

V. ISSUES RELATED TO PALAU'S LEGAL SYSTEM AND PROPERTY RIGHTS

88. The first part of this chapter briefly discusses some legal issues governing commercial transactions in Palau. This is not meant to be a comprehensive review, and does not undertake an in-depth analysis of the commercial legal system; instead, some of the constraints relating to private sector development resulting from the outdated and incomplete nature of the existing legal structure for commerce are highlighted. The second part of this chapter discusses some issues related to property rights in land in Palau.

A. Some Issues Related to Palau's Commercial Legal System

89. Palau's legal system is based on its Constitution, customary law and common law as understood and applied in the United States.¹⁶ An in-depth analysis of contract law in the North Pacific states that:

The statutory elevation of the Restatements to the level that the Restatements are the rule of decision is a unique regional development and a remnant of the Trust Territory Code, 1 TTC 103. This regional adoption is unique because in the United States, the Restatements of Law are not the rule of decision.¹⁷

90. In the absence of written law or local customary law, the courts of Palau apply common law.¹⁸ In practice, much commercial law is based on common law because neither the Constitution nor customary law address commercial issues to any great degree. This situation causes significant practical problems. In the United States, commercial transactions are governed by the Uniform Commercial Code (UCC), which was adopted in 1953. Palau has no equivalent of the UCC. Therefore, courts are forced to search for precedents in the United States among decisions that were taken prior to the adoption of the UCC. Since commercial practice in the United States has evolved substantially over the past 50 years, Palau's commercial legal system is hampered by having to rely on outdated precedents. Legal practitioners in Palau reported that there is a draft bill in the OEK to abolish the use of US common law and precedent, although they indicated that it would probably not be passed. They strongly opposed the draft legislation, on the grounds that it would result in "chaos" in the application of the law.

91. Additional gaps in the commercial legal system exist. For example, there is no specific legislation governing the sale of goods in Palau. The lack of a bankruptcy statute for individuals or companies has significant effects on the cost of doing business.

1. Sale of Goods

92. Free exchange is an essential building block of private sector development because it permits trade and the gains that stem from specialization. In most countries, the legal framework for the exchange of goods is governed by a "Law of Sales," which provides for freedom of contracting and may be used to set up a variety of transactions, including sales. A country can benefit from having laws that explicitly identify the rights and obligations of parties to contract as these serve to reduce the costs of contracting.

¹⁶ The common law of contract as set out in The American Law Institute *Restatement (Second) Conflict of Laws*, §188, 1981. This sets out the principles in terms of which contract law is applied and interpreted.

¹⁷ Ryan, D.P. 2005. *Essential Principles of Contract and Sales Law in the Northern Pacific*. New York: Universe, pp. xxxv,xxxvi

¹⁸ However, local customary law or written statutes supersede common law.

93. Ordinary business deals would require contracts extending to many pages if they could not rely on a legal system with clearly defined rules and precedents. Parties using such contracts would have concerns about the possible interpretation of the contract's clauses by other parties and the court. In Palau, where there is reliance on outdated US precedent, it is natural that case law is incomplete with respect to several aspects of any given contract. Therefore, transactions that rely on case law are risky, and that risk raises transactions costs for private sector contracts and business dealings.

94. Laws governing sales—an essential area where even the most ordinary statutes could include basic principles providing security and enforcement—do not exist in Palau. In the absence of sales-related legislation, issues such as the rights and obligations of parties and damages in case of breach of contract, warranties of merchantability, or fitness for a particular purpose must rely on outdated US precedent. Merchant liability is important in increasing economic efficiency, as businesses that are liable for production mistakes will be forced out of the market. Product liability reduces transactions costs by lowering risks. Without such liability, a buyer only feels comfortable buying from a seller with a well-established track record. If a new competitor enters the markets, buyers are slow to purchase from that competitor, even if prices are lower, because other product quality aspects are unknown. This legal gap in Palau limits competition, efficiency, and market growth; the situation should be rectified.

2. Bankruptcy Issues in Palau

95. Efficient economies require means for firms not only to enter but also exit the market; in other words, to go through bankruptcy. By means of bankruptcy, resources that were tied up in an inefficient firm can be released to more efficient purposes, thus increasing economic dynamism and stimulating private sector growth.

96. Bankruptcy is distinct from secured lending because it serves a different economic purpose and social end. Bankruptcy cancels debt collection and replaces other penalty systems for defaulting debtors—of which some can be draconian. 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. This in turn makes lenders more inclined to lend, which allows for business investment, financial market development, and ultimately, economic growth.

97. The original gain from bankruptcy arose from ending practices perceived as socially damaging. An imprisoned debtor not only produced nothing, but also required feeding. Originally, bankruptcy had no direct effect on the position of the secured lender: the secured lender's first recourse was the collateral for the loan. Only if that collateral was insufficient did the bankruptcy system apply to the balance (that which exceeded the sale of the collateral).

98. In general, legislation dealing with bankruptcies can be classified into two categories:

- (i) Those affecting individuals.
- (ii) Those governing the insolvency of entities, particularly companies.

99. Palau lacks a legal framework for bankruptcy, which presents some important drawbacks. The proof of debt procedure is also long and complicated for the average debtor or creditor. Even when only insignificant sums are involved, legal practitioners must be employed to assist clients in navigating through the complex maze of

procedures. As pointed out in the chapter on financial markets, debtors who cannot afford lawyers are still faced with large legal bills from the creditors' lawyers. There is no means by which any debts can be discharged, so that many people have no hope of getting out of debt. A bankruptcy law could help resolve this, although any legislation must protect the rights of creditors.

3. Company Formation

100. It is not difficult to form a company in Palau, although the President signs every corporate charter personally. But there are a number of other requirements that increase the burden of the process. For example, in addition to the company charter, a national business license is necessary; some states, such as Koror, require a state business license. There are yearly reporting requirements for every corporation that is domestically held and quarterly reporting requirements for foreign-owned corporations. Companies must provide financial and other information regarding directors. The requested information repeats much of the information contained in tax filings, and in general the information requests are very intrusive.

101. Foreign-owned corporations face additional burdens. There are essentially two separate commercial law systems in the country: one for Palauans and one for non-Palauans. The law for the latter is determined by the Foreign Investment Act, but its application is very subjective. The FIB requires a statement of no objection for the transfer of shares in foreign-owned corporations, a requirement that impacts the ability of corporations to do business. Finally, as is true in other Pacific countries, in Palau the prescribed activities attract many untrustworthy individuals.

102. Foreign business licenses are of limited duration, with terms ranging from 10 to 30 years, and this limit can serve counter to Palau's interests. A recent example is provided by a Japanese tour booking company, whose 10-year license expired. A 2-year extension was granted, but there will be no further extensions. Legal practitioners in Palau speculated that the business will almost certainly continue to operate by using a front, with much of the revenue moving offshore, a situation that does not benefit Palau in any way.

4. Arbitration

103. Arbitration is a form of alternative dispute resolution that allows for the resolution of commercial disputes outside the court system. When both parties agree to arbitration, they present their arguments to an arbitrator, who may be a legal practitioner or an expert in the area that relates to the disputed contract. Arbitration frequently allows for settlement of contract disputes at a much lower cost than is possible using the courts. Therefore, expanding arbitration involves working with a legal framework where the costs outweigh the benefits, especially for sole proprietorships and small and medium enterprises.

104. Currently, there is no legislation governing arbitration in Palau. Furthermore, the courts have ruled that provisions in contracts that allow for future arbitration in the event of disputes are not binding on the parties to the contract. In practice, this problem has been overcome in Palau by using external jurisdictions for agreements. However, such provisions can only apply to large companies and are of little use to small businesses and sole proprietorships, which could most benefit by the introduction of arbitration in Palau. What is needed in Palau is an arbitration system that is available for smaller businesses and transactions; a system that follows customary dispute resolution

mechanisms with formal legal standing and enforceability outside a closed community network.

5. Enforcement

105. While legal practitioners described the judiciary as the most efficient branch of government in Palau, issues exist with respect to enforcement, especially in relation to debt. To execute on debt default can take several years. This is not necessarily related to enforcement issues per se, but rather to the legal framework itself. As the preceding discussion illustrates, in many cases, the laws in Palau are outmoded and not suited to modern business practices. Modernization will help significantly in reducing enforcement problems.

B. Issues Related to Land and Fixed Property Rights

106. Only Palauan citizens can own land, but foreign individuals or foreign-owned corporations can lease land from a Palauan citizen. Legislation allows for 99-year leases, but a court decision has held that this amounted to *de facto* ownership, and set a limit of 50 years on leases. Currently, there are attempts to pass legislation to extend leases to 99 years, but the issue is controversial within Palau.

1. The System of Landholding in Palau

107. The history of land ownership in Palau is unique among the Pacific islands. Palau became a German colony in 1899, and the concept of individual property was introduced. "Land Book" recording began using a metes and bounds survey system.¹⁹ In 1926, during the period of Japanese colonization, a survey of the entire country commenced. By the Second World War, there were both complete surveys and Land Record Books for most states. However, during the war, the records for four of the states were destroyed. Both the complicated colonial history and the destruction of records have resulted in a large number of land disputes.

108. Currently, the Land Court is creating a new system of land recording and registration, and there is an ongoing program to register all land in the country. At this time, the Land Book is still used as evidence to prove ownership. A drawback with land law, however, is that it makes no distinction between legal and equitable title. In practice, this implies that the owner of a parcel of land cannot legally assign the use of it to someone else. The failure to distinguish between types of holdings weakens the validity of leasehold title. Foreign investors indicate that difficulties and uncertainties with land lease holding are major problems associated with doing business in Palau.²⁰

109. Land holdings are complex. In the past, lineages, clans, or villages owned most of the land. Inheritance was and remains matrilineal. More recently, individual ownership among Palauans has spread rapidly, as the value of land parcels has risen, particularly as new houses have been constructed. Several knowledgeable observers in Palau indicated that as private ownership has spread, the care, development, and cultivation of land has improved. Estimates put the number of private land parcels in the country at about 20,000, of which approximately 10,000 are registered. The Government owns a

¹⁹ A system for recording the boundaries of properties identified by directions and bearings of the compass. In Palau, this initially consisted of rough sketches (called the Tochi Daicho).

²⁰ The World Bank Doing Business Indicators accord Palau a very high ranking in terms of the ease of registering property. However, detailed investigation reveals that this ranking is spurious. There are many uncertainties in land dealings in Palau, as the accompanying discussion indicates.

significant portion of the land in Palau, but because much of this ownership is derived from the colonial past, a large portion of land in government possession is being disputed.

110. Although some states have taken over their land administration, the Land Court has jurisdiction over land disputes for public lands. It meets regularly to hear cases and to hand down judgments, but there is a substantial backlog of cases because of the complexity of the issues.

2. Lease Issues

111. The way land leases are structured has a powerful influence on the willingness of landowners to lease their land, their satisfaction with lease arrangements, and the term and type of investments that lessees will make. Essential elements of lease structures that promote both lessor satisfaction and confidence in lessees are:

- (i) **Long-term leases.** The length of the lease becomes increasingly important as the time of the lease proceeds. While 50-year lease terms are not a constraint at the outset of the lease, as time proceeds, expiry dates become increasingly important.
- (ii) **Terms of the lease for the lessor.** Lessors must have a mechanism for the adjustment of lease payments that reflects the success of the lessee. If all windfall benefits accrue to the lessee, lessors will feel that they have been taken advantage of.
- (iii) **Ability of the lessee to renew a lease.** If lessees are successful but unable to renew their leases under circumstances in which lessors are sharing in the success of a project, investment will be reduced.