

# **Preparing for CAFTA-DR: the need of commercial law reform in Central America**

by

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## **I- Introduction**

The recent approval of the Central American-Dominican Republic Free Trade Agreement (CAFTA-DR) with the United States of America is perceived not only as the commencement of a sophisticated economic integration process but as a critical means for wealth creation and poverty alleviation of the Central American countries.

Although CAFTA-DR does not mark the beginning of Central America's movement towards market-oriented economic systems: a trend that has emerged gradually over the past fifteen years, the agreement represents a unique opportunity, both in terms of newly created economic opportunities and in terms of political momentum, for the region to accelerate reform. But the expectations based on the agreement could not be satisfied due to intrinsic institutional and regulatory problems of their economies. That is the challenge CAFTA-DR brings and that is the topic of this article: what commercial institutions and laws need to be reformed to promote economic development?

This article departs from the assumption that economic openness, by allowing productive resources to be allocated with greater efficiency both between and within countries than

would be possible in a closed system, possesses the ability to propel economic growth and reduce poverty. However, although an open economy appears to be a condition necessary for development, alone it has proved insufficient to drive the productivity growth required for sustained economic growth.<sup>1</sup>

In the following sections we identify policies, laws and institutions that may prevent Central American States from exploiting the opportunities provided by the CAFTA-DR. In that sense, we examine several of the legal factors that appear to be important in determining economic growth as they apply to the commercial legal conditions of Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.

The issues considered here fit into the larger context of commercial law. However, we do not pretend to offer an exhaustive discussion of the commercial legal frameworks of the

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<sup>1</sup> See Mancur Olson, Jr., Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others Poor, 10 J. ECON. PERSP. 3, 14 (1996) or Why Doesn’t Capital Flow from Rich to Poor Countries, 80 AM. ECON. REV. (1990).

countries in question, but rather focus on property, contract and company law aspects that may have particular relevance in determining economic outcomes in the region.

The first area to be addressed will be property law. By granting an individual exclusive and transferable ownership rights and prohibiting unwanted seizures of a property, the State internalizes the function of protecting one's property and allows the owner to concentrate on her preferred task: increasing the value or yield of the property. Additionally, the existence of property rights creates an incentive for private investment by guaranteeing that an investment's economic returns may be captured by the investor.<sup>2</sup>

The optimal condition of costless enforcement of rights, while unattainable in practice, provides a useful context in which a State's provision of property rights may be evaluated. In particular, factors that increase an investor's cost to capture the returns of an investment shall generally be considered here as undesirable.

As formal recognition of private property rights is universal between the countries examined here, the pertinent factors become those related to the enforcement of written law and those conditions that limit the economic utility of ownership. Thus in assessing property rights, the following focuses on factors such as real property registries, cadastres, the judicial system and legal limits on transfer rights.

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<sup>2</sup> Douglass C. North, *STRUCTURE AND CHANGE IN ECONOMIC HISTORY* 5 (1981). Douglass North explains that the optimal condition for property rights is reached when the cost of enforcement is zero.

The second area of focus will be contract law, a topic closely related in terms of its economic function to property rights, since the function of contracts in economic growth relates to their role in increasing the predictability of commercial transactions and in providing means for enforcement in cases of breach. In that sense, evidence shows that impersonal transactions become difficult when State provided means of ensuring parties' compliance are absent. Besides allowing for greater complexity in a transaction's duration and terms, the protection provided by contracts lessens transaction costs for contracting parties by reducing the discovery costs associated with finding trustworthy partners. As non-contractual transactions require greater trust, which, in turn, requires a history of compliance or relationships with existing supplier or buyer networks, economies characterized by weak contract protection tend to deter new entrants and provide incumbents with an unfair advantage that dampens innovation.

We will also look at issues of company law. Since investors organize themselves through companies in order to diminish the risk of doing business, the protection investors might have in this area is both an incentive to do business and a safeguard of their property rights within the business. But the absence of that protection or the difficulty on attaining it has proved a serious obstacle to economic growth.

The majority of the information contained in this article was gathered during the CAFTA Trade and Commercial Law Assessment Activity: a United States Agency for International Development (USAID) sponsored project seeking to assess trade and commercial law in Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. The

study, conducted by Booz Allen Hamilton over the course of ten months in 2004-2005, sought to place the commercial and trade law assessment in the context of CAFTA by identifying areas which may prevent the Central American economies from benefiting from the agreement.<sup>3</sup> Much of the information contained here was gathered during in-person interviews with government officials, judges, lawyers, notaries, businesspeople and other private sector representatives.

## **II- Property, Contract and Company Law in Central America**

### ***PROPERTY RIGHTS***

While in each of the five countries examined here, individuals and companies are entitled to acquire, rent and mortgage real property, the legal frameworks for real property are hindered by indirect government seizures, inefficient supporting institutions and limited transfer rights. This section describes some of these ailments as they relate to limiting the effectiveness of property rights as written.

### ***Expropriation***

Although explicit forms of expropriation are no longer common in Central America, indirect or creeping expropriations have nonetheless deprived ownership to many.<sup>4</sup> The lingering effects of past expropriations are particularly evident in Nicaragua, where during the Sandinista revolution the State expressly seized many properties in the

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<sup>3</sup> The reports are available at <http://www.bizlawreform.com/>. They comprise a broader range of issues than what this article covers.

<sup>4</sup> Timothy Besley, Property Rights and Investment Incentives: Theory and Evidence from Ghana, 103 J. POL. ECON. 903, 903 (1995)

political context of land reform. Through the three popularly called the “*Piñatas* laws” passed after the Sandinistas lost the 1990 election title was granted to those who occupied properties that had been confiscated during land reform.<sup>5</sup> Once in power, the Chamorro administration annulled these laws. However before the annulment took effect, a portion of the titles granted by the Sandinista administration were registered. Other titles were left unregistered, leaving a gap in registry information. As a consequence of the confusion associated with real property ownership created by the successive regime changes, special offices were created to assess the situation, regularize land tenure, and properly compensate titleholders. It is estimated that there are roughly 11,000 pending cases for which compensation for expropriated land is demanded and countless more displaced persons who have yet to file claims. In addition, compensation for expropriated properties has been slow and when paid is often below market value. For example, often compensation is provided in the form of bonds, which sell in secondary markets at as low as 30 percent of their par value. Attesting to the direct economic effect of the ambiguity of ownership, properties affected by the *Piñatas* laws sell at lower prices than comparable non-affected properties.<sup>6</sup>

In Costa Rica, the expropriation law requires State payment of compensation for properties seized through indirect means. The Supreme Court has supported this by issuing an opinion in which it stated that regulations tantamount to expropriation could retain effect only if compensation is provided. While the Costa Rican government rarely fails outright to compensate those affected by expropriation, payment is often slow to

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<sup>5</sup> Martha A. Field & William W. Fisher III, LEGAL REFORM IN CENTRAL AMERICA, DISPUTE RESOLUTION AND PROPERTY SYSTEMS, 2001, at 219

<sup>6</sup> [http://www.bizlawreform.com/country\\_assess/NicaraguaTCLA.pdf](http://www.bizlawreform.com/country_assess/NicaraguaTCLA.pdf) at V-2

arrive and at below-market value. Many cases were reported in which compensation disputes spanned more than 30 years.<sup>7</sup>

In Honduras, indirect expropriation of property often comes under the auspices of land reform. The U.S. Department of State describes this practice stating, “The Honduran government generally expropriates property for purposes of land reform (usually related to a land invasion by farmer groups) or for public use such as construction of an airport. Land disputes related to actions by the Honduran National Agrarian Institute (INA) are common for both Honduran and foreign landowners. According to the National Agrarian Reform Law, idle land fit for farming can be expropriated and awarded to landless poor. Generally, an INA expropriation case begins after squatters target and invade unprotected property.... In most cases, claimants have found that pursuing the subsequent legal avenues is costly and time consuming, and rarely lead[s] to positive results. Compensation for land expropriated under the Agrarian Reform Law, when awarded, is paid in 20-year government bonds. Based on newly available evidence of significant expropriation, Honduras’s property rights score is 1 point worse this year.”<sup>8</sup>

### ***Restrictions to property rights***

Transfer rights are central to the notion of property rights in that they define the scope of entitlements provided to a titleholder by means of property ownership. Besley defines transfer rights as, “rights to sell, rent, bequeath, pledge, mortgage, and gift.”<sup>9</sup> In Central

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<sup>7</sup> [http://www.bizlawreform.com/country\\_assess/CostaRicaTCLA.pdf](http://www.bizlawreform.com/country_assess/CostaRicaTCLA.pdf) at V-2

<sup>8</sup> Heritage Foundation, Economic Freedom Index for 2004.  
<http://www.heritage.org/research/features/index/countries.html>

<sup>9</sup> *Supra* note 4.

America limitations on transfer rights are not, for the most part, prohibitively stringent but the laws governing property rental can prove burdensome to landlords.

In Guatemala, there is a special law on real property renting, called *Ley de Inquilinato* (Tenancy Law), which is very protective of tenants' rights, especially as they pertain to eviction procedures. In one case, it was reported that evicting a tenant that had breached a rental contract took a landlord ten years. To overcome those procedures, owners often rent properties to relatives or to specialized agents that sublease to the actual tenant. In such cases, should an owner want to evict a tenant, he would file a suit against his collaborating tenant, who, in turn, would accept the terms. Once the court authorizes the settlement, it issues an eviction order, which can be enforced against third parties, including subtenants. There are doubts about the legality of this process and courts have approved annulment actions for such improvised eviction practices, but the process remains widely used.<sup>10</sup>

Likewise, the Salvadoran real estate leasing law favors the interests of tenants over those of lessors. For example, the law allows tenants to remain on property after their lease expires provided they continue to pay rent. The leasing law also sets price limits and makes the eviction processes difficult.<sup>11</sup>

In contrast to the rigidities within the Guatemalan and Salvadoran laws on leasing, Costa Rica has facilitated eviction procedures in 1995 by passing a law on real property leasing.

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<sup>10</sup> [http://www.bizlawreform.com/country\\_assess/GuatemalaTCLA.pdf](http://www.bizlawreform.com/country_assess/GuatemalaTCLA.pdf) at V-2

<sup>11</sup> [http://www.bizlawreform.com/country\\_assess/El%20SalvadorTCLA.pdf](http://www.bizlawreform.com/country_assess/El%20SalvadorTCLA.pdf) at V-1

Under the new legislation, it was reported that eviction of noncompliant tenants occurs in a relatively timely manner. It was also reported that the 1995 law contributed to the development of a real property leasing market in Costa Rica.<sup>12</sup>

Squatter's rights in Central America tend to be strong and were cited as a contributor to ambiguity in ownership, as these rights generally allow legal occupancy to non-titleholders. In Nicaragua, a court can grant a supplementing title to an individual who has possessed a property of unknown ownership for longer than one year, can prove good faith, and has improved upon and maintained the property.<sup>13</sup> In El Salvador squatters can possess property in good faith without holding title. If the titleholder of the property is unknown, squatters may acquire title after 20 years of good faith possession.<sup>14</sup> In cases in which squatters possess, in good faith, land that is State-owned, they do not have the right to obtain title. In cases in which a squatter occupies land owned by a municipality, it was reported that the municipality usually grants the right of use to the squatter.<sup>15</sup>

Cost Rican law formally provides that squatters may only attempt to gain legal rights to non-maritime property by peaceful occupation for an extended period. However, it has been reported that squatters invade property and that in some cases of invasions the government has bought the invaded land from private owners and distributed ownership

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<sup>12</sup> *See supra note 7* at V-1

<sup>13</sup> Civil Code of Nicaragua, article 888

<sup>14</sup> Civil Code of El Salvador, article 2250

<sup>15</sup> *See supra note 11* at V-1

to the invaders. In absence of the State purchasing invaded land, titleholders are provided with legal means of eviction.<sup>16</sup>

In Guatemala the current housing deficit reported at 1.8 million dwellings illustrates the complexities associated with the government's role in providing property rights.<sup>17</sup> The housing deficit tends to be most severe amongst low-income populations. The central Government occasionally grants ownership rights to settlers of publicly-owned invaded land or in cases where property is not used by the owner. If the property invaded is owned and used by a private party, the owner can evict the invaders by use of public force. But that has proved politically and socially difficult to do.<sup>18</sup>

Restrictions related to the amount of land an individual is permitted to own and restrictions on foreign ownership are some of the most common ownership restrictions in Central America. For instance, in El Salvador no person is allowed to own more than 245 hectares of land.<sup>19</sup>

In Nicaragua a law passed in 1917 prohibits individuals from owning coastland.<sup>20</sup> Coastlands belong to the central government but are managed by municipalities that rent the land to individuals. Rent is paid annually and is calculated at 0.5 percent of the

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<sup>16</sup> See *supra* note 7 at V-1

<sup>17</sup> "Land invasions by squatters are increasingly common in rural areas. It can be difficult to obtain and enforce eviction notices, as land title is often clouded and the police tend to avoid actions against squatters that could provoke violence." The Economist, Intelligence Unit Report on Guatemala, 2004.

<sup>18</sup> See *supra* note 10 at V-2

<sup>19</sup> Constitution of El Salvador, article 105

<sup>20</sup> Agrarian Law of Nicaragua, article 2.

property's value, which is calculated each year by the municipality. Municipalities can revoke rent agreements at their discretion.<sup>21</sup>

In Honduras, foreigners cannot purchase property within 40 kilometers of the shoreline. If a transaction involving such an acquisition were to take place, it would be considered null and void. Under the Constitution, however, the Tourist Law contains special provisions regarding foreign purchase of urban properties regardless of their proximity to coastal zones. For example, the Bay Islands were declared urban territory and are thus purchasable by foreigners. The provision regarding urban land is an important safeguard for foreigners purchasing land on the islands of Roatan and Utila.<sup>22</sup>

In Guatemala, foreigners cannot own property near the borders, and cannot rent property in the maritime zone or acquire property through *usucapion* (i.e., by remaining on property and letting time pass, purporting in good faith to be the owner). Coastal property up to three kilometers from the sea line cannot be owned. Only Guatemalan citizens who owned a property before 1956 are allowed to hold title for coastal properties and to transfer title but to other Guatemalan citizens. With these exceptions, all real estate property along the maritime zone and that on rivers and lakes belongs to the central government, which can rent the property at its discretion.<sup>23</sup>

In Costa Rica, the central government can establish restrictions of use of certain areas for environmental or security purposes. Real properties within areas designated as national

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<sup>21</sup> See *supra* note 6 at V-2

<sup>22</sup> Presidential Decree of Honduras of March 30, 1982

<sup>23</sup> See *supra* note 10 at V-1

parks are frequently expropriated both directly and by indirect means. The government can grant concessions on the use of public land, but does not have selling privileges. In granting usage concessions, municipalities act as agents of the central government. Beachfront real properties in Costa Rica are governed by the Maritime Zone Law, which restricts the possession and ownership of these properties. According to the Maritime Zone Law, the government owns the first 200 meters of beachfront land starting at high-tide markers. Within these 200 meters, the first 50 are considered public zones, which nobody may possess or control. The local municipal government (acting on behalf of the central government) is granted leasing privileges on the last 150 meters.<sup>24</sup>

### ***Mortgage and Securitization of Assets***

In Central America, mortgage is frequently the only guarantee accepted by the financial system. The ambiguity described above regarding the titleholder of many real properties limits the availability of loan guarantees. In addition, securitization is hampered by legal restrictions and a lack of liquidity and regulation in local stock markets.

In Nicaragua, non-liquid rights on real property such as portfolios of mortgage credits, cannot be secured and converted into tradable instruments. There is no law on securitization, nor is there a law on trusts. Moreover, the stock market is not sufficiently developed to allow the securitization of real property rights or the issuance of bonds secured with mortgage portfolios.<sup>25</sup>

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<sup>24</sup> Maritime Zone Law of Costa Rica

<sup>25</sup> See *supra* note 6 at V-3

In Honduras, creditors have often responded to uncertainty in the real property system by requiring guarantees of 150 percent of a loan's value. Even when borrowers meet guarantee requirements, interest rates in Honduras are the highest in the region: fourteen percent for U.S. dollar-denominated loans. Likewise, non-liquid rights on real property cannot be secured and converted into tradable instruments. Securitization of real property rights and issuance of bonds secured with mortgage portfolios are prevented by the absence of laws governing securitization and an outdated stock market.<sup>26</sup>

Under Guatemalan law although there is no specific law on securitization of real property, in one reported case a creative structuring of trusts and banks permitted the public issuance of securities, which were guaranteed by mortgage and cash.<sup>27</sup> In El Salvador non-liquid rights on real property can be secured and converted into tradable instruments. For example, banks can use their portfolio of mortgage credits to secure commercial instruments. However, a law on securitization currently being discussed by the Salvadorian Legislative Assembly could open the door for sophisticated financial instruments based on real property.<sup>28</sup>

### ***Registration of Property***

Currently, less than half of the land in Central America is registered.<sup>29</sup> On the other hand, property registration is necessary in order to grant validity to a transfer of title. Registration, however can be time consuming and expensive. In 2004 in Honduras, it

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<sup>26</sup> [http://www.bizlawreform.com/country\\_assess/HondurasTCLA.pdf](http://www.bizlawreform.com/country_assess/HondurasTCLA.pdf) at V-2

<sup>27</sup> See *supra* note 10 at V-3

<sup>28</sup> See *supra* note 11 at V-2

<sup>29</sup> *Supra* note 5 at 259.

took up to 36 days to register a property at a cost of 8.8% of property.<sup>30</sup> In Guatemala, it can take up to two weeks just to obtain registry information about a property and there is uncertainty about how long it takes to have a real property transaction fully registered because information on property transactions is difficult to obtain.<sup>31</sup> In El Salvador, once a document is presented for registration it is given priority within the Real Property Registry. Once final registration is granted, rights are extended retroactively. The registry reported that the process typically takes eight days but in exceptional cases the process can take as long as six months.<sup>32</sup>

Besides the burden associated with the sluggishness of the region's property registry system, registration fees impose additional burdens on those seeking recognition of transfer rights. In El Salvador registration fees were reported as being high. A property sold for \$200,000 would cost \$12,600 to register in addition to fees to notaries. On top of that a general lack of coordination between registries and cadastres creates uncertainty as to the extension of entitlements associated with a property.<sup>33</sup>

In spite of a legal framework that encourages property ownership, land ownership in Central America remains low. In Honduras, for example, only 14 percent of those individuals who occupy properties do so legally.<sup>34</sup> The remaining 86 percent of occupants hold property extralegally, amounting to \$12.4 billion in informal occupancy.<sup>35</sup> Of

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<sup>30</sup> See *supra* note 26 at V-4

<sup>31</sup> See *supra* note 10 at V-4

<sup>32</sup> See *supra* note 11 at V-2

<sup>33</sup> *Id.* at V-3.

<sup>34</sup> Instituto Libertad y Democracia ([http://www.ild.org.pe/eng/hon\\_post\\_en.htm](http://www.ild.org.pe/eng/hon_post_en.htm)).

<sup>35</sup> *Id.*

properties held legally, only 30 percent are registered. Indicative of the vast gap in property registration are the statistics for the Comayagua Department where, of 146,000 lots, only 45,000 were reported as registered and only 15,000 are registered correctly. Confusion in the title system is seen in the prevalence of double and, in some cases, triple title holders. In order to correct this, on May 27, 2004 the National Congress unanimously approved the Property Law which switches the tenure system from a per-person filing land tenure system (folio personal) to the current property filing system, folio real, which recognizes property rights for settlers on municipal land who have maintained possession for longer than 5 years. In addition, the law provides for a system to individualize pieces of rural properties upon which usage rights, but not ownership, were granted.<sup>36</sup>

Prior to the passage of the Property Law it was said to take an average of two years and \$1,000 to purchase, subdivide, and begin building on a property in Honduras.<sup>37</sup> However, the new law seeks to reduce both the cost and time associated with this process. For example, prior to the passage of the Property Law, taxes were imposed on transfers of real property based on the property's value at 4 percent for urban non-built property, 3 percent for urban built property, 3 percent for rural non-built property, and 2 percent for rural built property. Under the new legislation the tax burden was reduced to 1.5 percent of the value of purchase price for all land categories. Registry fees, formerly \$0.30 for each \$50 of the property's value, were eliminated entirely.<sup>38</sup>

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<sup>36</sup> See *supra* note 26 at V-2

<sup>37</sup> *Supra* note 34

<sup>38</sup> See *supra* note 26 at V-3

As of September 2004, processing capacity of the registry of Tegucigalpa, which had authority over property and commercial matters, was in poor condition. Within the registry, transactions were recorded manually by staff in books in which information was indexed according to the persons involved in the transaction (i.e., folio personal). A permanent staff of 59 employees was responsible for processing, all by hand, the 400 documents received daily.<sup>39</sup>

However, under the auspices of a World Bank initiative, Honduras recently initiated a project to automate, consolidate, and make public all property information. The \$140 million, 12-year project, named *Programa de Administración de Tierras de Honduras* (PATH), is meant to strengthen the *Instituto de Propiedad*, which will be in charge of registries, cadastres, and land dispute resolutions. An experimental project within PATH recently created a unified system of registration, called *Sistema Unificado de Registro* (SURE), which will be accessible online. Using the new system, a data query, which previously took 6 to 9 months, could be completed in one minute. Under PATH, it is expected that property information, currently dispersed amongst 26 agencies, will be consolidated and accessible through SURE within 4 years. It is expected that automation and information consolidation of the registries of Tegucigalpa and San Pedro Sula will be finished in two years and that automation and consolidation of the registry of the Bay Islands will be finished in the next 6 months.<sup>40</sup>

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<sup>39</sup> *Id* at V-4

<sup>40</sup> *Id* at V-5

In Nicaragua, the Real Property Registry is a dependency of the Public Registry. It is regulated by the Public Registry Law of 1904 and is under the supervision of the Supreme Court. Real property transactions such as real property transfers, mortgages, and powers of attorney must be recorded in this Registry to be considered valid. Within the registries, information is handwritten into record books. In some provincial registries, records have been damaged by water and in some cases the information has been lost. Likewise, there is no national cadastre map, but updated cadastral information for only 20 percent of the country's land. In addition, the information held by the cadastres of some municipalities for tax purposes has not been integrated into other information systems.<sup>41</sup>

In Guatemala, there are registries in Guatemala City and Quetzaltenango. In some rural areas, information about real property is registered with a municipal office rather than with the main Real Property Registry. Thus, to determine the real owner of a property in rural areas it is not sufficient to check the National Registry. It was reported that around 80 percent of owners lacked the legal documents guaranteeing title on the property they possess. Information about properties is stored partially in written records and partially in electronic records. While a cadastre law has been in place since 1997, a cadastre agency has yet to be established.<sup>42</sup> The World Bank is financing a cadastre project the first stage of which is an assessment to be completed shortly.

In El Salvador, information on real property is maintained in three different systems: per person, per property, and electronically. Some properties are registered in one system and

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<sup>41</sup> See *supra* note 6 at V-4

<sup>42</sup> See *supra* note 10 at V-4

not in the other. On a positive note, a system of expedited payment which allows a registrant to prioritize an application by paying an additional fee has been approved. In addition, notaries who process a high volume of transactions at the Registry can enter into agreements to accelerate processing. But El Salvador does not have a national cadastre map, although currently one is being created. The Registry reports that 40 percent of the country's land has been measured and included in the national cadastre database. A plan to fully integrate information from the cadastre office and the Registry is under way.<sup>43</sup>

In Costa Rica, the Real Property Registry is automated and there are more than 130 Real Property Registrars located in San José. There are seven regional offices, but they only receive documents and do not make official registrations of real property transactions. The Registry follows the doctrine of first-in-time, first-in-right. Thus, recorded instruments presented therein are given priority according to the date in which they are recorded. However, information of the Real Property Registry and the Cadastre Registry are not consistent. These inconsistencies create problems determining the size, value and boundaries of properties and occasionally result in cases of double-title. A senior officer at the Registry stated that if one accepted the information contained in Cadastre Registry, Costa Rica would be three times larger than its actual size. However, the Real Property Registry now requires that parties to a land transaction present a map from the Cadastre Registry along with the property ownership transfer document to be filed. Consistency between the information of the Cadastre and the Real Property Registries is being

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<sup>43</sup> See *supra* note 11 at V-3

solicited at various levels. Local banks have developed a practice whereby they do not grant credit guaranteed by a property if the map from the Cadastre Registry is not under the name of the purported owner. The Cadastre Registry, in turn, does not grant a map if there is a difference with the owner's name as recorded in the Real Property Registry. Likewise, municipalities do not grant permit of use if the cadastre map is not presented or if the map has a name different from that of the owner, as recorded by the Real Property Registry. This situation affects access to credit because most lenders exclusively use real property as collateral. Because of that the Inter-American Development Bank commenced a project in 2004 to certify the accuracy of data contained in the cadastre.<sup>44</sup>

Chapter ten of CAFTA-DR provides protection against illegal and creeping expropriation.<sup>45</sup> However, that would not grant protection to investors from non-member countries or to local investors. Thus, possibility of creeping expropriation, restrictions on ownership, title certainty problems, lack of sophisticated mortgage legal frameworks and the existence of excessive steps to register property along with the deficiencies of the cadastre are all elements that discourage investments from foreigners and locals, hinder local economic growth and reduces the chances of successfully fighting poverty.

## ***CONTRACTS***

The problems contained in the legal frameworks governing contracts in Central America are generally due to either legislative or institutional shortcomings. Legislative problems

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<sup>44</sup> See *supra* note 7 at V-4

<sup>45</sup> [http://ustr.gov/assets/Trade\\_Agreements/Bilateral/CAFTA/CAFTA-DR\\_Final\\_Texts/asset\\_upload\\_file7\\_3931.pdf](http://ustr.gov/assets/Trade_Agreements/Bilateral/CAFTA/CAFTA-DR_Final_Texts/asset_upload_file7_3931.pdf)

tend to stem from the fact that the law governing the majority of contracts in Central America, typically the Civil Code, is either outdated or overly restrictive. Whereas the economically damaging effects of contract law as written tend to be generated by restricting the ability of commercial agents to enter into potentially beneficial relationships, the institutional or procedural problems tend to increase the transaction costs associated with the formation of contracts.

The regions' Civil Codes have, for the most part, failed to adapt sufficiently to changing business practices and thus do not provide specific legal guidance for the novel contract forms utilized in contemporary business. The legal framework's lack of reference to modern contractual practices is not necessarily negative, as allowing contracting parties to self-regulate contractual relationships permits a degree of flexibility in the scope of contracts, however should contracting parties fail to provide explicit content regarding how a particular situation is to be handled, adjudicators can be left without a legal instrument to which they can refer to "fill in the blanks" of a contract.

The lag between legislation and the needs of the private sector is observable in Nicaragua, where the Civil Code does not account for leasing, factoring, or electronic transactions.<sup>46</sup> While electronic purchase is increasingly common in Nicaragua, there are no provisions on electronic contracts or electronic signature. Such a legislative gap will be exposed as electronic commerce becomes increasingly common amongst the Nicaraguan private sector. The banking sector, for example, is currently planning to issue

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<sup>46</sup> The Nicaraguan Commercial Code was first passed in 1914 and like the Civil Code has not modernized sufficiently to govern current businesses.

products that require electronic signature such as credit cards and online utilities payment.<sup>47</sup>

El Salvador, on the other hand, has a leasing law but lacks a law on factoring (*factoreo*). The absence of a formal factoring law has been filled by the private sector's use of informal means to govern the terms by which purchases of accounts payable are managed. This informal instrument, known locally as *quedan*, is used by businesses of all sizes to finance operations, and in some cases to guarantee formal loans, through the sale of accounts payable or undelivered merchandise.<sup>48</sup> Such informal measures provide useful substitutes for an actual factoring law, but it has been noted that extralegal relationships tend to limit potential transactions partners, as they require a higher degree of trust than those governed by the State.<sup>49</sup> As factoring allows the utilization of dormant assets to finance a firm's operations or expansion, a formal law governing this practice may prove economically beneficial.

Honduran contract law allows parties to assign any name to a contract.<sup>50</sup> Although courts are supposed to look at the nature of the agreement rather than its assigned name when determining the contract's effect, contracting parties sometimes disguise the true legal nature of a contract by assigning to it a name that implies a different degree of entitlement than is provided in the body. For example, it is common for Honduran landlords to disguise rental agreements as not-for-payment loans, supplemented with

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<sup>47</sup> See *supra* note 6 at IV-1

<sup>48</sup> See *supra* note 11 at IV-1

<sup>49</sup> Kevin Davis, Michael J. Trebilcock & Bradley Heys, Ethnically Homogenous Commercial Elites in Developing Countries, 32 LAW & POL'L INT'L BUS. 331, 333 (2001)

<sup>50</sup> The Honduran Commercial Code entered into force in 1950

letters of credit, to facilitate tenant eviction. Such contracts should not be honored by a court if it is proved that the nature of the contract is that of a rental agreement rather than the assigned name.<sup>51</sup>

Besides limitations regarding scope, the legal framework for contracts in Central America is sometimes burdened by restrictions on the substantive content of contracts. In Honduras, discretion regarding labor contracts is limited by parties' inability to waive certain stipulations and the automatic applicability of certain provisions regardless of an agreement's actual written content. For example, labor contracts in Honduras prevent the use of night shifts and set costly severance pay standards for employee dismissal. Those limited restrictions on the discretion given to contracting parties in labor markets may be useful in preventing violations of basic labor standards. However, there is reason to believe that difficulties associated with replacing workers increases unemployment and dampens economic growth.<sup>52</sup>

Illustrating the effect of regulation governing labor contracts and turnover, Pavcnik conducted a study comparing the entry and exit of workers into the labor market between the United States and Portugal to find that strict employment protection reduces turnover in labor markets while flexible labor regulations have the opposite effect.<sup>53</sup>

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<sup>51</sup> See *supra* note 26 at IV-2

<sup>52</sup> Edward P. Lazear, Job Security Provisions and Employment, 105 Q. J. ECON. 699 (1990)

<sup>53</sup> Pavcnik, N. 2002. "Trade Liberalization, Exit, and Productivity Improvements: Evidence from Chilean Plants," THE REVIEW OF ECONOMIC STUDIES 69, 245-76.

In some cases restrictions in the legal framework for contracts comes in the form of bias against foreigners. That has been the case in many Central American countries in connection with distribution and representation contracts where the interests of local distributors have been disproportionately protected by not allowing foreign jurisdiction and foreign law to apply or by granting exuberant compensation to the local distributor after the distribution contract has been terminated by the foreign company.<sup>54</sup>

Under Annex 11.13 of Chapter Eleven of CAFTA-DR related to cross-border trade in services, countries took several commitments that to some extent diminish the risks involved for foreign investors in distribution and agency contracts. In some cases the risk is eliminated through the repealing of a law such as in the case of Guatemala. But in the case of El Salvador, the commitment extends to not apply restrictive provisions of the Commercial Code for distribution or agency contracts with U.S. parties; a solution that would not benefit investors from other countries.<sup>55</sup> Similarly, the commitment of Costa Rica under CAFTA-DR chapter eleven did not extend to a Civil Code provision that imposes limits on the use of foreign law to govern contracts.<sup>56</sup> Thus, a full reform of the

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<sup>54</sup> In Honduras, for example, distribution and representation contracts are subject to a law passed in the 1970s, which disproportionately protects the interests of local distributors. *See* Honduran Law of Agents, Distributors and Representatives of National and Foreign Enterprises

<sup>55</sup> Annex 11.13 of Chapter Eleven of CAFTA-DR.  
[http://ustr.gov/assets/Trade\\_Agreements/Bilateral/CAFTA/CAFTA-DR\\_Final\\_Texts/asset\\_upload\\_file7\\_3931.pdf](http://ustr.gov/assets/Trade_Agreements/Bilateral/CAFTA/CAFTA-DR_Final_Texts/asset_upload_file7_3931.pdf)

<sup>56</sup> According to Article 1023 d of the Costa Rica's Civil Code contractual clauses that refer to foreign law for enforcement and interpretation can be annulled at the request of one of the contracting parties. During interviews, this provision provoked diverse responses from lawyers and judges. Some respondents noted that the parties' freedom to contract superseded this article and that if parties agreed that foreign law should apply, the terms of the contract would override requests to annul the application of foreign law. Others considered the provision applicable only to prewritten non-negotiable contracts, where no bargain has occurred. One lawyer suggested that this restraint on choice of law—although legally binding—was not enforced and has been ruled inapplicable by judges. While each of these responses diminishes the degree to

commercial legal framework of the Central American for distribution or agency contracts from the current one to a much more balanced one might encourage the increase of trade in goods or services in the region and consequently the economic welfare of its citizens.

### ***Procedural Issues***

In general, contracts are subject to few procedural formalities in Central America, but certain contracts such as those related to the sale of real property, mortgages or letters of credit (*titulos ejecutivos*) often require authentication by a notary. Besides imposing additional transaction costs on parties, the requirement of authentication through notaries, whom lack stringent regulatory supervision, appears to be a source of fraud.

To form a public contract in Costa Rica, a notary must draft the document, confirm the identities of contracting parties, and certify the authenticity of the signatures. Upon the contract's completion, the notary assumes responsibility for the document's content and incurs liability should he fail to comply with his authentication duties or collude to commit fraud. Interviewed local businesspeople, on multiple occasions, commented that notaries add unnecessary expense and time to the process of contract formation, especially in their duties associated with drafting and presenting the document at the registry.<sup>57</sup>

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which the provision limits parties' discretion, the provision has not been legally repealed and thus creates the possibility that investors be subject to Costa Rican law regardless of contract terms stating otherwise.

<sup>57</sup> See *supra* note 7 .at IV-2

In Nicaragua contracts are valid regardless of notarization. However, in some cases for a contract to be considered valid vis-à-vis third parties, notarization is required. This is the case in contracts related to real estate, real property leases with durations of more than four years, and pledges of commercial property. Notaries in turn must be lawyers authorized by the Supreme Court to certify the verity of contracts and related documents.<sup>58</sup>

Lack of strict oversight of the notary profession, has led to cases of abuse and fraud. In Honduras, it was frequently reported that notaries commonly state that they have verified a transaction before the transaction has occurred. As a result of this practice, the rights of one party—usually that of the person whose document has been fraudulently authenticated—may appear to prevail over that of the other.<sup>59</sup> In El Salvador, it was also reported that notaries have been conspirators in fraud. In one case, a notary tried to file for the sale of a company’s real property using a document contained the forged signature of the company’s president. Another interviewee reported witnessing a notary falsifying the signature of a judge.<sup>60</sup>

Powers of attorney are commonly-used in Central America to allow an agent to act on behalf of a principal. In each of the Central American countries, powers of attorney require notarization. However, for a power of attorney to be valid in another country in the region, it must contain not only notarization from its home country, but notary

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<sup>58</sup> See *supra* note 6 at IV-2

<sup>59</sup> See *supra* note 26 at IV-3

<sup>60</sup> See *supra* note 11 at IV-2

approval from the country in which it will be used. For example, in Nicaragua, foreign powers of attorney must first be legalized through its consulates in the country where the power of attorney was granted, second through the Ministry of Foreign Affairs and finally they must then be notarized in Nicaragua.<sup>61</sup> El Salvador and Costa Rica are signatories of the Inter-American Convention on Legal Regime of Powers of Attorney to be Used Abroad. According to the Convention, powers of attorney granted in other signatory countries require only an apostil from the relevant officer in the country of origin. While in the case of El Salvador, the Convention's purpose of facilitating the use of foreign powers of attorney has successfully reduced procedural requirements for international firms, in Costa Rica interviewed notaries, judges, and lawyers noted that a power of attorney granted in a signatory country would not be considered valid if it did not contain an authentication by a Costa Rican notary.<sup>62</sup>

### ***Judicial Systems***

The economic utility of property rights and contract rights is dependant upon individuals' assumption that they can be enforced. Paramount in enforcement of these rights is the judicial system. In general the judicial system of Central America is in despair. Courts are slow, corrupt and hampered by tedious procedural requirements. Corruption in way of bribery and politicized court systems further contribute to the private sectors' lack of confidence in the enforcement of commercial rights and decrease the value of property and contract rights.

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<sup>61</sup> See *supra* note 6 at IV-2

<sup>62</sup> See *supra* note 7 at IV-3

In El Salvador, interviewees consistently mentioned the Supreme Court as the origin of problems with the judicial system. The Supreme Court is composed of 15 justices appointed by the Legislative Assembly for a nine-year term. Because of political polarization between a strong leftist coalition group and the center-right group, the appointment process is a function of politics rather than merits. Consequently, the best lawyers are often passed over for justice appointments due to contrary or lack of political affiliation. The Salvadorian Supreme Court is assigned administrative functions, such as supervising lawyers, notaries, and judges of lesser courts. These responsibilities distract Supreme Court judges from their duties in deciding cases and have allowed the politicization of the highest court to permeate into the larger judicial system. Salvadorian courts are also characterized by slowness in enforcement. It was reported that one would be considered fortunate if one's case reaches a decision within two years at trial courts.<sup>63</sup>

In Nicaragua, the USAID CAFTA Assessment stated: “The overwhelming need for judicial reform in Nicaragua surpasses all other governmental reform initiatives in its urgency. The country's lack of judicial independence, impartiality, and substantive and administrative competence dominates Nicaragua's legal landscape and economic institutions. If the absence of political will and commitment to change in this area continues to negate the impact of reform efforts, there is almost no hope for genuine economic development in the long run. Judicial reform must encompass not only current initiatives in human rights and criminal law but also whole-cloth improvements in the

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<sup>63</sup> See *supra* note 11 at IV-3

part that Nicaragua's courts play in addressing commercial law and institutional competencies."<sup>64</sup>

It also stated: "Corruption at all levels of the judiciary has been reported to be a common occurrence. Recently there have been three well-publicized cases in which firms were issued unfair rulings by courts. Commenting on corruption within the judiciary, the President of Nicaragua has said that the 'banks are no longer robbed by masked men, now the justices do so."<sup>65</sup>

Slowness of the judicial proceedings is a major problem. In Guatemala, according to the World Bank, it takes an average of 1,460 days to enforce a contract, compared with the regional average of 363 days and the OECD average of 213 days.<sup>66</sup> In Honduras contract enforcement averages 545 days and entails 36 procedures.<sup>67</sup>

In Costa Rica it was reported that a decision awarded by a trial judge within a 3-year period could be considered a successful exception to the slow moving judicial system.<sup>68</sup> In addition, there are no restrictions on appeals and the Supreme Court can also review the decision through the *casación*.<sup>69</sup> However, in Costa Rica there is a draft Civil Procedure Code that if passed would require that civil and commercial procedures be conducted orally which would make litigation easier, faster and more transparent.

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<sup>64</sup> See *supra* note 6 at I-1

<sup>65</sup> *Id* at IV-3.

<sup>66</sup> <http://rru.worldbank.org/DoingBusiness>.

<sup>67</sup> World Bank, doing business

<sup>68</sup> See *supra* note 7 at IV-3

<sup>69</sup> *Casación* is a Judicial Review mechanism where the facts are not reviewed but only the right interpretation of the law. Gerardo Solis and Raul Gasteazoro, West's SPANISH-ENGLISH LAW DICTIONARY, 1992 at 55

Throughout the region a lack of automation serves to exacerbate the judicial systems' resource shortages as information is difficult to locate, procedures cannot be initiated remotely, and courts cannot share information. Moreover, judicial procedures are required to be conducted in writing.

### ***Alternative Dispute Resolution(ADR)***

Alternative dispute resolution holds the potential of reducing the burden on resource strapped judicial systems. Arbitration could also increase investor confidence by allowing businesses to bypass corrupt or slow courts. In Central America the availability of arbitration centers is growing, but remains low. A primary factor in limiting the ability of arbitration to provide a significant alternative to State courts is limited because of the little awareness of their existence.

In Honduras, after the Law on Alternative Dispute Resolution was passed in 2001, two arbitration centers were created: one in Tegucigalpa and one in San Pedro Sula. The center in Tegucigalpa is part of the local chamber of commerce and has been in place for three years; it has 28 listed arbitrators and has handled eight arbitration cases and about 20 conciliations. Cases are typically settled within three months and no annulment procedure has been initiated against any arbitral award. It is expected that the Tegucigalpa arbitration center will be operating at full capacity in five years.<sup>70</sup>

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<sup>70</sup> See *supra* note 26 at IV-4

In Guatemala there is only one active arbitration center. It is not widely known that the arbitration center exists and for those who are aware of its services, its fees were reported as being high. Furthermore, in many center's cases the constitutional legal action of *amparo* has been used to move arbitration procedures back to traditional courts.<sup>71</sup> Costa Rica, on the other hand, has a sophisticated arbitration system containing at least three well-developed arbitration centers.

Foreign investors from CAFTA-DR States can initiate international arbitration against States before the International Center for Settlement of Investment Disputes (ICSID) according to the terms of the ICSID Convention and the CAFTA-DR. Means for enforcement of the treatment standards provided to investors by the CAFTA-DR is provided in Section B of Chapter Ten devoted to investments, which includes ICSID arbitration as option for dispute settlement. That is, should an investor deem a State's action contrary to one or more of the agreement's provisions, the investor may bring claim against the State to an impartial arbitral body that assures final, binding and enforceable settlements. Should the State fail to adhere to the ruling of the arbitral panel, it would be found in violation of the ICSID Convention and the investor's home State could then refer the dispute to the International Court of Justice. However, in general that mechanism would not be available to investors from non-member countries.

Thus, the main problem in the area of contract law relates to a weak and unreliable judicial system and a yet-not-sophisticated ADR system, all of which affects the flow of

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<sup>71</sup> See *supra* note 10 at IV-5

foreign business, discourages the growth of local business, adds transaction cost, fosters corruption and do not contribute to the economic development of the region.

### ***Securities Markets***

Active securities markets have been empirically linked to contributing to economic growth.<sup>72</sup> Liquid stock markets give investors greater confidence in making investments in long-term, high-return projects because liquidity reduces the cost associated with selling shares before an investment matures. Liquid exchanges thus increase capital flows into high-return projects, which in turn drives productivity. Also relevant to Central America is the positive relationship between the regulation of securities and the development of stock exchanges.<sup>73</sup> By regulating the informational requirements of security-issuing firms, the State provides investors' with greater confidence regarding the reliability of information provided by issuing firms.

Presently, local stock markets in Central America are characterized by low volume and dominated by debt instruments and government securities. In general, the countries in question have done well to establish the basic legal context in which the placement of securities may occur, but enhanced regulation may be necessary before the exchanges are sufficiently developed to provide a significant means for financing growth.

There is presently a regional exchange, which may be an appropriate strategy for developing a more robust securities market in the region due to the small size of the

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<sup>72</sup> Ross Levine & Sara Zervos, Stock Markets, Banks, and Economic Growth, 88 AM. ECON. REV. 537 (1998)

<sup>73</sup> Rafael La Porta, et al., Legal Determinants of External Finance, 52 J. FIN. 1131 (1997)

economies involved and the difficulties that local exchanges have had in attracting trade volume. But that exchange is not well developed. The difficulties encountered by TACA airlines when trying to issue bonds in the Central America stock markets underline the grievances created by the lack of harmonized regulations related to stock exchanges. TACA was forced to move its bond issuance to Panama due to differences in regulatory standards and incompatible procedures between exchanges in Central America.<sup>74</sup>

In Nicaragua, a stock exchange market has been in place for ten years. Purchases can be made electronically and the stock market is generally modern. However, due to low liquidity, lack of a regulatory framework governing securities, and a general lack of familiarity regarding the exchange, equity placements are rare. The majority of securities offered in the Nicaraguan exchange are bonds or other debt instruments and 90 percent of exchange's average daily volume involves government securities. It was reported that \$800 million was traded in the stock market in 2004 and most investments were made by banks as direct investors.<sup>75</sup>

In Honduras, there are two stock markets: one in Tegucigalpa and one in San Pedro Sula. The Tegucigalpa market is the larger of the two exchanges, but is not yet automated and mostly trades government bonds. It was reported that there are only 144 stockholders in the Tegucigalpa stock market, most of which are banks. The Honduran exchanges may be affected by fragility in the country's larger financial sector, which has still not completely recovered from the effects of the 1999 financial crisis spurred by a mass

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<sup>74</sup> See *supra* note 26 at III-8

<sup>75</sup> See *supra* note 6 at III-5

selling of bonds to pay for the extensive damage caused by hurricane Mitch. While the government structured a bail out, spending what amounts to half of the country's GDP to restore the solvency of the local financial institutions, and passed a new Law on Stock Market; neither of the exchanges has attracted an equity-based placement.<sup>76</sup>

In El Salvador companies can issue shares to the public, but this has not happened. A stock exchange market exists in which companies primarily trade bonds and other debt instruments. Reportedly, an average of \$30 million in these securities are traded daily. To publicly issue bonds, companies are required to receive authorization from the Stock Superintendency, comply with the provisions of the Stock Market Law and the internal regulations of the *Bolsa de Valores* (stock exchange).<sup>77</sup>

In Guatemala, companies are able to trade shares publicly but none has done so. Many companies trade bonds in the stock market, but not equity. Limited issuances occur in the form of the provision of stock options to employees.<sup>78</sup>

In sum, lack of a sound regional framework for the stock market and lack of stock market investment culture deter the growth of the regional stock market and with that the emergence of public companies. As a result companies are doing business elsewhere.

## ***COMPANY***

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<sup>76</sup> See *supra* note 26 at III-7

<sup>77</sup> See *supra* note 11 at III-4

<sup>78</sup> See *supra* note 10 at III-1

A good company law framework is paramount to economic development. The successful formula of business is one where the benefits exceed the costs. For investors to be unlimited liable for the activities of companies where they invest is a major deterrent to do business. On the contrary, if the investor's liability can be limited to the investment made, investors might be encouraged. But the society does not gain well if the concept of limited liability is abused or if the protection offered to investors is not sufficient or competitive as compared to what other countries offer.<sup>79</sup>

In all the Central American countries the legal framework provides businesses with different types of companies such as the limited liability corporation. For example in Nicaragua, the *Sociedad Anónima*, a limited liability corporation, can be created under the Commercial Code. The Code allows for other types of business structures, such as the *Sociedad en Nombre Colectivo*, a general partnership.

### ***Disincentive to do business***

However, the major problem Central American countries face in the area of Company Law pertains to the excessive and expensive requirement imposed to incorporate and operate a corporation. Moreover, lack of registration can make liable those that act on behalf of the business entity. Thus, the costs and requirements involved in company registration in and of itself discourage small business to formally incorporate them and add unnecessary transaction costs to foreign investors.

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<sup>79</sup> Easterbrook Franck H and Fischell Daniel R., Limited Liability and the Corporation, 52 THE UNIVERSITY OF CHICAGO LAW REVIEW, 52 (1985)

In Central America the costs of incorporation are unaffordable by the majority of the population. In Honduras a minimum equity of \$1,500.00 is required for registration of *Sociedades Anónimas*. A company cannot initiate operations if it does not meet this capital requirement, which is complied with by submitting evidence that money has been deposited into a bank account. After incorporation, however, the money is usually used for other purposes and thus is no longer available to guarantee the rights of the company's creditors.<sup>80</sup>

In Guatemala, the minimum level for capital incorporation is roughly \$500. Shareholders must pay 25 percent of the promised contribution, which can be paid in cash or in kind. In total, the cost of incorporation equals 62.8 percent of the gross national income (GNI) per capita, i.e., \$ 1,265.52.<sup>81</sup>

In El Salvador a *Sociedad Anónima* cannot be registered without initial capital of \$11,500, although only 25 percent needs to be paid during incorporation in cash or in kind.<sup>82</sup> However, registration fees are not high. In the case of incorporation, fees are determined by the capital of the registering company and cannot exceed \$5,700. To incorporate a company with capital ranging between \$11,428.57 and \$57,142.86, registration fees would be \$91.43.<sup>83</sup> In addition, in order to operate, a company needs to

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<sup>80</sup> See *supra* note 26 at III-1

<sup>81</sup> World Bank doing business (2004). <http://www.doingbusiness.org/Default.aspx>

<sup>82</sup> Commercial Code of El Salvador , article 192,

<sup>83</sup> Centro Nacional de Registros de El Salvador. <http://www.cnr.gob.sv/>

obtain a business license and renew it every year. Altogether the cost of incorporating a business equals 72.9 percent of the gross national income (GNI) per capita, \$ 715.40.<sup>84</sup>

Currently, it is not possible to register a company online, but in El Salvador plans have been drafted to allow incorporation via the Internet and to create a network between government offices. Once this network has been completed, it is expected that all business registrations can be conducted electronically at a virtual one-stop shop.

In Nicaragua, costs of registering a *Sociedad Anónima*, including associated legal fees, range from \$1,000 to \$3,500. This cost is considered high and is mentioned as a deterrent to business formalization.<sup>85</sup>

Company registration is a time-consuming process that involves many entities and processes. It typically takes about 60 days to complete the process. A foreign investor underlined the frustration and cost associated with registration by noting that he could incorporate a business in the United States by mail in 2 days at a relatively low cost, whereas in Nicaragua it would take months to process the request and cost significantly more.<sup>86</sup>

With the exception of El Salvador and Costa Rica, the Commercial Registries are very inefficient. In Tegucigalpa, the Commercial Registry receives more documents than it can handle. Approximately 400 documents are received daily, with only one computer available to process them. As a result of these limited technological resources, most operations are recorded manually, delaying registration. According to the registry's

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<sup>84</sup> World Bank doing business (2004). <http://www.doingbusiness.org/Default.aspx>

<sup>85</sup> See *supra* note 6 at III-4

<sup>86</sup> *Id.*

officers, registration of a company takes roughly 45 days. Lawyers interviewed, however, say that the process typically takes 2 to 3 months.<sup>87</sup>

### ***More requirements***

Requirements about the number of shareholders are another obstacle. In Honduras, until 2000, the Commercial Code required that *Sociedades Anónimas* have at least five shareholders. The Law on Administrative Simplification, passed in 2000, changed this provision so that companies now must have only two shareholders. Nonetheless, wholly owned subsidiaries are still not possible. The Commercial Code also does not provide for incorporation of companies without equity, as is the tendency now in the developed world.

In El Salvador, a company is required to have a minimum of two shareholders at any point in time. If the company has a sole shareholder, it is considered an irregular company for which the shareholder will have joint and unlimited liability to creditors.<sup>88</sup>

To operate, companies must obtain a great number of permits from various governmental entities. In Honduras, business operation permits, issued by the municipalities, are expensive by local standards and require that the company have a physical address for operations, for which a property deed or lease agreement must be presented. Because the majority of companies are unable to present either of these documents frequently they

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<sup>87</sup> See *supra* note 26 at III-5

<sup>88</sup> Comercial Code of El Salvador, article 17 and 357.

face obstacles to operate. For example, in San Pedro Sula, the municipality has threatened to close 700 stores because they lack the municipal permit to operate.<sup>89</sup>

On the positive side, in Honduras, the Law on Administrative Simplification also includes the principle of *afirmativa ficta*, according to which certain requests to the government must be responded to within a given time period. (If there is no response within the given period, the request would be considered approved.) Before the Law on Administrative Simplification was passed, it took 9 months to obtain the required permits to start a business, but since the law's passage it takes 3 months. In Tegucigalpa, however, it can still take up to a year to obtain the municipal business license, although temporary licenses are available during the approval process. The main reason for that is an environmental permit which takes roughly 6 months to obtain and is required for most activities in Honduras.<sup>90</sup>

The capital increase of companies can be subject to additional requirements. In Nicaragua, changes to by-laws for *Sociedades Anónimas* must be approved by a judge before the changes can be registered at the Commercial Registry. An increase in the equity capital of a *Sociedad Anónima* is considered a change in the by-laws.<sup>91</sup> Thus, increases in the equity capital are deterred by the transaction costs associated with registering changes. Hence, increases are often left unreported.

### ***Unreliable institutions***

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<sup>89</sup> See *supra* note 26 at III-4

<sup>90</sup> *Id.*

<sup>91</sup> Commercial Code of Nicaragua, article 213

The commercial registry is usually not automated, hence processes are slow. In Nicaragua, for example, the Commercial Registry processes are not automated, and registration information is handwritten into national record books. In addition, the few revenues they collect go to the central government. The government then allocates approximately 4 percent of its annual budget to the Supreme Court, which in turn allocates a portion of that amount to the country's registries. In Honduras the situation is similar. The lack of coordination is such that there is duplication of names of companies that have been registered in different offices. This has created uncertainty among creditors who do not know which of the companies is responsible for payment.<sup>92</sup>

In Guatemala, there is only one Commercial Registry for the entire country which is internally automated but does not provide information online. Likewise, information in the Commercial Registry is not confidential. Commercial Registry officers have a high level of discretion when it comes to registering a company. In one case, it took a company almost two years to register. In this case, a competing firm allegedly bribed officers to slow the process.<sup>93</sup>

In Costa Rica, the Commercial Registry is partially automated. A significant portion of the information is contained in paper folders. Efforts are being made to transfer that information into electronic folders. However, government restrictions on public expenditures make the Commercial Registry less effective because new business growth creates greater strains on its resources.<sup>94</sup>

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<sup>92</sup> See *supra* note 26 at III-4

<sup>93</sup> See *supra* note 10 at III-3

<sup>94</sup> See *supra* note 7 at III-5

El Salvador has the best Commercial Registry of the region. It is the only registry in Latin America to have received an ISO-9000 quality certificate. The registry is highly automated, has well-trained officers, and provides good accessibility.<sup>95</sup>

Nicaragua has a one-stop shop for investors, the *Ventanilla Única de Inversionistas*, or VUI, which opened 1 year ago. Through an agreement among the Trade Ministry, the Commercial Registry, the Mayor's office, and the National Revenue Office, the 72 steps associated with registering a business were to be brought into the VUI. By using the VUI, a business owner can reduce the incorporation process from 60 days to 15 days. The VUI, however, is available only in Managua. VUI officers have not conducted any large-scale promotional campaigns because the new institution still lacks the capacity to handle a large inflow of registrants. Since its inception, the institution has registered approximately 265 businesses and currently receives 40 new cases per month.<sup>96</sup>

Thus, automation of the commercial registries, reduction of steps to register, reduction of costs, integration of the commercial registries with other governmental regulatory agencies and with other regional registries are necessary in order to foster the growth of companies to formalize their existence.

In Central America, to register a company a notary needs to authenticate the documents. That not only increases the costs but has also been reported to be a source for potential fraud. In Guatemala, occasionally some notaries have filed false shareholders'

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<sup>95</sup> *Id* at III-3

<sup>96</sup> *See supra* note 6 at III-4

resolutions. In those cases, under the assumption that information provided by notaries is true, the Commercial Registry has been defrauded.<sup>97</sup>

Likewise in El Salvador, problems at the Commercial Registry typically are associated with errors made by submitting parties. In most cases, these parties are notaries. Examples of these errors include the presentation of prohibited documents, the delay in correcting mistakes on documents, and the withdrawal of the documents issued by the registry.

Although a large part of the business community of Central America think notaries provide some level of security to business transactions, their presence is required in too many processes. This requirement causes inefficiencies in the company registration process. Interested parties without notaries' involvement, for example, could do the company-name-availability research and file documents with the registry.

### *Consequences*

As a consequence of the costs, time and steps involved in company registration in Central America, there is a high level of informality, there is low tax collection and high tax rates and there are high levels of corruption.

In Honduras, estimates of informal operations range from about 50 percent to 89 percent of all businesses.<sup>98</sup> In fact, a business association interviewed reported that of the 2.8 million economically active inhabitants in Honduras, three-quarters are in the informal

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<sup>97</sup> See *supra* note 10 at III-4

<sup>98</sup> See Instituto libertad y democracia. [www.ild.org.pe](http://www.ild.org.pe); World Bank, Snapshot of Business Environment – Honduras, at <http://rru.worldbank.org/DoingBusiness/ExploreEconomies/BusinessClimateSnapshot.aspx?economyid=86>

economy. Roughly 600,000 Hondurans are employed by SMEs (Small Medium Enterprises), while the large apparel manufacturing companies known as *maquilas* employ about 130,000 people.<sup>99</sup>

Informality deprives entrepreneurs of opportunities to grow, but it also reduces the range of tax collection for the government. Because of that the governments usually increase the tax rate, but that creates more disincentives to formalize a business.

In Nicaragua one company stated that for every dollar it received in revenue, it paid 31 cents in taxes before income taxes were levied. Many kinds of taxes are levied on corporate revenues. An enterprise asset tax is levied on the value of companies' assets even in cases in which the firm has incurred annual losses. Additional taxes reported include a 15 percent value-added tax, a 9 percent consumption tax, a 1 percent municipal tax, and a 15 percent sales tax.<sup>100</sup>

In Honduras, companies pay income tax at a rate of 25 percent, sales tax at a rate of 12 percent, a solidarity tax (used to pay for social services) of 5 percent, and a business asset tax that is independent of profits. In an unusual provision, incomes accrued by companies operating food franchises are untaxed. Dividends paid to shareholders are tax exempt. Due in part to the heavy tax load, tax evasion is prevalent. It was reported that only 400,000 of 7 million Hondurans pay taxes.<sup>101</sup>

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<sup>99</sup> See *supra* note 26 at III-4

<sup>100</sup> See *supra* note 6 at III-3

<sup>101</sup> See *supra* note 26 at III-4

The vicious circle created by excessive registration steps has an ugly corollary: corruption. Through hidden payments, some steps are circumvented. In addition, the more steps imposed to incorporate a company the more transaction costs increase. In most cases those costs also involve the hidden costs of corruption. As a result, both formal incorporation costs and hidden corruption costs discourage the growth of business, employment creation and economic development.

Strikingly the countries that had required more steps to register a business were the ones with the worst indicators in corruption. For example, in Guatemala there are 15 steps involved on starting a business,<sup>102</sup> and the country was located in place 123 out of 145 of the Transparency International Corruption Perception Index of 2004,<sup>103</sup> and in the percentile 18.8 of the World Bank governance and anticorruption index for 2004.<sup>104</sup>

### ***Company credit***

Furthermore, as a consequence of all the steps and costs involved for registration many businesses cannot have access to credit and are impeded from growing and creating jobs. Even those that formalize their operations are unable to have access to credit because they lack the guarantees that financial entities ask for.

In Honduras, only 5 percent of the population has access to credit. SMEs have great difficulty obtaining credit because of a lack of guarantees. Micro-finance institutions provide a potential alternative source of credit, but interest rates are often prohibitively high (up to 80 percent). Funds managed by micro-finance institutions charge interest of

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<sup>102</sup> World Bank doing business (2004). <http://www.doingbusiness.org/Default.aspx>

<sup>103</sup> Transparency International, CPI <http://www.transparency.org/cpi/2004/cpi2004.en.html#cpi2004>

<sup>104</sup> World Bank Governance Indicators. [Kaufmann D., A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996-2004.](#)

up to 3 percent monthly. Other options include credit card financing (with \$5,000 credit limits and interest rates of 2.75 percent annually) and special programs offered by some banks that grant \$30,000 loans to be paid back in 5 years at 9 percent and require a guarantee such as a mortgage on real property. In the case of each of these options, stringent requirements often prevent their use.<sup>105</sup>

In the same country some alternatives have been developed. For example, the Honduran Council of Private Enterprise, *Consejo Hondureño de la Empresa Privada* (COHEP), has \$200,000 available for SME financing. With these funds, provided by the Government of Taiwan, the organization grants loans of up to \$5,000 to SMEs under flexible terms.

Likewise, the *Fundación Coveló*, a foundation for financing SMEs, which has accumulated almost \$25 million to assist small businesses provides SMEs with credit lines of up to \$16,000.00 on favorable terms (monthly interest rates of 3 percent versus the 10-percent daily rates that some micro-finance institutions charge). The foundation seeks loan guarantees, but guarantees are not required.<sup>106</sup> Similarly, in El Salvador the FUSADES think-tank has a branch called PROPYME which provides credit to SMEs usually at a higher rate than the market but without many guarantees and with technical assistance devoted to business development.

In sum, excessive requirements to establish a business affects the growth of business in general and that of SMEs particularly. No one wins with the obstacles imposed to starting up a business. Some positive steps are being implemented in individual countries, such as the excellent performance of the El Salvador Commercial Registry on incorporating a

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<sup>105</sup> See *supra* note 26 at III-4

<sup>106</sup> *Id* at III-7

company or the one-stop-shop for investors of Managua; but problems remain at a larger scale.

#### **IV- Recommendations and Conclusions**

Coase provides a useful theoretical context for assessing the State's participation in securing contract and property rights, calling for the State's intervention in instances in which intervention would reduce transaction costs below what would be present without intervention.<sup>107</sup> However, when looked at in the practical context, especially when considering finite financial resources, determining the appropriate reform of a State's role becomes more difficult. Nevertheless, several areas mentioned in the sections above seem both particularly detrimental to the economies in question and amenable to reform.

Together the Central American countries make a market of almost 40 million inhabitants. From the business standpoint, Central America as a region is much more appealing to foreign investors than the individual countries. In addition, most of the problems found in each country are similar to the rest. For these reasons, it is recommendable to approach the solutions to some of the problems in a regional way.

In this sense, an effort should be made to make laws and regulations pertaining to property both simpler and more consistent throughout the region. Transparent property laws that punish indirect expropriation should be encouraged. Regulatory measures that affect the property for environmental and security reasons should be well defined and

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<sup>107</sup> Ronald H. Coase, The Problem of Social Cost. J. LAW & ECON. 3. (1960)

fairly implemented. Restrictions to property rights both by law and *de facto* should be minimized. Tenancy laws should be more balanced and abuses by holders of squatters' rights should not be permitted.

National bodies charged with overseeing property registration should develop processes for acting in a coordinated fashion, reviewing regional best practices for collateral laws and registry operations. A long-term automation strategy should be developed, one that includes, as a precursor to automation, improved business processes, procedures, and workflows. A vital long-term goal would be that of using technology to facilitate sharing of information of the registries within the region to ease research and investigation of encumbrances. The example of the Honduran PATH should be extended regionally.

In addition, the CAFTA countries would benefit from a joint strategy to harness remittances more efficiently, allowing them to be used as a powerful tool in the property market. Specifically, an effort to encourage Central Americans living in the U.S. to invest directly in local property, rather than through middlemen, would reduce transaction costs and fees, and allow more of the money to be used for actual investment in real property. In addition, business organizations and professional associations should attempt to promote the services of Central American brokers for transactions in Central America. Finally, the same organizations should endeavor to enable real estate sales searches over the Internet, so that they are accessible to expatriate Central Americans.

In contract law, the legal framework should be modernize in order to provide balanced rules for distribution and agency undertakings and in order to “fill the blanks” for electronic, factoring and leasing arrangements.

Likewise, all CAFTA States would benefit from a regional conventions designed to harmonize and simplify procedures, such as the power of attorney. This should prove a solution that at low cost and in short term might bring about positive externalities to the region.

The crisis of the judicial systems is hindering the economic development of the Central American region. Reforms of the systems and litigation procedures are paramount. Introducing practices that encourage transparency such as oral procedures is crucial. Likewise, the establishment of a regional court having officially sanctioned appellate powers over commercial disputes between different countries should be considered.

Significantly, the CAFTA agreement itself calls for regional approaches to resolving disputes. This regional focus could be a catalyst to re-energize efforts to promote ADR. Working in cooperation with judges, lawyers, and professional associations, donors should encourage programs that focus on improving understanding and use of commercial arbitration and mediation.

With respect to the ability of businesses to raise money through the sale of stock, two primary suggestions have emerged: (1) harmonization of stock market/exchange laws

within the CAFTA region; and (2) development of an inter-regional private sector working group focusing on a long-range goal of establishing a regional stock market. Similarly, securitization legal frameworks should be passed in all the countries. That will create tremendous opportunities for the financial market and for the construction industry.

In the area of company, efforts should be made to set up the framework for regional companies, similar to the *Societas Europaea*.<sup>108</sup> For example, a convention could be drafted for regional companies, whereby companies incorporated under the formalities of this convention are treated as a local entity in any Central American country with no more formalities needed. Similarly, a regional registry should be established for these companies.

Likewise, the role of the SMEs could be strengthened regionally. All of the individual countries would benefit from a system similar to the U.S. Small Business Administration's Business Development program, which provides support for new businesses through facilitating access to government contracts, assisting with access to capital, providing management and technical aid, and helping companies export their goods. Such a system would be stronger if it were designed in a fashion that is coordinated and consistent throughout the region. A collaborative effort to assist SMEs would:

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<sup>108</sup>Restatement (Third) of the Foreign Relations Law of the United States at 131

- grant benefits to participating businesses, including special tax treatment and small-business quotas for government contracts;
- reduce complications and delays with the registration process; and
- reduce risks of credit lenders as qualified small businesses could be “backed up” by donor funding.

In addition, the region would strongly benefit from improved coordination of donor funding for SMEs. One way this might be achieved is through the establishment of a regional, specialized SME development bank with preferential rates.

In sum, CAFTA-DR needs to be complemented with several legal reforms in order to materialize the opportunities it brings about. In that context, the commercial law reforms are essential. They will create the appropriate scenario for investment attraction, business growth, economic development, job creation and poverty alleviation.