

THE COLLATERAL FRAMEWORK IN PALAU

1. Interviews with bankers, regulators, and businesses indicated that there are many deficiencies in the collateral framework that impact negatively on the ability to borrow and the risks of lending. This Appendix outlines in detail some of the deficiencies of the secured transactions framework in Palau and makes suggestions for reform.

A. Elements of a Properly Functioning System of Secured Transactions

2. For borrowers to be able to pledge movable property as security for loans and for lenders to be able to accept such property as collateral, the secured transaction system must provide for the following essential functions.

- (i) **Creation.** Creation is the process by which the creditor establishes a security interest in property (the collateral). Creation must cover all economically important property and transactions in such property; agents and the law must permit creation at a low cost relative to the value of the transaction.
- (ii) **Priority.** A properly functioning system must provide for the unambiguous ranking of priority rules—by which the lender establishes the priority of the security interest against all other claims in property—and 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.
- (iii) **Registration.** A legal process must be in place that makes public the ranking of the priority of the security interest. It must let a potential lender establish a ranking of priority in collateral by filing a notice of the security interest in a publicly available archive or registry. It must also let a potential lender search the archive easily, quickly, and inexpensively to determine whether other claims exist against a borrower's property.
- (iv) **Enforcement.** The enforcement process—by which, upon the debtor's default, the creditor will seize 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.

3. The legal framework in Palau for secured transactions does not provide for these essential economic and legal functions. In every area, problems prevent the secured transactions process from functioning in a way that gives confidence to lenders that in the event of default they can seize the property and sell it to satisfy the debt. These problems are analyzed below. The secured transactions framework in Palau requires a new law, a new way in which to register security interests, a new way of enforcing repossession in the event of default, and the abrogation of clauses in other laws that could adversely affect the functioning of a secured transactions system. Partial reform of the secured transactions framework in Palau will have little impact on improving access to credit. The system must be reformed at each of the critical stages that determine whether lenders can take security interests in movable property with the expectation that in the event of default, the assets can be repossessed quickly and sold at relatively low cost, in a manner that will allow the repayment of the debt. This requires drafting a comprehensive statute, regulations, and filing system governing the entire process.

B. The Creation of Security Interests

1. Problems

4. Legal practitioners specializing in debt collection described the process of creating security interests in Palau as “chaotic.” There is no requirement in the law for registration of security interests. As a result, courts have refused to authorize repossession based on the registration of property as collateral for lending. Since there is no requirement for the registration of security interests, there is no way that they can be assigned. This eliminates the potential for using assets such as accounts receivable as collateral.

5. Legal issues outside the realm of pledging security also affect secured lending. The Usurious Interest Act sets interest rate ceilings on loans at 18% per annum. While this may seem high, other work²¹ has found that for smaller and micro loans, interest rates of 2.5% per month (or 30% per year) are necessary to cover risks and transactions costs. For example, a highly successful microcredit program in Vanuatu charges interest rates of close to 50% per year and evaluations report substantial borrower satisfaction. The Palau interest rate ceilings prevent the development of such programs, however. To be fully effective, any reform should repeal such ceilings.

2. Solutions

6. A properly functioning system of secured transactions integrates all functionally identical security devices (leasing, trust, pledges, mortgages, hire purchase, and assignment of rights) into one comprehensive legal framework and filing system. This broader concept—a functional approach—organizes security interests along the lines of what actually serves as an instrument of security. The most beneficial economic impact is assured when the law includes a broad coverage of all property, transactions, and lenders, with minimal restrictions on lenders or descriptions of collateral. Either individuals or companies should be able to create security interests. To permit and facilitate inventory financing, the legal framework should permit parties to choose a security interest against “generally described” collateral. The law should not require that the security agreement or the court be required to identify items of collateral specifically. To meet standards for fast collection, crucial for the greatest economic benefit, the law should permit continuation in proceeds and set out clear rules for their recovery; these should supersede old narrow rules for the tracing of proceeds.²²

C. Prioritization of Security Interests

1. Problems

7. Priority plays an essential 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. Priority problems lie at the

²¹ See Holden, Paul, Sarah Holden and Jennifer Sobotka. 2003. *Policies Towards Micro Credit Institutions: What do the Data Tell Us?* Washington, DC: Multilateral Investment Fund.

²² As with all good legal 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.

heart of a legal system for secured transaction because they present insurmountable difficulties in determining the value of the property as collateral. In a fragmented framework, the existence of different laws concerning security interests provide unclear information regarding registries and priorities. Where ambiguity or conflicts of priority exist, secured financing will not take place at all.²³ Typically, recording a notice or filing of the lender's security interest in an office of recordation where the notice is publicly available will establish priority through the date and time of the record.

8. Palau has not adopted any of the provisions of UCC 9, which in the United States governs the framework for secured transactions. Since there is no requirement for registering security interests, there is no way in which the priority of any pledged assets can be determined.

2. Solutions

9. To remove ambiguity regarding priority, any reform should place the priority rules in one law that applies to any and all interests in property. This arrangement should cover all types of security interests, including financial leases, consignments, and sales with retention of title. It will also establish clear and unambiguous priority among existing special instruments.

D. Publicity (Perfection of Security Interests)

1. Problems

10. Due to the chaotic nature of recording security interests, publicizing them in Palau is virtually impossible. Lenders have no sources to refer to in order to determine whether there has been a prior registration. A number of issues must be resolved in order to reform the system.

11. **Registry versus notice filing archive.** Within a framework of making public a security interest, differences exist between an approach that registers the agreement, and one using a notice filing archive. In a system that registers the agreement, a lender registers the entire security agreement or a lengthy abstract of it. The registry staff will typically undertake some check of the agreement's legal correctness. In practice, however, this check is of little value, because registry staff members lack the skills necessary to detect irregularities in the documents. By contrast, in a 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. The parties to the security agreement are responsible for the correctness of the underlying document and for keeping copies of any agreements.

12. A new law of secured transactions should eschew requirements that call for filing of the entire agreement. Registering the entire agreement is more costly, and costs are not standard; checking is complex and time consuming. Moreover, because so much

²³ In default, loans without priority will become portfolios of uncollectible loans unless the assets of the business, when sold, are sufficient to allow all creditors to be paid. 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.

information is filed, both filers and administrators have incentives to restrict public access. This defeats the purpose of the filing system: making such data public.

13. **Private versus public operation.** There are many ways to organize the management of a filing archive that records security interests. Many different examples exist around the world, ranging from management by a consortium of private operators to those operated entirely by the state. Hybrid management systems also exist in which the management of the filing archive is operated by a non-profit user group that includes associations (e.g., an association of banks, a chamber of commerce, and an association of lawyers), which is then overseen by the Ministry of Justice. This approach has been followed in Romania and Colombia with great success. Canada has experimented with a monopoly private franchise with less success. The United States has kept a state-operated core with many private points of entry, which allow lenders to check whether security interests have been registered against property that is being pledged as collateral. While many management options exist, all registries or filing archives should meet certain core criteria for effective operation.

- (i) Information on the existence of a security interest should be readily available at low cost, both for particular assets and for particular persons, organizations, or companies.
- (ii) It should be simple to record security interests in collateral.
- (iii) The system should easily and reliably rank priority over pledged assets.
- (iv) The information should be available remotely over the Internet.

2. Solutions

14. Any reform should introduce an electronic filing archive as described in the preceding sections. For example, an association of banks and lawyers could establish and run an archive. A relatively inexpensive notice-filing system requires only that creditors file a notice of the existence of the security agreement. The law should require simple and standardized information so that simple databases can readily store it and make it accessible to registered users over the Internet. Potential lenders can then check existing security interests and other encumbrances on property by searching the filing system themselves.²⁴

E. Enforcement

1. Problems

15. The ability of the creditor, in the event of default by the debtor, to repossess and then sell the property that the debtor gave as collateral lies at the heart of any system of secured transactions. Any rational lender or credit seller will focus on the value of collateral after the costs of sale and seizure, not on its nominal market value when it is pledged. Lenders who face slow and expensive enforcement will simply adjust the size of the loan downward relative to the value of collateral realized after the costs of sale and seizure. Alternatively, lenders will not make loans under circumstances where repossession is overly costly or uncertain.

²⁴ 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.

16. Enforcement of contracts in Palau currently takes place through the court system. Cases involving sums of \$5,000 or less are heard in the Court of Common Pleas, with all other claims heard in the High Court. In practice, there are few delays. Even so, enforcement of judgments in commercial cases is not rapid.

17. Currently, the schedule for processing unpaid debts is as follows:

- (i) A judgment can be obtained 20 days following failure to respond to a demand for payment. A pre-judgment attachment can be obtained when the lawsuit is filed.
- (ii) A writ of execution can be obtained 14 days after the judgment. Attorneys report that there is reasonable accommodation in debt collection, in that bailiffs (Public Safety) do cooperate in repossession to enforce judgments.
- (iii) If repossession is resisted, it can take 3–8 months to obtain a motion of summary judgment; this may extend to 2 years if a trial is involved.

18. Lawyers in Palau report that there is growing opposition within the political and legal communities to creditors' rights.

2. Solutions

19. Any new law should permit non-judicial repossession (when possible without disturbing the peace)²⁵ and specify rapid "ex parte" court orders for forcible repossession. If the borrower agrees to non-contested repossession, or if it could be done without disturbing the peace, such activities should be carried out by private agents. If the circumstances under which repossession takes place could lead to violence, then the involvement of law enforcement officials is necessary. These methods should be administered by the courts, but can be carried out with a minimum of delay and without recourse to judicial hearings or other procedures that could slow down execution.

20. Collateral must be saleable through creditor-administered sales conducted under commercially reasonable standards.²⁶ However, there should be no prohibition on any form of sale, as long as there is no collusion in the selling process. Creditors that have repossessed property should have the right of private sale without the need to advertise, and should not have to go through court mandated procedures such as auction, compulsory valuation, use of court specified sellers, and other mechanisms that are common in unreformed secured transactions systems. The essence of reform of the sale of repossessed property is quick and inexpensive collection mechanisms. However, consumer protection principles should be observed in such seizure and sale. Critical criteria for this process are as follows.

²⁵ Called "harmless repossession" in reformed systems

²⁶ Suitable measures, when properly drafted and explained, include: legal instructions for summary court judgments (ex parte court orders); harmless repossession, wherein the lender can repossess collateral without court intervention; expanded private authority for repossession; and expansion of public services to include some private incentives and competition. Suitable measures include penalties against public officials who do not carry out duties in conformity with law; these might be personal or they might involve automatic compensation from state funds for delays (e.g., a credit against taxes equal to the interest foregone on the uncollected debt). These elements provide a legal framework for creditor-administered sale, sanctions for creditors that abuse that process, and a workable way to enforce those sanctions. That legal framework should cover the rules of commercial reasonableness, rules for notification of debtors, specification of rights of redemption, and conditions under which the secured party may undertake strict foreclosure (seizing and keeping the collateral).

- (i) In the event of default, creditors should be able to obtain the pledged collateral rapidly and inexpensively.
- (ii) There should be no legally mandated process for the sale of the collateral. For example, the law should not specify that the property should be auctioned or that the sale has to be publicized.

21. Penalties for the abuse of repossession and sale should be severe in order to strongly discourage the abuse of the secured transactions framework by unscrupulous lenders.

22. Weakening creditors' rights in Palau would be a severe step backwards. The effect would be to sharply reduce lending by the banking system and would result in a large increase in business for loan sharks, who charge rates of interest that amount to several hundred percent per year. Such lenders flourish in systems where creditors' rights are weak. Pending legislation in Palau requires careful consideration of this issue.