

THE LEGAL BUSINESS ENVIRONMENT

Why is commercial law needed?

Commercial law determines how businesses are created, the ways contractual arrangements are structured, the enforcement of contracts, and how businesses close down. It governs lending, debt collection, the protection of consumers, the promotion of competition, as well as the assertion of property rights. In short, commercial law regulates all aspects of business activity.

Countries and regions where the legal system functions effectively have an advantage in encouraging both local and foreign investment over those where the law is outdated, opaque, slow, and costly. At present, many of the commercial laws and associated processes of the Pacific island countries are outdated, placing their businesses at a severe competitive disadvantage.

Company law

A fundamental requirement for all well-functioning economies is a sound legal framework to support companies. Company law specifies the rules that determine how companies are structured, operated, and closed. It establishes limited liability for companies which are registered under the law. It also regulates the external relationships of a company, identifying the duties of directors and other management, as well as the rights and liabilities of shareholders. The rules that govern reporting and disclosure embodied in company law differ, depending on the number of company shareholders.

The outdated and ineffective company law in many Pacific island countries substantially increases the costs for registered businesses. Throughout the Pacific region, most registered companies are required to specify their purpose for establishment and have a minimum number of directors, as well as provide audited accounts annually—a process that adds greatly to the cost of doing business. In many Pacific island countries, there are no provisions in the law for the formation of limited liability partnerships or simplified organization arrangements for sole proprietors and community structures. As a result, much business is conducted informally between individuals.

In most Pacific island countries, outdated Companies Acts specify a number of detailed requirements to be submitted for

registration. In some countries, ministers must even sign the incorporation papers. At present, none of the Pacific island countries allow electronic filing. These factors raise the costs of incorporation and operation.

The best Companies Acts allow registration to be easy, quick, and low cost. They minimize formal obligations and have few restrictions regarding, for example, what companies can do and the number of directors they should have. In this way, registration is encouraged.

Pacific island countries are increasingly giving recognition to the shortcomings of their respective company laws. They acknowledge, in particular, that existing laws do not support the development of small businesses, especially those operating in remote areas. Samoa has already reformed its company law along these lines. Meanwhile, comprehensive reforms are ongoing in the Solomon Islands and Vanuatu, and are also planned in Tonga.

Business registration

The objective of business registration is twofold:

- To establish the legal address for serving notices for purposes of tax collection, contract enforcement, or other judicial proceedings; and
- To designate which officials in the business have the authority to sign legal documents on behalf of the business, thus ensuring that contracts are binding and enforceable.

Some Pacific island countries have commenced or are considering reforms to their business registration processes and systems. For example, Samoa, Solomon Islands, and Vanuatu are in the process of reforming their business registration system, while the Fiji Islands and Tonga are preparing for reform.

Business licensing

Business licensing requirements around the world range from simple to extremely complex. Although business licenses are a formality designed to allow governments at the national and local levels to keep track of businesses operating in their jurisdictions, in many countries, including the Pacific Islands, the administration of licensing regulations is onerous, lengthy, and inefficient. While licensing should provide regulation in cases where markets do not function effectively or where safety

standards are needed to protect the public, rules should be transparent and the process should be simple. Excessive regulation stifles business. Studies of the private sector in the Pacific region show that businesses are often burdened by a myriad of regulations that could usefully be eliminated with no detrimental effect on the economy or consumer welfare. It is with this understanding that Tonga has recently taken steps to improve both its system of licensing and the processes by which foreigners can obtain work permits.

Contract and sales law

Contract law governs practically every aspect of business arrangements. Sales law governs the legal framework for the exchange of goods. Without these laws, which allow the standardization of contracts, lengthy legal documents are necessary to set out in detail the rights and obligations of each party in a business transaction. Standardization lowers costs and reduces uncertainties for contracting parties. In the Pacific region, the contract and sales laws are, in most cases, outdated, relying on versions of English or United States laws from many decades ago. As a result, contracting in the region is both complicated and costly, and it is the modernization of contract and sales laws that is most urgently needed if the region is to prosper.

Enforcement of contracts and judgments

In many Pacific island countries, the inadequate enforcement of business contracts and property rights is a serious impediment to private investment. Without reliable contract laws and enforcement, doing business with strangers will remain a risky economic activity limited to a small geographic area and a narrow commercial circle. In Pacific island countries, where growth and prosperity is dependent on dealings with people from thousands of miles away, this constraint is especially damaging. Reliable enforcement, based on a sound system of contracting, will not only permit, but facilitate negotiations to take place across vast distances—even among unacquainted parties. This expands opportunity, increases competition, and improves economic efficiency. Tonga has recently demonstrated this: by introducing a computerized case management system, Tonga has dramatically reduced the time it takes for cases to be processed through its court system.

Arbitration as an alternative to courts

Arbitration is an effective process for settling business disputes at a low cost. Moreover, it can also accommodate some traditional practices among Pacific islanders. Many

international contracts stipulate arbitration when there is disagreement. But due to the outmoded or non-existent arbitration laws in the region, all international contracts require arbitration to take place offshore. This effectively removes from local firms what could be a low cost means to settle differences. Furthermore, the lack of an arbitration framework also contributes to the overburdening of the courts which, as a result, cannot focus on larger cases. Mediation, an alternative form of dispute resolution that does not require going to court, has recently been introduced successfully in Tonga.

Updating arbitration laws and developing institutional capacity will encourage a more meaningful framework to resolve business disputes quickly and cost effectively. A good arbitration law will provide an efficient alternative to expensive and time-consuming court action.

Small claims courts

Small claims courts are an effective mechanism for small and medium enterprises, sole proprietorships, and individuals to settle commercial disputes involving smaller amounts. It is, however, important to determine the proper monetary threshold for small claims. If the threshold is too low, the usefulness of small claims courts becomes diminished; if the threshold is too high, the requirements for the training of magistrates is likely to be beyond capacity. As a result, the upper limit of small claims courts is usually no more than US\$5,000 (depending on the country's specific circumstances).

Bankruptcy and insolvency

To ensure that resources are in the hands of the most able entrepreneurs, it is important not only that businesses can enter the market, but also that the unsuccessful ones close down through orderly bankruptcy or insolvency proceedings. Bankruptcy is the final step after debt collection fails, which can assist in the reallocation of resources toward higher yielding activities. In addition, bankruptcy allows those who have failed through adverse circumstances to begin anew. Without a good bankruptcy and insolvency law, entrepreneurs are unable to discharge their past failure and do not get a second chance at setting up potentially lucrative business endeavors. Almost without exception, bankruptcy and insolvency laws in Pacific island countries are either non-existent or overly complicated, stipulating procedures that are cumbersome, protracted, and costly. With this in mind, both the Solomon Islands and Vanuatu have taken important steps to improve their respective frameworks for bankruptcy and insolvency.

Foreign investment law and regulation

Most countries in the region have foreign investment laws that cover such issues as business activities reserved for citizens, local ownership requirements, the employment of foreigners, the granting of work permits, and the procedures to obtain licenses. However, international evidence suggests that most of these regulations are counterproductive. So while Pacific island countries are keen to gain access to foreign markets and attract foreign capital, technology, expertise, and skills, more often than not, red tape and burdensome regulation that has no sound economic justification get in the way of realizing this goal. Since this greatly raises the costs and often causes lengthy delays for investors, the gratuitous regulation of foreign investment should be reduced without delay.

Laws governing electronic transactions

Electronic transactions law provides for documents transmitted electronically to be the legal equivalent of documents sent by mail. In the event of a dispute, for example, electronic documents are admissible as evidence in court.

Since Pacific island countries are distant, and most of them dispersed, the legality of documents instantaneously exchanged through the Internet or by fax would generate a significant reduction in the costs of doing business both within the region and beyond. Among the other benefits of having an electronic transactions law is the potential for transactions to take place through new channels. For example, mobile phone banking is currently being pioneered in other parts of the world. With this comes convenience, reduced costs, and increased access to banking services. Another major benefit of a well-functioning system of electronic transactions is that combined with mobile phone technology, it offers a low cost means of transferring remittances.

Of the Pacific island countries, to date, only Vanuatu has in place a legal framework for electronic transactions. However, the Fiji Islands is currently in the process of electronic transactions reform.

Collateral and Business Credit

Finance enables entrepreneurs to start new businesses and expand existing businesses. Businesses need credit to buy equipment and inventory, and to allow them to extend trade credit to their customers. Farmers need credit to fertilize land, plant seeds, as well as raise crops and livestock. Credit may come from banks or from sellers of equipment, inventory, seed and

fertilizer. Whatever the source, creditors want to know that they will be repaid. Collateral (i.e. property of the debtor pledged to the creditor to secure payment) provides an important part of the assurance creditors require. Credit flows more freely when the law and supporting institutions on collateral are strong and inexpensive. Credit is scarce when they are weak and costly, as is the case in most countries in the Pacific.

Land, land leases and buildings are the favored collateral for banks, but laws governing them are weak in many countries in the region, especially where the majority of property is communally owned. Many people do not have property ownership or rights in a form that lenders can use as collateral. Further, non-bank creditors, such as inventory suppliers and equipment sellers, do not generally take collateral in the form of mortgages on land.

With proper legal support, movable property in the form of equipment, inventory, accounts receivable, crops, livestock, shares, and the like may serve effectively as collateral. The law on movable property is weak in most countries in the Pacific region, however, with the result that most business credit is unsecured, if credit is available at all. Compared to unsecured credit, loans secured by collateral are easier to obtain and typically feature lower lending rate and longer tenors. The more a country needs economic development, the more it needs modern laws defining and protecting property rights of all types, including legislation on the use of movable property as collateral.

Why is more credit available where movable property may effectively be pledged as collateral? First, the cost of creating agreements to pledge collateral is lowered. Second, the rights and duties of borrowers, lenders, and others who may lay claim to the collateral are clearly established, reducing risk and enforcement costs. Third, costs are minimized through streamlined rules on foreclosure upon default of the borrower.

Until recently, virtually no country in the Pacific region had a well-functioning system for the use of movable property as collateral. More recently, however, substantial progress has been made. New Zealand enacted comprehensive reform in 1999. The Federated States of Micronesia implemented full-scale reforms in 2005. Effective law has been adopted (but is not yet implemented) in the Republic of the Marshall Islands in 2006. In 2008, similar legislative reform proposals are under consideration in Samoa, Solomon Islands, Tonga, and Vanuatu.

Competition and consumer protection

Competition law aims to “level the playing field” between large companies and consumers or small businesses by prohibiting anti-competitive behavior and requiring that accurate information on products and services be provided to the public.

Studies show, however, that such laws often do not lead to competitive outcomes and that vigorous competition, contestability and low barriers to imports are the most effective means to achieve these. In the Pacific region, competition is often held back by monopolistic arrangements developed partly because of small market size and the common view that it is the government's duty to provide essential services. While many in the Pacific island countries are still reluctant to accept the virtues of competition, there is overwhelming evidence from around the world that competition brings enormous benefits in the form of increased efficiencies, lower prices, and innovation.

In Pacific countries, competition is especially critical in services that can help reduce a country's geographic isolation—namely telecommunications, air transport, and shipping services. In many cases, telecommunications services, including Internet service provision, are provided by legally enshrined public sector monopolies which, more often than not, provide poor and costly services while keeping out private sector competitors. It should be noted that introducing competition does not necessarily mean the privatization of existing state-owned enterprises. It should, however, encourage the entry of private firms to compete with the incumbent.

Currently, the penetration of both mobile phone and Internet services is low in Pacific island economies. Yet, it is common for incumbents to strongly resist the legislative repeal of their monopoly power. Sometimes governments accede to such pressure despite evidence that liberalization tends to reduce prices, improve the quality of services and increase market size dramatically. Many incumbents have benefited from liberalized markets and have improved efficiency in response to competition. The beneficiaries have been consumers and businesses in countries where this has occurred.

The rapid expansion of coverage and dramatic price reductions of 40–50% from introducing competition in the mobile phone sector in Samoa and, more recently, Papua New Guinea, vividly illustrate the benefits of competition. In the airlines sector, adopting open sky policies and eliminating state-owned monopolies will drive down the otherwise high cost of air transport. The dramatic reduction in airfares and the consequential increase in tourist

arrivals from the partial privatization of Samoa's international airline routes demonstrate the immense benefits that can be reaped from competition.

In order for Pacific island countries to benefit from competition, their legal frameworks should be reformed to encourage open markets and punish anti-competitive behavior. A sound competition law is needed to regulate natural monopolies. The legal framework for competition is also the basis for a code of conduct for the business community with respect to product standards, liability, and the prohibition of collusion as well as the protection of consumers. Pacific island countries should move toward the introduction of modern competition laws which embrace and support the development of markets. This will have profound benefits for the economy and every level of society.

Reform is underway

Over the past few years, the pace of legal and regulatory reforms to improve the business environment has accelerated throughout the region. The examples cited above illustrate the extent to which Pacific island countries have reformed, or are in the process of reforming their company laws and registries, introducing new legal and technical frameworks that support secured lending, and seeking to simplify regulations and eliminate red tape to make doing business easier and less costly.

These measures will bring the Pacific island countries into the modern age in terms of local and international business transactions, contributing to investment, economic growth, and better income opportunities for Pacific islanders.

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