous, forcible, or unlawful proceeding. Breach or the peace is a generic term, and includes all violations of public peace or order and acts tending to a disturbance thereof. *Black's Law Dictionary* (6th ed. 1990).

⁶⁶ The authors are grateful to Julio Kelly and Alejandro Garro for this observation.

⁶⁷ The authors are grateful to Julio Kelly for this observation.

requirements for "legitimate" self-help.

By contrast, if a country's law criminalizes taking possession of property by private parties regardless of whether they have a right to that property and a right to take that property from the possession of another, then such provisions will conflict with self-help repossession, and must be amended to provide for legitimate takings.

e) **Disclosures and uniform contract provisions**

Finally, a necessary component in the creation of repossession procedures involves disclosure and mandated contract provisions. Failure to include provisions for disclosure and mandatory contract provisions could render the security agreement unenforceable, and this would hinder a creditor's ability to enforce repossession rights.

Disclosure and mandatory provisions raise certain public policy concerns. The main goal of reforming the secured transaction laws and improving creditors' ability to repossess collateral is to facilitate borrowing by the poor, landless, and illiterate. As discussed elsewhere,⁶⁸ a secured transactions law reform should enable these segments of the population to borrow using tractors, herds, and inventory as collateral. Yet these are the individuals most likely to be exploited by unscrupulous lenders. One way to equalize the bargaining power between sophisticated lenders and unsophisticated borrowers is to mandate strict disclosure requirements and uniform contract provisions.⁶⁹ Such provisions will enable borrowers to better understand their rights and obligations under the loan agreement. The model outlined below for expediting repossession of collateral will reduce abusive behavior by lenders, and hence encourage more equitable treatment of borrowers in default.

8. Options for repossessing collateral without judicial intervention

How can repossession not require going to the courts? This section discusses procedures that could be introduced in developing countries, which do not require judicial intervention. The options include harmless repossession, administrative repossession, and receivership. These procedures seek to establish a standard in which repossession is achieved within five calendar days. The five-day standard is used because this is the typical period in which creditors in countries such as the United States and Canada, which have efficient repossession systems, are able to repossess collateral.⁷⁰ Ideally, the procedures are designed to fit into a chapter dealing with the enforcement of security interests of a new law on secured transactions. The procedures assume that following a repossession, creditors are entitled to privately sell collateral under a standard of commercial reasonableness. The procedures also assume that a new law on secured transactions will include special provisions enabling courts to quickly grant a temporary restraining order,⁷¹ compensation, or similar relief to a debtor injured by a creditor's wrongful

⁶⁸ See *Supra*, at Ftn. 1.

⁶⁹ The authors are grateful to Prof. Girton for this suggestion.

⁷⁰ For example, this time for liquidation of collateral permits Kansas bankers to safely accept cattle as collateral for loans. See Fleisig, Heywood and de la Peña, Nuria, "How Legal Restrictions on Collateral Limit Access to Credit in Uruguay," [Processed, CEAL, 1996].

⁷¹ Broadly speaking, a restraining order involves an emergency judicial remedy of brief duration which may be issued only in exceptional circumstances and only until the trial court can examine the evidence, as the circumstances require, on the subject matter of the controversy and otherwise determine the appropriate relief. *Black's Law Dictionary* (6th ed. 1990). In Latin American civil jurisdictions, this remedy is known as a *medida de no innovar*.

repossession.⁷²

The procedures recommended in this section do not require a secured creditor to seek judicial intervention. Instead, they place the burden on the debtor of seeking a temporary restraining order or some other relief that he considers justifiable. This is crucial for the procedure to comply with the constitutional due process requirements of many countries.

a) Harmless Repossession

Harmless repossession, also known as self-help repossession, permits creditors to seize collateral in a debtor's possession, provided that creditors act peacefully. "Peacefully" has some clear requirements. Creditors may not breach the peace, use force, or resort to the aid of the police. Under this procedure, creditors may pick up abandoned machinery, drive away a car parked in a public garage, or set aside the amounts due from the debtor's bank account. However, they may not enter the debtor's home uninvited to retrieve the collateral. Self-help repossession is simple and inexpensive and it is a valuable tool in situations where a creditor is able to retrieve collateral peacefully.⁷³ Combined with "continuation in proceeds" as a creation tool, harmless repossession actually can apply to a broad range of debtor assets physically beyond the control of the debtor.

Self-help repossession evolved as a Common Law right, and was later included in the security interest laws, such as Article 9 of the Uniform Commercial Code of the United States and the Personal Property Security Acts of the Canadian states.⁷⁴ However, Civil law systems have also successfully adopted self-help repossession procedures. In Bolivia, the Banco Agrícola Boliviano's charter law, provided for harmless repossession of pledged goods.⁷⁵ In Quebec, Canada, harmless repossession is granted to those holding a security interest.⁷⁶ The system set out below follows Section 9-503 of the Uniform Commercial Code of the United States mainly because the repossession system introduced under UCC Article 9 functions efficiently. The Bank supported secured transactions laws for Romania and for Ukraine also contain such procedures.

(1) Main features of harmless repossession

The law will provide that, unless otherwise agreed, a secured party has the right to take

⁷² For example, the procedure could include in the definition of "wrongful" situations in which a creditor repossesses (1) without having a perfected security interest in the collateral, (2) without default actually occurring, or (3) in a manner that breaches the peace. A. Craig Cleland, Note: Wrongful Repossession in Georgia, 8 Ga. St. U. L. Rev. 223 (1992); see also Barkley Clark, The Law of Secured Transactions Under the Uniform Commercial Code, ¶ 4.05 [2] at 4-66 (2d ed. 1988).

⁷³ See Soia Mentschikoff, Peaceful Repossession Under the Uniform Commercial Code: A Constitutional and Economic Analysis, 14 Wm. & Mary L. Rev. 767, 779 (1973).

⁷⁴ Self-help repossession is well established in Canada. For example, the Saskatchewan Personal Property Security Act, section 58(1) is quite specific in providing that upon default the "secured party (including a receiver) has, unless otherwise agreed, the right to take possession of collateral or otherwise enforce the security agreement by any method permitted by law." Indeed, the right to self help repossession is so entrenched in the common law jurisdictions of Canada, that few cases arise in which question the legitimacy of the creditor's right to repossess the collateral. The disputes that do occur frequently focus on some other issue. For example, the secured creditor may seek a court order preventing the debtor from interfering with the repossession, or the debtor may claim that notice should have preceded the self-help repossession. See Costley v. Pioneer Credit Union (1992), 2 Personal Property Security Act Cases (2d series) 212 (Saskatchewan Court of Queen's Bench); and Bank of Montreal v. Judges (1991), 1 Personal Property Security Act Cases (2d series) 212 (Ontario Court of Justice), respectively. We are thankful to Prof. Ron C.C. Cuming for these comments.

⁷⁵ See Carta Orgánica del Banco Agrícola Boliviano, article 5 [Prenda] (Bolivia).

possession of the collateral upon the debtor's default.⁷⁷ In taking possession, a secured party may proceed without judicial intervention, only if he is able to do so without causing a breach of the peace. If the security agreement so provides, the secured party may require that the debtor assemble the collateral, and make it available to the secured party, at a time and place designated by the secured party, as long as it is reasonably convenient to both parties.

In the most economically effective legal drafting, harmless repossession must be provided for by the law regardless of whether the parties provide for such right in their agreement. An alternative solution, that appears superficially attractive, would permit the alternative of harmless repossession only where the parties agreed to it in the security agreement. Under some views, such a proposal would protect private repossession from a constitutional challenge that might arise on the grounds that the procedure permits a deprivation of property without a court hearing. However, such a strategy would probably not avoid constitutional challenges because if the right is a constitutional right, then parties cannot waive it by agreement.

Moreover, there are three important disadvantages associated with requiring the parties agreement to harmless repossession: First, it may diminish the rights of creditors that are careless in drafting the security agreement; second, it may not be enforceable against third party possessors of the collateral, because in the case of third parties, such a clause in the agreement would most likely be ineffective; and third, it may not protect debtors in situations in which there is unequal bargaining power between the debtor and the creditor.⁷⁸

The law will allow a secured creditor to proceed with non-judicial, self-help repossession only if the debtor does not actually and physically object at the time of repossession.⁷⁹ This means that a creditor must back off upon any actual objection by the debtor at the time of repossession. This provision is crucial to the proposed self-help procedure because it discourages conduct that may incite violence, such as where a debtor physically sits in the car and refuses to step out of it when the creditor seeks to repossess the vehicle. This requirement is not intended to protect debtor's rights of due process or property. Rather, it addresses the public policy concerns, and seeks to prevent a breach of the peace.⁸⁰

The law will require a creditor to notify the debtor that he is in default and why he is in default. The debtor's right to due process imposes this requirement because only a debtor on notice of his default can seek judicial protection of his rights to the collateral. The appropriate timing of the notification must be determined.

⁷⁷ See U.C.C. 9-309 and its official comments.

Default is an omission of that which ought to be done. Specifically, the omission or failure to perform a legal or contractual duty; to observe a promise or discharge an obligation (e.g., to pay interest or principal on a debt when due); or to perform an agreement. Black's Law Dictionary (6th ed. 1990). Note that the Uniform Commercial Code does not define default, rather it leaves the definition to the agreement of the parties. Barkley Clark, The Law of Secured Transactions Under the Uniform Commercial Code, ¶ 4.02 [1] at 4-4 (2d ed. 1988).

⁷⁸ We thank Alejandro Garro for pointing out this limitation vis-a-vis third parties.

⁷⁹ Public policy should bar the secured creditor from "taking justice into his own hands" when the debtor refuses to cooperate with the creditor.

⁸⁰ For example, in the United States, where in some states debtors have the right to resist by all lawful and reasonable means a nonjudicial take-over, a similar rule has developed to lessen the risk of a breach of peace. Stone Machinery Co. v. Kessler, 1 Wash. App. 750, 463 P.2d 651 (1970); Deavers v. Standridge, 144 Ga. App. 673, 242 S.E.2d 331 (1978).

The law will allow the parties to define default in the security agreement.⁸¹ Further, the law will stipulate that the debtor's default gives the creditor the right to take possession of the collateral or its proceeds. Such provisions will enable the creditor to apply the appropriate industry standard or trade practice for the particular collateral involved. This will allow creditors to define default in a way that allows a creditor to repossess in situations where the creditor's claim may be threatened. For example, the agreement may provide that the debtor would be deemed in default if the debtor is served with a tax lien, files for bankruptcy or if the creditor, in good faith, becomes concerned over the prospect of payment or performance by the debtor.⁸²

The law must provide that the general public will have direct access to all registries where security interests and liens in movable property are filed. This direct access will allow a third party to immediately identify the creditor and the specific collateral to which the creditor holds a right.

The law providing for the self-help procedure must clarify its application vis-à-vis any existing laws protecting possessors, regardless of whether or not they have a right to that property, and which seemingly conflict with the self-help procedure.⁸³

The law will not permit creditors to use force in repossessing collateral. Where creditors act in an abusive or otherwise inappropriate manner, debtors will be given the right to seek a temporary restraining order⁸⁴ against self-help repossession and disposal of collateral.

In many proposals, wrongful repossession would also be punishable by a substantial fine (relative to per capita income in the country). . This penalty will apply even if the debtor has not suffered any economic loss. Moreover, the creditor will be subject to any tort liability, which he may have incurred.⁸⁵ This statutory penalty is justified because a suit for compensatory damages may provide inadequate compensation for many small loans. Alternatively, the procedure may adopt a flexible penalty computed based on the original principal amount and the total interest charge at the original rate.

In case of wrongful repossession, the procedure must not enable the creditor to collect any deficiency between the amount realized on resale, and the outstanding balance on the loan.⁸⁶

⁸¹ This requirement is modeled in UCC § 9-501(1), which reads "[w]hen a debtor is in default under a security agreement..." and where then, the key term "default" is nowhere defined. The omission was intentional and was based on the argument that the parties should define the events constituting default.

⁸² U.C.C. 1-208. See also, *State Sec. Sav. Co. v. Pelster*, 296 N.W.2d 702 (1980), *Van Biber v. Norris*, 419 N.E.2d 115 (1981).

⁸³ For example, in Argentina these include Articles 2468 to 2501 of the Civil Code, Articles 606 to 622 of the Federal Civil and Commercial Procedure Code and similar provisions in provincial procedure codes. Julio Kelly and Alejandro Garro provided the authors with these citations.

⁸⁴ The hearing on the temporary restraining order would not be limited to disputes about the amount due, but may include other issues. If a country does not provide for an expeditious and costless means of obtaining a temporary restraining order (*medida de no innovar*), the procedure itself must establish such provisions, because the constitutionality of the self-help procedure rests on the ability of the debtor to obtain judicial protection of his rights.

⁸⁵ Furthermore, it may be if the debtor has a cause of action to sue the creditor to recover these damages under an abbreviated procedure.

⁸⁶ Ronald C. Cuming, in "Collateral Repossession in Canada", (April 22, 1994, unpublished paper on file with CEAL, at 10), points out that Canadian laws are more favorable to creditors that wrongfully repossess collateral. In most Canadian provinces the secured creditor's misconduct raises a presumption that the value of the collateral is equivalent to the amount of the debt, hence precluding the secured creditor from suing the debtor for the deficiency. However, even under the Canadian system the creditor may still be entitled to a deficiency judgment if he can establish that this misconduct had no economic effect on the debtor. The situation under Article 9 is otherwise. There is no clear

That is, the law must preclude a secured creditor from collecting a deficiency payment from the debtor if he wrongfully repossesses the collateral, even if the wrongful repossession did not result in any economic harm to the debtor.⁸⁷

b) Administrative repossession

Where self-help repossession refers to a non-judicial repossession administered by an individual or the individual's agents, administrative repossession refers to a non-judicial repossession administered by non-judicial public or private parties hired or paid to undertake repossession. Under administrative repossession,⁸⁸ licensed private parties will issue ex parte⁸⁹ repossession orders. The secured transactions law will establish which private parties can be licensed. Potential candidates for a license are arbitrators, registry officials, notaries, accountants, chambers of commerce, attorneys, and policemen. The orders will be enforced by the regular police or by a "licensed deputy police."⁹⁰

This system is similar to administrative foreclosure procedures found in other countries. For example:

In Peru the "Registro Fiscal de Ventas a Plazos" provides a quick method for collecting the unpaid balance of an installment sale without court intervention. This enforcement procedure is limited to secured transactions in which the collateral is identified by number and sign, hence it has been effective in financing easily identifiable goods such as identified agricultural machinery.⁹¹

The state of New York has adopted a private procedure for garnishing wages of parents who are delinquent in their child support payments. The New York Support Enforcement Act of 1985 authorizes an attorney to issue, without a court order, an income execution order⁹² against a parent in default of court-ordered child-support payments.⁹³ The Act also authorizes the creditor's attorney to issue a similar income execution order upon the debtor's current or

support under UCC § 9-507 for the proposition that the creditor's misconduct precludes the debtor's liability for the deficiency. But, in most states, in the case of security interests in consumer goods, failure to give notice of the sale of the collateral precludes the creditor from obtaining a deficiency judgment. See *Wilmington Trust Co. v. Conner*, Supreme Court of Delaware, 415 A.2d 773 (1980). We are thankful to Prof. Ron C.C. Cuming for bringing up these issues.

⁸⁷ See UCC § 9-507 (1), which refers to a flexible method for computing the fine applicable to a secured creditor with a security interest in consumer goods that fails to comply with the requirements of Part 5 ("an amount not less than the credit service charge plus ten per cent of the principal amount of the debt or the time price differential plus 10 percent of the cash price").

⁸⁸ The term administrative repossession is used because those private parties, who are licensed by the state, would be acting on behalf of the state administration.

⁸⁹ Orders issued without giving an opportunity for opposition.

⁹⁰ See *infra*, part II.A.4.

⁹¹ See Pedro Sagastegui Urteaga, *Procesos de Ejecución y Procesos Cautelares*, Editorial San Marcos, Lima, 1993, at 225. See also Ley 6565 of March 12, 1929, regulated by Supreme Decree of June 6, 1929, and Ley Orgánica del Ministerio de Industria y Turismo (Legislación 1969 a 1993).

⁹² Issued where a judgment debtor is receiving more than a specified income per week from any person, and which provides for the collection of a specified percentage of such income in satisfaction of the judgment. The judgment debtor is given notice to commence payment of specified installments to the sheriff, upon default of which the execution will be served upon and enforced against the person from whom he is receiving the income. 30 Am. Jur. 2d 884, Executions § 787.

⁹³ N.Y. Civ. Prac. L. & R. 5241. (McKinney 1978). The procedure applies also to the enforcement of a separation agreement obligation, which is incorporated into a divorce judgment.

subsequent employers, or upon any other person obligated to pay income to the debtor. Upon the attorney's request, the state is compelled to withhold the tax refunds of parents who are delinquent in child support payments.⁹⁴

In Uruguay and Argentina, the charter of their Banco Hipotecario's Establishment Law (Carta Orgánica) permits the Banco Hipotecario to foreclose on a real estate mortgage in default without the judicial intervention.⁹⁵ To the extent that the Banco Hipotecario is an instrumentality of the state, this is a case of genuine "administrative" repossession. Using the same analysis, under this proposed administrative repossession process, licensed private parties would become instrumentalities of the state, and thus any repossession orders they were to issue would be "administrative".

(1) Main Features

The law will authorize the government agency to license individuals and corporations to issue orders for repossession of collateral. The law will provide that upon default, a secured party can seek an ex parte order for repossession of collateral from such licensed reposessor. The licensed reposessor will be required to issue such order upon verifying the security interests and the default.

Many features of harmless repossession also apply here. Other specific features include the following:

The security agreement may or not include a consent clause, which would allow the creditor to use this administrative procedure for the repossession and sale of the collateral.

This procedure will require the enactment of provisions, which regulate the licensing of individuals, and which establish their liabilities.

The relevant associations, whose members are eligible for licenses, must provide a guarantee to the debtor against a wrongful issuance of a repossession order. The law will require the licensed private party to post a bond. Such bond will be a precondition to obtaining a license. Both, individuals or corporations could be licensed; hence the bond requirement should work as sufficient incentive to act appropriately in their dealings with creditors and debtors.

A licensed private party will be required to immediately issue a repossession order only after the secured creditor provides him with specific documentation, such as evidence of the security agreement and of the registration, and an affidavit by the secured party verifying the failure to comply with the loan terms.⁹⁶

The procedure will require a creditor to seek a repossession order within a specific time period.

The procedure will require that the licensed private party notify the debtor of the pending repossession order. This will satisfy the constitutional requirements of due process by giving the debtor the opportunity to challenge the creditor's right to the collateral in court, and to enjoin its repossession and sale. Alternatively, this will give the debtor the opportunity to correct the

⁹⁴ In the United States, attorneys are prevented from maliciously or falsely issuing such orders by the ethic rules of their Bar Association. They may be sanctioned or even disbarred for violations of these rules. They may also be subject to malpractice liability for wrongs against their clients.

⁹⁵ See Argentina, "Carta Orgánica del Banco Hipotecario, and Uruguay, Carta Orgánica del B.H.U. Art. 81.

⁹⁶ The author is grateful to Roberto Muguillo for this suggestion.

default by paying the amounts due. The timing and form of debtor notification must be determined.

The procedure will impose severe civil and criminal penalties on licensed private parties that disobey any court order.

The local police or licensed deputies (described below) can enforce the repossession order.

The licensed private parties may also order the garnishment of money and any other proceeds of collateral which are held by a third party, including banks. The law will establish penalties for third parties that disobey these orders.

The repossession order will continue even if another creditor levies an attachment on the goods, or if the debtor dies, or becomes incapacitated. Bankruptcy rules must be amended so that the repossession procedure will not be suspended should the debtor become bankrupt.

c) Licensing deputies (private or semi-private police) to order the repossession or eviction and to repossess or evict using force

This option additionally certifies licensed private parties as deputy police with powers to enforce repossession and eviction orders. In other words, a licensed private party will have the authority to issue a repossession or eviction order and the police power to effectively execute them. The creditor would file his request for seizure directly before these deputies. This option would be beneficial because the regular police do not expeditiously execute orders affecting property rights.⁹⁷

Alternatively, the procedure would not license deputy police, but rather, would provide that the creditor can file a request for seizure or eviction directly with the regular police. Then, the police can effectively enforce the order after obtaining a certificate from the registry. Provisions must be included in the procedure to shorten the period in which the regular police must execute repossession orders.

(1) Main features

These licensed private police will be dedicated exclusively to the repossession of collateral or eviction of occupants from real estate. It will be their responsibility to: (1) verify that the creditor has a perfected security interest in the collateral, (2) verify that the debtor is in default, (3) order the repossession or eviction of the collateral, and (4) execute the order by taking possession of the collateral and giving it to the creditor. Further research is needed to determine the exact magnitude of the problem, and to determine the manner in which such a dedicated police unit could be efficiently structured.

The licensed private deputy could authorize and execute the repossession after (1) verification from the registry that a perfected security interest exists, and (2) a sworn affidavit from the secured creditor that the debtor is in default. No judicial or arbitral order would be necessary. Some share the opinion that the process is unlikely to withstand a constitutional challenge and it may be delayed through subsequent judicial challenges. However, in Argentina, for example, the process would better suited to stand these challenges by requiring a certification from the registry. The intervention of an administrative organ (the registry) in the process in

⁹⁷ Comments provided by Dr. Julio Kelly and Prof. Alejandro Garro. They regard it as unlikely to withstand a constitutional challenge and it may be delayed through subsequent judicial challenges.

Argentina may be crucial if the procedure is to be constitutionally valid.⁹⁸

The procedure would also apply to the garnishment of money belonging to the debtor but held by financial institutions, and to amounts owed to the debtor by third parties.

9. Preserving due process of law under non-judicial repossession

Do the proposed repossession procedure violate a debtor's rights to due process under Argentine, Bolivian and Uruguayan constitutions? They will not. A procedural law may regulate when a debtor's right to defend his interest in collateral arises or is lost, the potential defenses that may be raised, and the applicable limitations of those defenses.⁹⁹ The proposed repossession procedures would specify that the debtor may defend his rights before or during repossession, through a temporary restraining order or some other judicial action. A debtor must receive notice of the default and a sufficient time period to cure the default. Further, if the debtor has a legitimate claim or defense, he can stop the creditor from repossessing the collateral within the specified time period.

Crucially, the proposed private procedures shift the burden of pursuing judicial litigation to the debtor. Why should the burden shift? For the same policy reasons that prompted Argentina, Uruguay, Bolivia and other civil law countries to establish a summary proceeding known as *procesos ejecutivos* (executory process) also called *procesos monitorios*. The *procesos ejecutivos* are quick procedures for disposing of a claim only after a showing of highly probative evidence. Later, the debtor may sue the creditor for relief under the *procesos ordinario* (ordinary process).¹⁰⁰ Shifting the burden to the debtor allows the creditor to liquidate the collateral in a shorter period, and hence reduces credit costs.

Moreover, this constitutional analysis of the procedure is supported by the fact that the creditor also enjoys a property right that the constitution protects. Given that the creditor has a valid security interest, and a security interest is a property right, then creditors should be

⁹⁸ For example, Argentine courts have upheld the constitutionality of Article 39 of the Pledge Law, reasoning that the registry of pledges (licensed to private notaries in Argentina) works to certify the existence of the pledge. See *infra* part II.B. at ¶ 66 and note 42 for a quotation of the Argentine Supreme Court's rationale.

⁹⁹ See Argentine Constitution, Article 14. See also judgments of the Supreme Court; *Ercolano, Austín of Julieta Lanteri de Renshaw, s/ consignación*, Fallos 136:161; *Avico, Oscar Agustín c/ Saúl G. de la Pesa s/ consignación de intereses*, Fallos 172:21.

¹⁰⁰ Amendments introduced to the French New Code of Civil Procedure in 1981 provide an innovative (and apparently quite effective) balance between the needs of expediency and traditional notions of due process. Under the new code, the traditional three-judge panels do not operate any longer as such. Under the new rules, the complaint is reviewed only by the presiding judge, who must try to settle the case before it goes to trial. If the parties refuse to settle, the case is assigned to a single judge (*juge de la mise en état*) in charge of dealing with preliminary matters (Arts. 755-787).

The most interesting amendment for our purposes is Article 771, providing that if existence of the claim appears "not to be in reasonable doubt", the judge may **grant an advance to the plaintiff on the eventual damages that the plaintiff may recover in a final judgment**. If necessary, the plaintiff must provide a bond. In short, the court may anticipate an award of damages to the plaintiff if it appears "prima facie" that the plaintiff will win the suit. It has been reported that a significant number of suits in France end at this stage. Having obtained a recovery of some importance, the plaintiff may decide not to prosecute the action further in order to save litigation costs. On the other hand, once the defendant receives an indication as to how the three-panel court is likely to rule, he too may not wish to continue with the suit, if he thinks that he is likely to lose and will have to pay an even greater amount in damages.

It seems that this preliminary "advance" allowed under the new French rules on civil procedure is another attempt (as in the *proceso ejecutivo*) to reconcile the right to due process with the need to obtain a swift decision.

The authors are grateful to Alejandro Garro for presenting this example.

protected on their security interest in property.

a) Public policy concern of preventing violence

It may be argued that the proposed procedures could incite violent and abusive conduct by creditors. However, experience in other countries with private repossession procedures has been positive.¹⁰¹ Empirical studies undertaken in the United States indicate that the benefits of non-judicial repossession outweigh the costs because requiring judicial intervention in repossession does not necessarily reduce the risk of abusive conduct by the creditor.

In the Canadian provinces that have adopted harmless repossession, breaches of the peace and other abuses rarely accompany seizure. The enduring support in other systems for seizures conducted by a public official is attributable mainly to the cost savings that secured creditors are able to realize by having a government official seize the collateral for them (rather than incurring the repossession costs themselves), and not to a concern with breaches of the peace.¹⁰² The experience in the United States reveals that once debtors know that they will lose the collateral, they voluntarily agree to give up possession.¹⁰³

b) Invitation to abuse debtors -- other rights the constitution might protect

One may argue that self-help repossession procedures are per se unconstitutional if they are an invitation to violence. One can identify at least one scenario in which abuse may arise. However, this constitutional challenge is a weak one:

Experience has shown that private repossession procedures do not encourage breaches of the peace. There is no evidence to support the argument that jurisdictions that allow self-help repossession necessarily experience a greater incidence of breaches of the peace, than jurisdictions that require judicial intervention.¹⁰⁴ In places such as Spain and Peru, which allow the private enforcement of mortgages and conditional sales, and in the State of New York, which permits the private garnishment of child support payments, such repossessions are carried out peaceably.¹⁰⁵

c) Whether a non-public party may authorize the use of force

Should a licensed private party entitled to order the repossession of collateral also be empowered to order the use of force? Some would argue that they should not. However, the actions of licensed individuals are similar in substance to governmental administrative acts. Since administrative acts are immediately enforceable, the due process standards require that a debtor be allowed to challenge the act by seeking a temporary restraining order or some other form of judicial relief. If the same protections were afforded a debtor after an order from a licensed private party, the debtor has equivalent protection and there is no reason to deprive the

¹⁰¹ Self-help repossession in the United States has generally been a positive solution. See Johnson, *supra*.

¹⁰² This has been the experience in Alberta, Canada, and in Honduras for loans secured with automobiles.

¹⁰³ "The possibility of [private] repossession may provide considerable incentive for the debtor to agree to an amicable arrangement." See James White & Robert Summer, *Uniform Commercial Code* at 570 (3rd ed. 1988).

The data gathered by Prof. Johnson indicates that, in numerous cases, repossession is achieved with the cooperation -- or at least submission -- of the debtor. Thus, one financier reports that in almost 62 percent of the default cases, repossession was accomplished through voluntary relinquishment of the collateral after the initial creditor-debtor contacts, and the remaining 38 percent of repossessions were self-help. See also Johnson, *supra* at 95.

¹⁰⁴ See, James J. White, *The Abolition of Self-Help Repossession: The Poor Pay Even More*, 1973 Wis. L. Rev. 503, 525.

¹⁰⁵ *Supra*, part II.A.2. ¶ 28-30.

private party of the power to order the use of force.

The same is true for the administrative foreclosure of property, which is similar to other administrative acts. Using this reasoning, the Argentine and Uruguayan Supreme Courts have upheld the Banco Hipotecario's administrative foreclosure of real property. For example, the Argentine Supreme Court has stated that "to declare a law unconstitutional, it is not enough that [the law] establishes, for special cases, a summary procedure . . . nor [is it enough] that the law authorizes the Banco Hipotecario to foreclose without judicial intervention . . . [T]hese procedures do not exclude the possibility of challenging the performance of the contract or any other matter in a proceso ordinario . . . Administrative foreclosures, based in a freely negotiated agreement between the parties, and with the foundation of general need and convenience, have been admitted by the jurisprudence of this court."¹⁰⁶ Similarly, Spain, has upheld an extrajudicial procedure for real estate mortgages, enforced by notaries.¹⁰⁷ The law was enacted in 1992 because slow mortgage executions, under the exclusive competence of the judiciary, were impairing the availability of credit.

Argentine courts also have upheld the constitutionality of the ex parte court order for seizure under Article 39 of the Pledge Law on these grounds. Since the registry of pledges (licensed to private notaries in Argentina) certifies the existence of the pledge, this registration qualifies the procedure as an administrative foreclosure.¹⁰⁸

d) The right to private property

The proposed procedures do not violate the debtor's constitutional rights to property because the constitution allows parties to consensually allocate property rights among themselves consistent with the principles of freedom of contract. These principles permit a debtor to relinquish any rights in collateral.¹⁰⁹

e) Validation of the procedures against bankruptcy

The above procedures may conflict with bankruptcy laws in effect in these countries. Where such conflict exists, the bankruptcy laws should be amended to protect the rights of the repossessing secured creditor faced with a debtor that files for bankruptcy. Otherwise, bankruptcy laws would prevail against procedural provisions in a secured transactions law. For example, in Argentina, the appointment of a receiver by agreement of the parties may conflict with the provisions of Bankruptcy Laws. In addition, foreclosure should continue even when a

¹⁰⁶ *Fallos Corte Suprema de Justicia de la Nación (CSJN), 1944, Recursos de hecho deducido por Amaya Lorenzo y Nicanor en los autos Fisco Nacional c. Amaya Lorenzo y Nicanor.* Later court cases applied the same reasoning as this case and refused to find that Art. 39 of the Pledge Law violates the constitution.

¹⁰⁷ *See* Royal Decree 290 of March 27, 1992. Bulletin Oficial del Estado, April 24, 1992.

¹⁰⁸ *See supra*, part II.A.3. This was the controlling rationale supporting the constitutional validity of Art. 39 in Argentina. *See* Fallos CSJN "Recurso de Hecho deducido por Poggio, Marta del Campo de; Poggio, Jose Victor, y Saavedra, Delia Josefina Poggio de, en la causa Fernandez Arias, Elena y otros c/ Poggio, Jose (sucesión) at 652.

¹⁰⁹ "These patrimonial rights, equivalent to the right to property, regardless of their constitutional protection, may be validly waived by the parties; this means that the constitution does not oppose private parties who surrender these rights, and that when this occurs, there is no constitutional violation, nor any constitutional protection to claim." Fallos CSJN Vol. "Recurso de Hecho deducido por Poggio Marta del Campo de; Poggio, Jose Victor, y Saavedra, Delia Josefina Poggio de, en la causa Fernandez Arias, Elena y otros c/Poggio, José (sucesión)." at 652.

Thus, it has been held that a debtor's consent to the creditor's retention of the pledged collateral in payment of the debt does not constitute a violation of public policy. *See* CN Com B 15-4-66, Kleiban, A c/ Suarez, O y otro. *See also*, Cámara, Prenda con Registro o Hipoteca Mobiliaria, Ediar, Buenos Aries, 1961, p. 508 and Cámara Nacional en lo Comercial de la Capital Federal, Jurisprudencia Argentina, T. 51, at 244; t. 60 at 588.

debtor files for bankruptcy. For example, although the repossession procedure of Article 39 of the Argentine pledge law, as it applies to banks, is quick, it ceases to be valid after a debtor files for bankruptcy. Consequently, banks opt for the slower procedure of *ejecucion prendaria*, and do not take advantage of Article 39.¹¹⁰ In addition, the procedural reforms must be harmonized with consumer laws and exempt property protection laws.

- **Lessons Learned**

- **Privatize repossession**

A private repossession system, couched in system that provides the right checks and balances to debtors and creditors, will yield the most value in collateral to the private sector. Even industrial country courts cannot supply the speed possible with private repossession systems. Different constitutions and judicial interpretations may limit the private role, but the objective should be to maximize its presence. This is particularly true in developing countries where judicial systems are major governance problems and judicial reform will occur only after a long investment.

- **Privatize sale**

While there are important public policy problems in privatizing repossession, privatizing sale should always be a clear objective of reform. In no developing country is court administered sale work in way useful to either creditors or debtors. Court administered sale split the proceeds between court maintenance and payments to a group of semi-private functionaries who are connected to the courts but add not other value to the process.

- **Explore licensed state agents to back up private parties**

Some threat of the use of force usually needs to back up private repossession and sale systems. Explore various combinations of license private agents and non-judicial public officials to supply that force without the use of judicial intervention. As with all systems, competition in supply provides the best service. Use a standard of “commercially reasonable sale” in place of awkward codified sale processes that are neither fair nor efficient.

- **Introduce cheap mechanisms for appealing and enforcing creditor abuse**

Arbitration based systems, fee based petty claims courts that operate competitively, all can provide quick enforcement for violations of the procedures for repossession and sale. The existence of such procedure will quell judicial concerns that new provisions violate due process. Such procedures will contribute to eliminating welfare losses that would undercut the large economic gain from the reform.

- **Streamline relevant court procedures**

Specify rapid “ex parte” court orders for forcible repossession and eviction

- **In undertaking property rights reform, do not presume that the mortgage system works or covers other important property rights**

The reform of the laws on secured transactions should crucially include real estate collateral. Most studies in the 1990s refer to the mortgage laws and emphasize their economic importance.¹¹¹ However, World Bank land titling projects reviewed in Latin America have not included the mortgage law as a component (e.g., Nicaragua¹¹² and Guatemala¹¹³); these projects

¹¹⁰ Information obtained in private interviews with bank attorneys.

¹¹¹ See, for example, United Nations, Economic and Social Council, Committee on the Development of Trade, Working Party on International Contract Practices in Industry, Forty-Fourth Session, 13-15 November, 1995, item 4 of the provisional agenda: “Guide on the Adaptation of Real Property Laws in the Countries of Central and Eastern Europe Including Questions of Ownership, Valuation, Security, Restitution, Property Management and Brokerage,” at p. 27 par. 153, and 335-368.

¹¹² [Agricultural Technology and Land Management Project](#) P007780, 44 IBRD/IDA Nicaragua, Closed 20-JUL-1993.

*incorrectly assumed that mortgage laws in these countries work well and need not be revised.*¹¹⁴ *Mortgage law components were often included in countries where there was no prior mortgage law before. Even then, the laws introduced in the early 1990s were very defective in addressing the key creation, priority, publicity and enforcement problems in real estate (e.g., Ukraine).*

IV. Other Laws Governing Business, Commerce, and Investment

What rules govern the entry of businesses into the market? What rules govern the operation of different businesses -- partnerships, sole proprietorships, and corporations? How are these rules enforced? What are fundamental economic functions of a business registration system: registration addresses public policy problems contract enforcement question by permitting one business to "officially" find another business to serve process and sue to settle under liability claims; permit one business to discover whether a business employee has the right to obligate a business. When transactions costs for torts are low (see below) the law's structure of business liability can economic efficiency by "internalizing" externalities. Can drive absolutely inefficient businesses out of the market.

A. Legal Problems in Entry: Licensing, and Registration of Businesses

What rules govern the entry of businesses into the market? What rules govern the operation of different businesses -- partnerships, sole proprietorships, and corporations? Are these rules economically efficient? How are they enforced?

A business registration system serves a central economic functions in contract enforcement: the registered address permits one business to "officially" find another business to serve process and sue to settle liability claims. It serves a key economic function in stating whether a business employee has the right to obligate a business and permitting lenders to discover this. When transactions costs for torts are low (see below) the law's structure of business liability can economic efficiency by forcing firms to "internalize" costs that are external when the tort system does not work. This makes the private market better at driving absolutely inefficient firms out of business.

In some developing countries more than half the total businesses operate informally. "Informal" means that these businesses do not follow the legal requirements set out by the law for registering a business. Why? First, the law often sets out unreasonable, difficult and expensive requirements. They reach well beyond the public policy and business development justifications for commercial registration. Inform firms find those legal requirements expensive and see their effect mainly in increasing their chances of being taxed. At the same time, because of other problems in the legal framework, registration does not change their access to credit. Without expanded access to credit, becoming formal rarely enables small firms to get large contracts to deal with other formal sector firms. Faced with those high expected costs and low expected benefits, most rural micro businesses and even SMEs operate informally. Farmers may face greater hurdles, as some laws classify them as non-commercial entities that cannot operate as businesses at all.

¹¹³ [Land Fund Project](#) P054462, 23 IBRD/IDA Guatemala Active 07-JAN-1999

[Land Administration Project](#) P049616, 31 IBRD/IDA Guatemala Active 03-DEC-1998.

¹¹⁴ This may explain why land titling projects have not yet increased access to credit with the security of real estate. See for example, "Study Looks at Squatters and Land Titles in Peru" By Alan B. Krueger, New York Times, January 9, 2003, citing the study of Erica Field, a Ph.D. student in economics at Princeton University, available from www.irs.princeton.edu.

1. *Business and company registration*

A simple economic objective underlies commercial or business registration: a business should establish a certain domicile with the public so that the business can be found "legally" for purposes of contract enforcement or in case it causes damages, such as not paying its taxes, owing penalty fees for improper waste management, or owing a tort claim. It also provides a place for designating officials with the power to obligate the firm, facilitating business transactions. Almost every legal system provides for some form of business registration.

However, laws in most developing countries go far beyond these basic public policy objectives. For example, in El Salvador, among other requirements, the law asks for annual audited tax returns; corporate documents signed in a notary public deed; paper filings in person in the registry; and certificates related to the business real estate establishment, to name a few. In addition, the commercial registry office in most developing countries is in complete disarray. Long lines, bad service, errors and fraud are common complaints. As with the registration of security interest, which in many countries takes place at the same commercial registry, state and monopolistically run registries rarely serve the public well.

Box 8. Costa Rica: Privatizing a Business Registration System:

CEAL's design of a one-stop-shop for business registration for Costa Rica (Inter-American Development Bank project) calls for operation of an integrated business registration system electronically linked to existing government data bases and offices. A consortium of NGOs, including the chamber of commerce and chamber of industry will run this archive. Designing an organization where service vendors compete is crucial in avoiding the problems of ordinary monopolistic privatizations of public services. Before the system is set up, the legal framework will be reviewed and changes proposed. Similar opportunities arise in organizing arbitration, processing bankruptcy, and filing security interests against land rights.

2. *Other licensing requirements*

In addition to registering to do business, farmers and merchants must also comply with numerous other legal requirements and licenses, each often imposed by a separate government agency. For example, in Costa Rica there no coordination exists among these agencies and the farmer or business must consecutively undertake each step repeating the documentation that it must submit. These add costs, in terms of time and money, to entering the formal business community.

IRIS at the University of Maryland, the Foreign Investment Advisory Service of the World Bank, the US Agency for International Development, and some World Bank Projects have supported one-stop systems for the formalization of companies, for tax collection, or for exports procedures.

However, one-stop shops do not address the legal restrictions to business entry, because they do not include a legal reform component of the substantive and procedural laws that govern the first stage of creating a business or incorporating a company.

For example, in some countries businesses may suffer high costs from extensive procedures before multiple ministries, and there is little coordination among ministries in imposing permits, licenses, and reporting requirements on businesses. Development of a one-stop shop for permits, licenses, approvals, and inspections has proven to be an effective and popular approach in many countries to make it easier for businesses to deal with paperwork. For

example, the Ukraine People's Voices Program, supported by the World Bank and other donors; and the Model Customs and Tax Center (MCTC) in Egypt, supported by USAID, are examples of what has been reported as successful one-stop shop projects. The Foreign Investment Advisory Services has also undertaken technical support for one-stop shops.

However, one-stop shops do not deal with removing the underlying legal barriers to business entry unless they reform the law. Moreover, they deal with the development of simple, cheap, and easy registration processes and business friendly one-stop-shop arrangements, but they often do not revise the laws that give rise to such processes to begin with.

For example, in Costa Rica, businesses must undergo procedures before several ministries before they can "legally" begin to do business. The Costa Rican government is now pursuing a project to set up a one-stop shop for these processes. However, in the first legal step a business must register to do business as an individual merchant, or incorporate as a legal entity. Here, Costa Rica's Commercial Code sets out extensive requirements that are costly without meeting a public policy objective to outweigh such costs. These include legal provisions that demand filing before the commercial registry only paper documents, expensive notarized documents, and filing annual audited financial statements, among many other requirements. Moreover, the Commercial Code sets out a Commercial Registry administered by the government under a monopolistic framework. The commercial registry provides very poor services to the public in comparison with advance commercial registries around the world. The one-stop project in Costa Rica may improve the licensing and permits once a business entity is created, or a merchant is registered to do business. The project may even improve the internal equipment processes inside the Commercial Registry. However, unless the project revises the Commercial Code, it will not address the legal barriers to create a business or a company. Similarly, FIAS work, acknowledges many legal barriers, but does not propose changing these laws, and rather focuses on the administrative barriers.

Box 9. Quick Fix: Exclude Small Business and Farmers?

The best fix usually does not lie in a blanket exclusion of small businesses and farmers from environmental certification or other commercial law requirements, as it is incorrectly the case in El Salvador Commercial Code. Small businesses excluded from the commercial registry get none of the benefits of formalization. Quite the contrary, the benefit to public health of many environmental regulations far outweighs their costs. Often, small businesses and farmers pose as great risk to the environment as large ones. For example, a farmer who dumped toxic material into the water and killed two families in Bolivia caused great damage even though a poor small farmer.

Lessons Learned

As in any registry reform, the first and most important step lies in thoroughly reviewing the commercial and other business laws that set the requirements for entering the formal business sector. Such a review should present a detailed analysis of the law's costs and expected benefits, including the public policy objectives they espouse.

Quick fixes rarely work (see box). Rather, the analysis should evaluate each legal requirement, the procedural steps it encompasses, and the options for minimizing the costs in both time and money to comply with them. For example, when the requirements are administered by six different agencies, the best intervention lies in designing a "one-stop-shop" for business registration that centralize all requirements at once. Such registration system can

further permit private and competitive sustainable operation.

However, one-stop shops systems are different from legal reforms. These systems, in and of themselves, are not systems that may solve the legal problems. Some may work with regional and municipal authorities in order to promote the relationship and communication between the public authorities/administrations and the citizens of that region/city. Others may automate different licensing offices in one system. One-stop shop projects address the above-mentioned legal problems only if such legal reform became also part of the work (e.g., in the Costa Rica Ventanilla Unica project of the IDB, legal reform is one of the activities). One-stop shops will not reduce the costs of business registration to the degree that they do not address the legal reforms needed.

We found no evaluation reports on the reforms of business and company registration, or evaluation of one-stop shop projects, and how to measure improvement in this field is difficult. USAID has developed some standards. Many of these standards are based on measuring the number of companies registered after a reform. This, however, will not actually tell us that the system works better, maybe business development increased too. Instead, the next generation of projects that aim at addressing the business environment will benefit from including legal reform components that specifically attend to revising these legal restrictions. Such work, instead of focusing of following international best models, could be set up under economic indicators, and standard objectives of lowering the registration costs compared to the county's citizens average income, and monitoring such progress.

As to further requirements to conduct business, the evaluation and monitoring activities could then be extended to one-stop shop systems. In the 1990s, government's set up of one-stop shops, such the one-stop shop for business exports in Bolivia (Ministerio de Comercio 1991) and the one-shop for exports in Argentina (Ministerio de Economía 1999), have not focused first on derogating or revising legal and regulatory provisions that demand unnecessary permits, licenses, filing or reporting requirements. In 1992, interviewees described the Bolivian system as just a window, because then it will still take as long and be as expensive as before. Care in setting up one-stop shops projects in the future may benefit from not automating legal and regulatory requirements that impose costs without a public policy gain that outweighs such costs. Therefore, further work on this area could benefit by first undertaking a careful economic assessment of these laws and regulations, and revising them when necessary, and only then, automating and streamlining processes and/or creating one-stop shop institutions.

B. Reform the Commercial Code

The World Bank could achieve more economic impact in private sector development, in particular in SME development, if it were to support the reform of the commercial codes' provisions that limit the legal registration of business and companies. Such reform should govern rural business, remove economically unsound provisions, and introduce the minimal set of rules needed to register a modern business or company.

C. Contract Enforcement¹¹⁵

Well-developed legal systems have several ways to enforce contracts. The earlier section on secured transactions discussed one system -- enforcement of a loan contract or other transaction secured by collateral. The secured transactions enforcement system may permit fast repossession and sale because an underlying agreement between the parties has granted a creditor a property right in collateral, in the form of a security interest. Such creditor is not only protected by the general enforcement laws, but because the creditor also holds a security interest in property, which is a property right, such creditor is also backed up by the constitutional provisions that protect private property rights. However, in many transactions no prior security agreement exists for using property to guarantee contracts. For example, in microlending, a business venture, or a service contract, there is often only an agreement, without an additional security agreement.

1. *Enforcing secured contracts*

Secured contract enforcement follows the steps laid out in the framework for secured lending. Many obligations or contracts may be secured, not just a loan. These could include obligations such as future sale of crop or the timely delivery of shipments, the performance of a service, or a licensing agreement. Parties cannot use secured enforcement when a poorly drafted law on secured transactions limits the obligations (transactions) that may be secured. A well-drafted secured transactions law has a scope of application that encompasses all transactions, lenders, borrowers, and assets. The section above discussed at length the different options for improving enforcement of security interest.

2. *Enforcing unsecured contracts*

Many contracts are not secured with property. What procedures can an injured party follow to enforce such a contract? A further distinction matters for contract enforcement. Consensual claims rest on a voluntary agreement. That voluntary agreement can provide for arbitration and other alternative dispute resolution systems. That permits bypassing problematic judicial systems. Reform should then focus on arbitration and these other systems.

However, when no agreement exists, the claim is non-consensual. For example, suppose A's sheep is run over by B's truck. Parties to such disputes cannot be forced to use alternative arbitration mechanisms. Reform efforts in these cases must focus on the court system. Non-consensual dispute resolution is not discussed in this paper.

Disputes involving parties to a contract could specify within the contract that disputes be settled outside the court, possibly by arbitration. For example, if a farmer purchases a patented plant and then replicated it, the manufacturer's claim, under intellectual property law, could arise from the licensor-licensee agreement that was part of the sale agreement. Such a license agreement could provide for arbitration.

a) **Is the criticism of arbitration valid for developing countries?**

The literature on arbitration and the studies in the United States do not show that is

¹¹⁵ "...a major impediment to the development of peer monitoring—as well as the development of other institutions—comes from inadequate legal systems to enforce contracts", Joseph Stiglitz, "Peer Monitoring and Credit Markets" *The World Bank Economic Review*, Vol. 4, No. 1 (Washington, DC: The World Bank, 1990), pp. 363.

unambiguously cheaper than court resolution. Many studies find that it is not a better solution than court-based alternatives.¹¹⁶ Are these criticisms relevant for developing countries?

Three characteristics of the present studies leave their findings consistent with the view that arbitration should still be developed in countries with severe enforcement problems.

First, most studies on arbitration group arbitration with other alternative dispute resolution mechanisms under the general subject of Alternative Dispute Resolution or ADR. However, there are enormous differences among ADR systems. Compulsory mediation, for example, which is one system within the Alternative Dispute Resolution group, differs substantially from arbitration. For example, Washington DC, the small claims procedure provides for mediation. DC small claims court sets out the date for trial in 30 days from the filing time. However, before trial proceeds, parties must attend a mediation session. Including waiting time, this can take another day. Since mediation never compels the mediating parties to conclude and agreement, the mediation session represents another one or two days lost to the contending parties. That is, compulsory mediation means that the entry into the process is mandatory but agreement is optional. In compulsory arbitration, both entry and outcome are mandatory.

Second, the laws for arbitration vary enormously from jurisdiction to jurisdiction, both in the United States in developing countries. General data on their effect in one jurisdiction under the laws of such system will not apply readily to another jurisdiction's laws on arbitration. Once analysis reveals which feature of arbitration make it work under developing country constraints, developing countries can draft new legislation that maximizes the economic impact of introducing arbitration.

Third, a major draw back in arbitration lies in its frequent feature of lack of publicity. Under most arbitration laws, the procedure may be made private by the parties. This is not a logical necessity of arbitration; rather, it is a common feature. In developing countries that endorse the policy principle of public trials, this secrecy has adverse public policy implications, for example, in tort claims, divorce proceedings, civil rights issues, and land disputes. It is easy to address this problem, though: the arbitration law simply needs to specify that the results of arbitral findings – either all or only those in specified areas – be made public. However, this problem does not seem to apply to using arbitration to settle contract disputes.

For these reasons, in principle, in the context of developing countries, it seems that finding non-judicial ways to deal with contract enforcement, such as providing for arbitration can be a great tool for speedy contract enforcement, relieving the congested courts from more cases,

¹¹⁶ Shirin Sinnar, "Alternative Dispute Resolution" the World Bank web pages, 2003, citing: Bernstein, Lisa "Understanding the Limits of Court-Connected ADR: A Critique of Federal Court-Annexed Arbitration Programs," *University of Pennsylvania Law Review* 141(6): 2169-2254 (1993) Brooker, Penny. "The 'Juridification' of Alternative Dispute Resolution." *Anglo-American Law Review* 28:(1)1-36 (1999)

[Institute for Civil Justice](#) - RAND's studies of the U.S. Civil Justice Reform Act have found no significant effect in cost or time-to-disposition with the introduction of ADR. Landes, William M. and Richard A. Posner. "Adjudication as a Private Good." *Journal of Legal Studies* 8:235-284 (1979)

Mitchard, Paul. "A Summary of Dispute Resolution Options." *Martindale-Hubbell International Arbitration and Dispute Resolution Directory* (Exeter: Matindale-Hubbell International, 1999) 3-24.

Whitson, Sarah Leah. " 'Neither Fish, nor Flesh, nor Good Red Herring' *Lok Adalats*: an Experiment in Informal Dispute Resolution in India." *Hastings International and Comparative Law Review* 15:391-445 (1991-1992)

and providing an alternative to the delays that these countries face in reforming the judiciary.¹¹⁷ More evidence should be specifically collected on arbitration. The key will lie in studies that consider the different features of arbitration laws and their economic impact of different options.

b) Enforcing arbitral awards

One issue that severely limits the economic usefulness of arbitration lies in how the laws sets out the enforcement of arbitral awards. If the arbitral court itself can order the use of force, or if a judge must automatically give orders to enforce arbitral rulings, then arbitration can be fast and efficient.

At the other extreme, sometimes the arbitration law still requires a lengthy court intervention to enforce the arbitral decision or award. Under those circumstances, arbitration will have no effect. Rational litigants, knowing that the evidence must be presented to the court to get enforcement, will go immediately to the court and bypass arbitration. This appears to be the situation in the arbitration laws for most Latin American and Eastern European developing countries.

Bolivia's laws for example, do not reflect modern trends on arbitration, especially compared to modern arbitration laws, such as the UNCITRAL Model Law on International Commercial Arbitration adopted by the United Nations Commission on International Trade Law in 1985, or the 1988 Spanish Arbitration law. Bolivia's major legal deficiencies in arbitration include the following: the requirement that arbitrators only be lawyers; the lack of authority of the arbitral tribunal to enforce provisional orders; the lack of freedom of party autonomy to determine the place of arbitration, to appoint independent experts, to take certain types of evidence; and the judicial court's broad authority to review the arbitral tribunal's findings of facts.¹¹⁸

A recent study on project financing,¹¹⁹ confirms these types of obstacles to achieving arbitration to resolve disputes involving independent power projects, in spite of provisions in contracts. The study explains how the laws permit local or national courts to intervene and overrule arbitration. The article reviews the experience of three independent power projects in Indonesia, two in Pakistan, and Dabhol in India.

Of primary concern here is the use of arbitration to enforce contracts in the local country, not with international arbitration that is used mainly to permit enforcement abroad, since we are concerned here with the laws and institutions in the developing country. The distinction is important: There is quite an extensive literature on international arbitration that often is not concerned at all with contract enforcement in the local developing country, and which, often being enforced in industrial countries, works out much better.

World Bank projects, however, have not focused on arbitration. A search since 1947 for “arbitration” “mediation” or “dispute resolution (ADR)” shows that arbitration, as a specific

¹¹⁷ For example, “*In the context of lending for court and case management in a few countries, these regulations might have been examined.23 Studying these regulations in more countries, deciding which disputes should be subject to judicial enforcement, and finding nonjudicial ways to deal with the other regulations would have been more relevant and efficacious than providing equipment, infrastructure, or training in an inhospitable context.*” (Legal and Judicial Reform in Europe and Central Asia Poonam Gupta, Rachel Kleinfeld, and Gonzalo Salinas, OED, the World Bank, 2000.

¹¹⁸ See, Código de Procedimiento Civil, Articles 712 to 746, and Código de Comercio, Articles 1483 to 1486.

¹¹⁹ The Journal of Structured and Project Finance, Institutional Investor 8 (3): pp. 42-57, Fall 2002.

component of any project, has only been specifically included in one project in Peru in the 1990s (Judicial Reform Project P040107 22.5 IBRD/IDA Peru Closed 04-DEC-1997);¹²⁰ and in Bolivia and El Salvador as part of larger components.

15-16. - Capitalization Program Adjustment Credit P006173, 50 IBRD/IDA Bolivia Closed 06-JUL-1995; and Judicial Reform Project P006205 11 IBRD/IDA Bolivia Closed 13-APR-1995

17- 18. - El Salvador. Competitiveness Enhancement Technical Assistance Project P040824, 16 IBRD/IDA El Salvador Active 28-SEP-1995

However, these efforts have proceeded without a full analysis of the laws that limited to the use of arbitration in the first place. For example, in these countries the Code of Civil Procedure permits the loser to appeal an arbitral award before the judicial courts. Potential winning parties, knowing that appeal means an additional long judicial enforcement process, avoid arbitration and go directly to litigation. Not surprisingly, many arbitration centers and training programs, often established at great donor expense, have few cases (e.g., El Salvador).

Inadequate basic legal and economic research meant that a basically sound reform had little economic impact on investment and growth in the country. Businesses continue to complain about the lack of a system for dispute resolution. The annex discusses arbitration for these cited country projects.

- **Lessons Learned**

- **Support arbitration¹²¹**

Merchants and business operators have settled disputes privately for at least 1000 years, with good results. Arbitration is one modern version of this system. For all the ink spilled about the rule of law and contract enforcement, this simple system for settling disputes outside of the developing world's notorious courts should be underway in every Bank developing member country.

- **Permit compulsory arbitration**

Once parties elect to use arbitration, they must be bound by the outcome. Otherwise, arbitration does not provide a path to resolution outside the court system.

- **Enforce awards automatically or privately**

Society's saving from private parties' agreeing to arbitrate is lost or minimized if the evidence must be presented again to the judge to get enforcement. Awards must either be enforced automatically by the courts or, even better, enforced by licensed private agents. These may include, for example, rights to set-off from the loser's bank account, automatic deduction from checking accounts, harmless repossession, private sale, and ex parte court orders for seizure and eviction when the use of force is necessary, together with simplified and cheap police procedures to execute such orders.

¹²⁰ They included:

[Judicial Conflict Resolution Improvement Project](#) P057369 5 IBRD/IDA Colombia Active 08-NOV-2001

[Legal and Judicial Capacity Building Project](#) P044810 30.6 IBRD/IDA Bangladesh Active 29-MAR-2001

[Legal & Judicial Reform Project](#) P044809 18.2 IBRD/IDA Sri Lanka Active 20-JUN-2000

[Competitiveness and Enterprise Development Project](#) P057295 40.8 IBRD/IDA Rwanda Active 19-APR-2001

[Legal and Judicial Capacity Building Project](#) P044810 30.6 IBRD/IDA Bangladesh Active 29-MAR-2001

[Legal and Judicial Development Project](#) P063918 5.3 IBRD/IDA Morocco Active 15-JUN-2000

[Legal and Judicial Reform Project](#) P057182 9 IBRD/IDA Albania Active 21-MAR-2000

¹²¹ Jennifer Widner, of the University of Michigan Department of Political Science, sets out an excellent overview of arbitration history in the United States and its political features in "Reflections on Judicial Reform" in Legal Institutions of the Market Economy World Bank webpages.

V. Conclusions: Lessons of the 1990s

The importance of law for economic affairs and the importance of an economic analysis of the law precede the 1990s. It can be found at the turn of the last century in the work of the Wisconsin School (Frederick Jackson Turner, Richard T. Ely, and J. R. Commons). For at least twenty or thirty preceding years in the work of the law and economics movement (see particularly Richard Posner and William M. Landes) and to a great degree in the public choice writings of James M. Buchanan, Gordon Tullock, Anthony Downs, and William A. Niskanen. However, the economic importance of law and property rights took a leap into prominence with the awards of the Nobel Prize to Ronald A. Coase in 1991 and to Douglass C. North in 1993. The economists had it right when they decided that property rights were important. Certainly the formal economic literature has recognized these issues. The number of "hits" in standard economic data bases for topics like "collateral" and "land tenure" have increased by nearly a factor of 10 in the period 1990-2000 compared with the period 1980-1990.

However, even now, ten years after this burst of publicity from the Nobel awards, most economists do not realize the broad and pervasive importance of property rights for development projects, and the need for their active collaboration with lawyers in devising economically efficient legal solutions to property rights problems.

Lessons of the 1990s for Project Design.

What do findings mean for effective policy? Most World Bank funded projects would do considerably better - and in some cases succeed instead of fail - if economically-relevant laws were revised in ways relevant to the needs of the economic objectives of the project. The body of the text contains detailed examples.

Were projects in the 1990 dealing with laws and legal institutions tracking the economic logic and economic effect of the legal changes they recommended? Rarely. Simply looking at the projects shows that few even mention reforming the laws that govern the environment for their projects. While a full review has not been undertaken for this paper, those projects have typically underinvested in analyzing the economic fundamentals of modern laws and seeing how to apply them effectively in a developing country context. Nor has there been a clear vision about connecting legal problems to sectoral programs.

A. Examples

Here are some examples taken from the more detailed discussions in the text.

- In all major countries in which financial crises occurred, lenders face major difficulties in collecting debts. Yet in no such country - Mexico, Brazil, Argentina, Russia, Indonesia, Korea, Thailand, and Uruguay - has any MDB made a reform of the legal framework governing debt collection a condition of a rescue operation.
- Extensive support for microfinance the World Bank has included no analysis of the legal barriers that make microfinance so much more difficult in developing countries than in industrial countries. The result? Even in countries where World Bank projects supported legal reforms, these reforms leave the needs of microfinance untouched. Microfinance struggles on in its hostile legal environment.

- World Bank land titling projects focus on title and leave the other land-use rights and mortgage laws untouched; typically they fail to support reform of the laws governing land-use rights as collateral. The result? Multi-billion dollar land titling projects produce no improvement in access to credit secured by land. In some cases this is absurd, as when a Ukrainian and Egyptian mortgage reform applies to no more than a few percent of the country's land, or when projects refuse to grant to the traditional residents of Papua New Guinea and the Altiplano the same set of property rights that residents of New York and London enjoy
- MDB reports lament about the burden of regulations on business, but not a single project has proposed an economic analysis of the Commercial Codes governing these businesses. Some projects propose computerizing the business registration process, as if computerizing nonsensical requirements will make them less burdensome.¹²² One project even boasted that it could be undertaken with no legal reform. No project has undertaken reform of the key economic functions of the commercial registry.

B. Progress

These attitudes seem to change at glacial speed. In a competent 1995 study of the role of collateral in microfinance undertaken by the International Labor Organization, the donors were polled to see if they thought revision of the laws governing collateral were important to microfinance. All donors polled said no, except for the representatives of USAID and the World Bank. In a 2003 survey of donors on rural finance, the BID also expressed concern.

In reviewing past Bank activities in this area during the 1990, we have limited the search to actual projects that dealt with these issues by attempting to identify the problems, and then design and reform them. We have not, for example, considered research, symposiums, surveys, or general studies of these topics. They abound in these legal areas, yet, actual reforms, as we will discuss, have been limited.

C. Logically Link between the Development objective to the Legal Problem; set out a feasible path between the legal reform and the development objective

The central logical sequence has three stages: first a project must set out clearly the development problem that prevents a desired economic outcome. Second, it must develop clearly how the legal problem prevents that economic outcome. Here, extensive legal and economic studies should describe how each legal restriction produces an economic inefficiency that leads to the stated economic problem. Finally, the project design must set out the path in which modified laws and institutions will make it work, measure its impact in a cost and benefit economic analysis of the desired legal reform; and set out monitory standards and conditions of progress, not in terms of x law pass, but in terms of the desired legal features and expected economic outcome.

Accordingly, a logical table for a legal reform component in property rights and business entry, could look like something like this:

Development Problem	Legal Problem	Project Design
Underdeveloped	An Effective Property	Support legal reform for changes in these four areas will

¹²² InterAmerican Development Bank, Ventanilla Unica, Bolivia.

<p>land market; poverty; Lack of formal property ownership in the country</p>	<p>Rights system require four distinctive stages: creation, priority, publicity and enforcement of interests in real estate. The law limits each one of them as set out in x report. Furthermore, in the publicity stage, the laws set out a Registry that provides poor services because it operates under a state and monopolistic institutional legal framework.</p>	<p>achieve the desired economic outcome Broader and clear definition of property rights, low costs for creating such rights, including laws that: - endorse private, natural descriptions of boundaries, and - derogate notary costs, and set up low costs transfers of real estate procedures and inheritance procedures; Certain priority rules as to the competing claims in real estate from the time of filing in a notice of the claim in a public archive; A private and competitively run publicity real estate registry system of claims in real estate with full public access, where notice of claims in real estate may be filed; Limited support for the state cadastral mapping system to only cases of titling unoccupied land. Set out this in a separate track that does not delay reform of the property rights system. Expedited and low cost enforcement system of claims in real estate.</p>
<p>Lack of access to credit; Unequal distribution of wealth</p>	<p>The laws limit creation, priority, publicity and enforcement of security interests in movable property and real estate as set out in x report.. Furthermore, in the publicity stage, the laws set out a Registry that provides poor services because it operates under a state and monopolistic institutional legal framework.</p>	<p>Support legal reform for changes in these four areas will achieve the desired economic outcome: Broader the scope of property and rights that can be used as collateral for loans; Certain priority rules as to the competing claims in collateral based on the time of filing in a public archive; A private and competitively run publicity archive of notices of security interests, with full public access; Private, expedited, and low cost enforcement systems of claims in collateral</p>
<p>Underdeveloped private sector; impediments to business entry</p>	<p>The laws set out high costs for setting up a business or registering a corporation. The laws set out a Commercial Registry that provide poor services because it operates under a state and monopolistic institutional framework</p>	<p>Support legal reform for changes in these two areas will achieve the desired economic outcome: Change the law to lower the costs and requirements of registration of a business or incorporation of a company Change the law to set up a private and competitively run commercial registry, with full public access. Change the laws and regulations to set up an online network to process once all the required licenses to operate.</p>

D. Good and Bad Practices in Legal Reform

- **Don't automatically codify existing practice**

Existing practice may have some good clues about what works. But it may also represent behavior that is only economically optimal if the existing legal constraints cannot be changed. Existing practice must also be examined for its economic effectiveness.

Codifying existing practice in developing countries without analyzing economic impact might capture some clever market adaptations. More likely, it will just capture a hodge-podge of practices that reflect bygone historical episodes (laws from period of the King), the past or present influence of relevant or irrelevant interest groups or power structures (e.g. notaries guaranteeing "authenticity" of a document, the guarantee of an insolvent state), actions that are technically obsolete (e.g. sewing the pages of a case in to a physical ledger), or brutal violation of human rights agreements (e.g. imprisonment for debt in Bolivia; stoning defaulting debtors or burying them alive)

- **Don't automatically copy industrial country codes**

Some reformers seem to believe that adopting laws from industrial countries ensures industrial country success. As one evaluator put it to the authors, "this is not the way we do it in Milwaukee". Other reformers seem to believe in total legal relativism and want only the codification of existing practice. This may reflect an optimistic view that market forces will lead agents to adopt economically beneficial laws.

Neither of these approaches is likely to work. Constraints in developing countries differ from constraints in industrial countries. It may be reasonable for Santa Clara County or the Province of Ontario to contemplated state operation of a filing archive; the case for Bolivia, Uganda, or Papua New Guinea is considerably less compelling. Developing country laws need to solve developing country constraints. AT the other extreme, laws in industrial countries reflect the history and constraints of industrial countries. Real estate and personal property are subject to two different security interest systems in the United States because the US real estate industry resisted any change from existing practice when the general legal framework for secured transactions was developed in the 1950's. US reformers have been attempting to close this gap for years. However, it is much more sensible to unify these regimes and this can easily be done in transitional and customary systems where there is no entrenched real estate industry. There is no need to make developing countries adapt to constraints unique and peculiar to the industrial countries.

- **Check markets for the consequences of laws**

Poorly performing markets almost always have legal roots. As a rule of thumb, whenever you see economic agents failing to engage in activity that is common in the industrial countries, there will almost always be a direct or indirect legal barrier to that activity. Search for those legal roots. World Bank projects support credit lines to the poor, where the legal framework makes them unfit for private credit and prevents the refinancing of the private sector's portfolios of unsecured loans; they support housing programs where problems in the legal framework prevent the use of the latest housing technologies, where existing land use rights cannot be legally transferred or used as collateral, and where lenders cannot safely finance home improvements because the law does not envision any system for using those improvements as collateral; they support privatization of public services when the law itself makes the private provision of those services illegal; None of these problems can be solved with training or credit lines. Only changing the law can only solve them.

- **Check economic laws for their economic consequences**

The land codes, the commercial code, the laws of secured transactions, the bankruptcy law usually have enormous bearing on the conduct of economic activity in the country. In addition, where it appears that economic activity is underway with no reference to these codes that should itself ring warning bells. It means that the entire legal structure provides so little assistance in operating businesses that it is useless, that enforcement is so weak that it cannot be relied on. Recall the Bangladesh fertilizer dealer who wonder in amazement why a questioner would think he we would go to court to collect a debt.

- **Work in teams of economists, lawyers, and, as necessary, technology experts**

Interdisciplinary work has taken on Pollyannaish connotations in recent years; you never get into trouble recommending it and it never does you much good. This is different. Lawyers and economists really do have different and very complementary skills in this area. Some economists order up laws the way consumers order breakfast cereals: get me a law of secured transactions, get me a box of Rice Crispies.

Not so easy. The economist needs to explain to the lawyer exactly what problem needs to be addressed. They need to work together to understand how the law blocks that goal. Then they need to work together on analyzing the economic implications of different legal solutions. Economists are only kidding themselves when they think they can read a law and really understand what it means. Usually, they need to sit with a lawyer and ask what this clause means and what is it supposed to accomplish. Lawyers are only kidding themselves when they think they can see the impact of laws on markets, incentives, and economic growth. They need economic advice. Economists need lawyers to draft laws. Lawyers need to be able to explain the logic of every clause in a law to their economist partner. It is hard work.

It is certainly not practice. Based on searches of terms of reference for World Bank legal work, no economists are included in the actual legal work. In no case, did the terms of reference call for economic analysis of the legal work. As a result, for example, many projects support laws that did not meet the needs of a developing market economy. The financial sector laws call for regulating non-deposit taking financial institutions producing ludicrous situations in countries like Romania and Ukraine -- certainly "regulatory challenged" countries -- of regulating loans by fertilizer dealers and food wholesalers. Or bankruptcy laws that contain expansive reorganization provisions, whose benefits are unclear even in industrial countries, and that promise bringing newly privatized but insolvent state enterprises back under the aegis of the state -- this time in the bankruptcy courts. Or pretend to reform key economic institutions like registries by turning them back over to the same government officials whom they lament elsewhere (strategy papers, ESW) are unable to competently deal with the government's present scope of authority. Or, incredibly, recapitalize private banks under the management of the same owners and the supervision of the same supervisors who let them go under in the first place.

- **Take some small steps forward even if a full reform is not possible in the context of a project**

Most development projects have important legal and regulatory components. These projects would be much more effective if these issues were addressed at the same time or before the non-legal components were begun.

However, even where a project cannot support an entire legal or regulatory component, it could at least exhibit and record a clear understanding of the links between the project goals and the legal and regulatory environment. That would help get those changes onto the agenda of other specialized World Bank legal reform programs. It is preposterous that the World Bank finances an extensive reform of the law of secured transactions, for example, only to discover later that it has left untouched the collateral problems of private infrastructure financing, microcredit lenders, or housing rehabilitators supported in their other projects.

Many projects have limited budgets, certainly insufficient for a full-scale legal reform. In such cases, the most crucial first step, which will never waste money, lies in preparing a careful investigation of all the points at which the law impedes a successful project. That would at least permit the individual project -- e.g. Microfinance, or dealer outreach, or producer cooperatives -- to have an agenda for reform that could be presented to other donors or managers of other projects to get these items on the legal reform agenda. For example, World Bank, BID, and IMF task managers often propose banking reforms that call for regulation of firms engaged in any

financial activity instead of deposit taking institutions. At a stroke, this places rural fertilizer dealers under the regulatory system of the Central Bank. This is absurd. But when such task managers draft these laws, they are usually not worrying about rural fertilizer dealers. Yet, what project or document warns against this provision in a banking or financial sector reform? For example, many secured transactions projects routinely fail to address the problem of registration of accounts receivables transfers. The result? Even after a donor-funded legal reform, microlenders and trade creditors still cannot use their portfolios as collateral in order to refinance their operations.

Aside from this, limited budgets might be guided by the rough rules about priority areas and the sequence of analysis, law, and institutions set out below.

Interestingly, few donors have supported work analyzing these questions. Some interesting exceptions: a thoughtful USAID- funded piece on the experience in reforming Latin American Codes; an Asian Development Bank piece on integrating the legal frameworks for bankruptcy and secured lending; World Bank on best practice rural finance reforms; and GTZ on the requirements for opening a small business in Costa Rica.

- **Properly sequence legal, regulatory, and institutional reform**

The first step in legal reform is a careful diagnostic paper that looks at the legal roots (citing laws, chapter and paragraph) of legal obstacles to successful projects and discusses options for solution. Such work requires a study of the law and fieldwork that verifies the law's presumed consequences. That paper should explain clearly the economic links between the legal problems and the development problem. The options for reform should explain clearly how they would work and, in particular, set out a clear feasible path in which existing institutions or modified institutions will make the option work. As unremarkable as this point may seem, it is even more remarkable how many donors and MDBs move ahead on legal reform without such a diagnosis. Or with a diagnosis that is mainly hand-waving: "Gee, no credit for housing? We need a mortgage law!" In more than ten years of work, we have seen fewer than ten diagnoses that explain clearly why an economic problem has legal roots and how the proposed legal solution will achieve its stated economic effect.

The second step lies in drafting the law. There may be general agreement about the diagnosis in the paper, but a great deal of resistance once solutions appear in black and white. Resistance is especially likely when good drafting tracks down all the other laws that must be amended or repealed. Many more public policy issues will emerge at that point.

The last step is institutional reform. Laws sanction the operation of institutions. Little real impact can come from a reform of a commercial registry without fixing the commercial code; or the real estate registry without a reform of the legal system for filing security interests against land-use right. However, the design of institutional reform should start in the diagnostic paper and continued through the legal drafting. The lawyers, economists and technicians should work together at all points. Achieving an Internet based commercial registry has less to do with programming than with a law that sets out how that will work and that addresses the public policy issues involved in dropping signature and verification requirements. Only then can the registry operate with low cost modern technologies.

- **Undertake high priority legal reforms first**

While it is axiomatic in project appraisal that high return projects come first, that principle has evaded much of the legal and judicial reform area. There, reforms get picked up and dropped in a pattern that is difficult to explain.

These reforms discussed in this paper could probably be ranked in order of importance and ease. Reform of the framework for secured transactions secured by personal property would probably

rank at the top in terms of ease and effectiveness. Broadening the scope of rights to real estate that can be traded and used as collateral would probably be second. While quantitatively possibly more important than fixing the framework for lending secured by personal property, the political problems in codifying land rights is probably politically more intractable. Bypassing defective judicial and police systems with arbitration, petty claims courts, private prosecution and the laws governing private police would probably come third. After that ordering will depend on the particular circumstances of the country.

The pity is that these reforms, done properly, are inexpensive relative to other programs and could all be undertaken without seriously compromising other objectives.

- **Provide for competing and, where possible, private legal institutions**

For all relevant legal institutions - write governing legislation that permits competing, and where possible, private, systems civil and commercial registration systems; provide for a notice filing system for security interests property and for land-use rights in immovable property.

- **Reform the fundamental laws governing economically-relevant rights**

World Bank projects typically lament the consequences of bad laws without attempting reform of the underlying laws. World Bank supports the expansion of cooperative organizations without fixing laws that prevent cooperatives from undertaking commercial transactions, including buying, selling, and lending to their members. Donors and MDBs promote voter registration in countries where as much as 50% of the population is not in the civil registry and therefore not entitled to vote by law. The World Bank laments the failure of formal sector banks to lend to micro finance lenders where the underlying laws make those portfolios of credits useless as collateral. The World Bank promotes using rural dealers as conduits for new technologies, ignoring the inability of rural dealers to use their inventories or accounts receivable as collateral or take the pledge on real estate or future crop from those to whom they sell new technologies. The World Bank promotes rural cooperatives, ignoring laws that prohibit cooperatives from engaging in commercial or for-profit activities. These objectives are all worthy, but the World Bank cannot achieve them without a careful analyses and reform of the laws that govern these arrangements.