

2ND EDITION

AN INTRODUCTION TO  
COMMERCIAL LAW OF  
AFGHANISTAN



Stanford  
LawSchool

An Introduction to the

# Commercial Law of Afghanistan

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## PREFACE & ACKNOWLEDGEMENTS

To understate the obvious, Afghanistan is currently undergoing a critical transition period. The Afghan people now face the immense task of rebuilding a society and a country. This challenge, while daunting, is also an opportunity for the youth of Afghanistan to effect momentous and positive change as the future leaders of their country. To seize this opportunity, however, Afghanistan's human resources must be revitalized and replenished urgently. The decades-long conflict in Afghanistan has devastated the country's infrastructure and severely stunted the institutions that are central to educating and cultivating leaders. Consequently, the country faces a dire shortage of qualified lawyers. This shortage is felt ever more keenly during this time of transition, as the participation of skilled legal practitioners is crucial to rebuilding the Afghan republic.

In response to this need, Stanford Law School's Afghanistan Legal Education Project (ALEP) began in the fall of 2007 as a student-initiated program dedicated to helping Afghan universities train the next generation of Afghan lawyers. ALEP mandate and goals are to research, write, and publish high-quality, original legal textbooks, and to build out an equally high-quality law curriculum at the American University of Afghanistan. ALEP's broader vision is to help train the next generation of leaders who will drive Afghanistan's reconstruction and recovery.

The ALEP team would like to acknowledge those individuals and institutions who have made this project possible. ALEP's faculty advisors are Erik Jensen (Co-Director of Stanford Law School's Rule of Law Program) and Stanford Law School Dean Larry Kramer. ALEP has obtained generous support from public and private sources, including a three-year grant from INL at the U.S. Department of State. The ALEP team would also like to acknowledge the support of Deborah Zumwalt, General Counsel of Stanford University and member of American University of Afghanistan's (AUAF) Board of Trustees. ALEP is also delighted to continue its partnership with AUAF and is particularly grateful for the support of AUAF's President, Dr. Michael Smith and Dr. Bahar Jalali, Department Chair of Political Science, Humanities and Law. Finally, this book would never have come to life without the dedicated and inspiring teaching of Malalai Wassil, who has been teaching ALEP's commercial law course since its inception.

Erik Jensen, Faculty Advisor, ALEP  
Palo Alto, California, June 2011

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# CHAPTER 1: COMMERCIAL LAW AND ECONOMIC DEVELOPMENT

## I. INTRODUCTION

Commerce and trade have been the lifeblood of Afghanistan since the nation was born in the eighteenth century. Afghanistan sits at the crossroads of major trade routes that link Asia and Europe and have shaped the course of world history. The fabled Silk Road passed directly through Afghanistan and was the chosen route for caravans bringing **goods** from China, India, and the Arabian Peninsula.

As Afghanistan emerges from three decades of violent conflict, commerce and trade are once again the keys to its future. Economic development will help bring stability, peace, and prosperity to Afghanistan. But economic growth does not occur in vacuum—it is closely linked to the establishment of the rule of law. A clear and effective framework of laws and independent tribunals facilitates commerce and encourages economic growth. Commercial laws and institutions, in particular, are crucial for sustained economic development because they regulate commercial transactions.

Commercial law and institutions empower commercial actors and enable them to expand, compete, resolve disputes, access markets, and trade with relative ease. Good commercial law enables landowners to tap into their property's value, facilitates access to **capital**, streamlines procedures for registering a company, and ensures the enforcement of contracts and debt. Good institutions are also crucial because illogical and inefficient bureaucracies, unreasonable administrative costs, and widespread corruption undermine commercial law. Broad-based economic development requires institutions and individuals, such as the courts, judges, registries, lawyers, the private sector, and non-governmental organizations (NGOs).

This Chapter will explore the linkages between commercial law and economic development in both theory and practice. It begins with a brief overview of Afghanistan's economy, including major macroeconomic indicators. Next, it analyzes the business environment in Afghanistan. It then provides an overview of Islamic commercial law, which has shaped **commerce** in Afghanistan for centuries. The second part of the Chapter focuses on the empirical connections between rule of law and economic growth. This section will explore the role of **commercial law** and institutions in a country's economic development.

### **Key Definitions – What is *Commercial Law*?**

Commerce is the exchange of goods or services for money or other goods or services. Commercial law is a broad set of legal rules that governs commercial and business relations in a country. It covers contracts, company formation and dissolution, property purchase and sale, bank transactions, loan and guarantee matters, tax matters, as well as dispute resolution. Commercial law is a key part of the legal architecture of a country.

## Reading Focus

What are the goals of commercial law? What areas of law are most important to the conduct of business? Is legal regulation of commerce necessary for economic growth? What is the best way to balance the interests of different actors in the marketplace?

## II. AN ECONOMIC OVERVIEW OF AFGHANISTAN

The economy of Afghanistan is developing rapidly. Businesses and the transactions they conduct are becoming more and more complex. The growth of commerce increasingly requires commercial actors to transact with strangers outside of their families, local communities, and social groups. Family ties and reputation that have traditionally controlled commercial behavior are ill-suited for larger more complex transactions that span wide geographic areas.

As Afghanistan's economy has evolved, so has its commercial law. In many ways, Afghanistan's commercial legal system is still in the early stages of a rebuilding process. Several new business laws have been enacted since the adoption of the 2004 Constitution, and as of 2008, others were in the process of being drafted. Implementation of these laws has been limited, however. Commercial courts and government institutions frequently rely upon customary practice or older laws when rendering their decisions. In most instances, Afghans resolve their commercial disputes through informal channels, such as the *Shura* or *Jirga*, because fair and reliable enforcement of commercial laws through the formal system remains a challenge.

Afghanistan has a long tradition of entrepreneurship and a vibrant private sector. Creating an environment in which Afghan businesses can once again thrive is, of course, dependent on security and political stability throughout the country. Equally important is the establishment of a strong judicial system able to effectively enforce laws and regulations. Energizing the private sector requires a commercial legal framework that is fair, transparent, and simple.

Creating and successfully implementing laws that provide an efficient and reliable commercial framework is vital to Afghanistan's future. This chapter will define commercial law, explain its various facets, and focus on the link between commercial law and economic growth. It will trace the historical evolution of commerce and the ways in which it is regulated. This chapter will provide the theoretical foundation for the discussion of specific topics in commercial law in later chapters.

Three decades of conflict as well as drought and other natural disasters severely damaged the Afghan economy. Afghanistan is one of the poorest countries in the world, as it has one of the lowest **per capita Gross Domestic Products (GDPs)** anywhere. As a result of prolonged conflict, Afghanistan now has: (i) less manpower (many people died or were injured during the conflict or fled the country); (ii) diminished **human capital** (due to lack of education and flight of well-educated citizens); (iii) damaged or useless physical **infrastructure**, such as the irrigation system, road network, and power grid; and (iv) less available land due to landmines and disputes over ownership. Armed conflict has also had a negative effect on "social capital," such as weakening governance and the rule of law. Overall, more than a generation's worth of economic development has been lost due to the conflict.

## A. Economic Snapshot

The economy of Afghanistan is still largely agriculture-based. The agricultural sector is primarily subsistence-oriented, and cereal crops (mainly wheat) are most common. Other crops and vegetables, such as grapes, apricots, and almonds, generate higher profit and potentially exports. The livestock sector produces milk, meat, and wool. The main cash crop is poppy, which generates a significant portion of the country's GDP. Although underexploited, Afghanistan has rich mineral resources, including copper, coal, construction materials, and gemstones. There are also deposits of iron and gold that are not currently exploited. Large-scale industry is extremely underdeveloped, and what little there was in the late 1970s—most of it in the public sector—has become defunct, or is poorly performing. Most industrial production consists of activities linked to agriculture, such as fertilizers or handicrafts. The electric power sector has very limited capacity; Afghanistan is unable to import large quantities of electricity and it has shown an even more limited capacity to generate and distribute electricity domestically.

The services trade is very important and stimulated in large part by restrictive trade regimes in neighboring countries, which encourage unofficial trade (in particular smuggling). The financial sector is almost completely in the unofficial economy, financial services being provided by the *hawalas*. The recovery of the economy is expected to generate considerable additional demand for financial services. Out of the many products and processes that do or could exist in Afghanistan, the economy will have to discover those that are most valuable. The carpet industry is an important export that survived the conflict. Organized traders, providing advice on demand and sometimes raw material and capital, have managed to continue their business throughout the last quarter-century. However past experience, while useful, cannot give investors or the government any certainty about potential successes. For instance, dried fruits from California have taken a major part of the market in India, which Afghan products used to occupy. California has now established a technological advantage for this market (adding variety to suit Indian tastes with new treatments for dried fruit).

One striking feature of Afghanistan's economic structure is the dominance of the informal sector throughout all markets. For example, small-scale generators in the informal sector provide a large portion of electricity supply and outstrip that provided by the government-regulated power grid. Many experts estimate that 80-90 percent of economic activity in Afghanistan occurs in the informal sector, which has been largely responsible for the recent economic growth in the country.

While the formal sector is relatively easy to describe, the informal sector covers a range of diverse economic activities. The formal sector includes businesses that are registered with the government and pay taxes, as well as the government itself. It also includes activities that are registered but by law are exempted from taxation, such as NGOs. Outside the formal world, there is a continuum of activities that are more or less legal. Many economic activities are in-kind and do not lead to any market transaction or are conducted on a barter basis. Sharecropping—where a farmer agrees to give a share of his harvest to the landlord in exchange for the right to farm the land—is an example of an in-kind activity. A range of other services, such as carpentry, is provided on an in-kind basis. Extralegal transactions occur when the output is legal and the

production could be legal if registered with the government. Such transactions are usually small-scale and include money exchange dealers, small shops, small traders, small manufacturing, agriculture, and much construction. There is also a host of illegal economic activities in Afghanistan, ranging from trade in illegally exploited natural resources (e.g. trafficking in emeralds from the Panjshir Valley or illegally harvested timber) to opium production.

The wide reach of the **informal economy** in Afghanistan contributes to weak governance, challenges to state authority, insecurity, lack of rule of law, and a poor investment climate for formal-sector activities. The informal economy has been dynamic, but will struggle to be the engine of sustained long-term growth because the adverse impact on institutions of the illegal component most probably outweighs the positive impact of the informal economy as a source of livelihoods. Informal activities generate hardly any revenue for the State but may support forces opposed to the State and provide scope for opportunism and rent-seeking. Informality does not protect property rights and reduces the capacity to formalize and enforce contracts, weakening incentives to invest and opportunities for division of labor and trade. Savings tend to be channeled toward investments with lower risks (e.g. in real estate and trade) or transferred outside Afghanistan. Entrepreneurs in an informal setting have an incentive to remain relatively small and to diversify their activities to manage risk, which prevents them from exploiting economies of scale and in many cases from adopting more modern technologies.

## **B. Recent Economic Reforms**

An important cornerstone for Afghanistan's economic recovery has been macroeconomic stability. The country's GDP grew by an estimated 8.2% in FY2010, which followed high growth of 20.4% in FY2009. Private consumption remained the economy's main driver, based on continued high external assistance inflows and security spending that fueled demand for production of goods and services, including construction.<sup>1</sup> Moreover, the government has proven quite adept in its currency reform program after more than a decade of high inflation. Monetary policy has kept inflation under control and maintained a stable exchange rate since 2003. Significant reforms are also underway in budget preparation and execution. The State budget is becoming an increasingly effective tool to implement policies and coordinate aid.

The government has also made progress in reviving the financial system and supporting private sector development. New financial sector legislation (the Central Bank Law and Banking Law) was adopted in the summer of 2003 to grant the Central Bank independence and establish a modern legal framework for the banking system. Several banks have since been licensed under the new legal framework. A new Law on Domestic and Foreign Investment was enacted in September 2002, and the Afghanistan Investment Support Agency (AISA), was established in August 2003. Significant foreign private investment has been attracted into the telecommunications sector, with strong results in terms of expansion of private mobile telephone services across a number of cities on a competitive, cost-efficient basis. Afghanistan has also implemented a number of reforms to foster trade, including simplification and rationalization of customs tariffs. Existing trade agreements have been renewed and new agreements signed with neighboring countries.

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<sup>1</sup> ASIAN DEV. BANK, ASIAN DEVELOPMENT OUTLOOK 2011: SOUTH-SOUTH ECONOMIC LINKS, 143 (2011), *available at* <http://www.adb.org/documents/books/ado/2011/ado2011.pdf>.

Exploiting Afghanistan's historical position as a land bridge between Central and South Asia as well as other economies is a significant potential source of growth. The experience of landlocked countries, such as Uganda and Laos, demonstrates that improving trade logistics, diversifying transit routes, heavier reliance on air transport, and supporting corridor agreements can overcome Afghanistan's geographical disadvantage. Regional cooperation, moreover, can turn Afghanistan's geographical position into a positive advantage, by expanding markets, lowering costs of long-distance trade, and sharing regional resources like electricity and, over the longer term, water.

Achieving robust long-term growth of trade will require serious effort in terms of structural reforms as well as immediate actions to foster a strong enabling environment. For example, Afghanistan has been encouraged to: (i) implement a functioning payments system for international and domestic transfers through the formal banking system; (ii) define and implement regulatory conditions and terms on which foreign banks or joint venture banks will be permitted to operate in Afghanistan; (iii) make transit bonds and transport insurance available with entry of companies capable of providing coverage; (iv) better develop the role of government as a promoter and facilitator of trade and investment; (v) support a larger role for a private chamber of commerce to assist in export promotion activities; and (vi) design and implement major capacity building programs to develop skills and professionalism in law, banking, insurance, and customs. Afghanistan has taken this advice to heart and embarked upon major reforms in many of these areas.

### **C. The Markets**

Private sector-led development is the key to Afghanistan's long-term economic development. However, discussions about private sector activities are often based on an assumption that markets in Afghanistan are open and all that is needed is the stimulation of entrepreneurship among Afghans. This assumption is not completely accurate given the non-competitive features of Afghanistan's current business environment. The operation of markets in Afghanistan is closely linked to broader political and economic issues. Insecurity remains a major obstacle to commerce and a serious concern of businessmen.

Afghanistan's political system was dramatically reshaped after the fall of the Taliban, but economic processes, patterns and players were less affected. The traders who dominate trade in Afghanistan today have been active since the 1970s. A relatively small group of businessmen control major trading activities in Afghanistan. They exclude competitors and derive economic benefit through the possession of capital (when credit is unavailable to others), political influence, and high levels of vertical integration (e.g. their companies own other companies or service-providers with which they do business). Additional investment and the return of capital to Afghanistan are constrained because of such imperfect markets. Many returnees are reluctant to risk the capital they have out of a fear that only the dominant group can benefit in the current business environment.

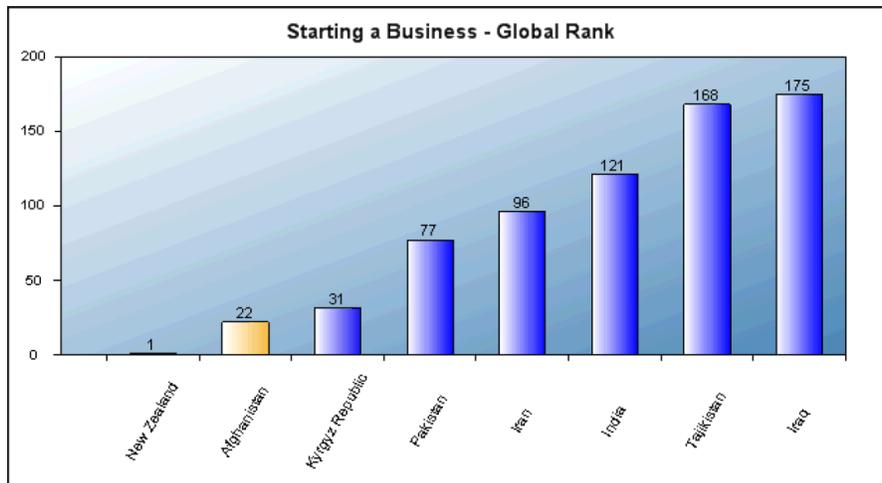
Most business is conducted on the basis of social networks and personal relationships. These relationships are based on a complex mix of factors, including family connections, ethnicity, and common religious beliefs. They are not simply based on family ties. These networks provide information, regular trade flows, as well as credit and risk sharing. The

business elite also has strong financial and personal links with national, provincial and local political and military power holders. These relationships are mutually beneficial. Businessmen obtain security, tax exemption and credit, and (in some sectors such as construction) lucrative contracts. Government officials or powerful individuals outside of government (e.g. militia commanders) receive a means of investment, the potential for money “laundering,” and an overall strengthening of influence by the linking of military, economic, and political power. Power brokers also often control production “inputs” in Afghanistan, such as water and land.

Many markets in Afghanistan are “informal” because they operate outside formal government regulation. Such markets are, however, heavily regulated by “non-state” norms and rules. Many of these informal regulations are embedded in social norms and institutions. For example, gender plays a significant role in the division of responsibility in the carpet industry. Women dominate as producers but are totally invisible at all other levels of the production chain where men are the primary actors. Government regulation of markets is increasing with the adoption of new laws and greater coordination between ministries and the private sector. Lack of information and low awareness of tax, tariff, and other regulatory issues is challenging for smaller traders and companies with fewer resources and a smaller presence in Kabul.

#### **D. Doing Business in Afghanistan**

The formal legal requirements for registering a business in Afghanistan are relatively straightforward: registering with the commercial court, obtaining initial investment and operating licenses from the AISA, and in some sectors, obtaining a sector-specific license (e.g. hotels, restaurants, insurance, and import-export companies). Afghanistan has been relatively proactive in establishing a streamlined system for registering a business and obtaining initial investment licenses and ranked 22 out of 181 countries surveyed in the World Bank’s “Starting a Business” index. The following chart illustrates Afghanistan’s performance compared to other countries in the region.



*Source: World Bank, Doing Business 2009, Country Profile for Afghanistan.*

Yet, Afghanistan's impressive ranking is deceptive because the process of starting a company in Afghanistan does not conclude after registration and initial licensing. Instead, a company must obtain many additional licenses and approvals from various government ministries for specific activities. Obtaining these approvals can be costly and time-consuming. Consider the following excerpt.

**Commentary: Company Registration and Licensing in Afghanistan Today**

Company registration and investment licensing are only a first step; they do not reduce the need or time for separate approvals that are mandatory in Afghanistan for an overly-long list of specific activities. These include banking, freight-forwarding, security guard, insurance, insurance agency, private university, travel agency, tourist accommodation, animal clinic, film producing, printing, pharmacy, hotel and restaurant, construction, electricity connection, medicine import, animal medicine import, land transfer, building, mining, health care, construction, tourism and commercial agriculture.

Every interviewee on this subject remarked that the processes for getting these permits and licenses are lengthy, arbitrary, unpredictable, and/or very expensive. One commented that he acquired his investment license from AISA in a few hours but has been dealing with a ministry for a sectoral license for over a year "and it is still not resolved." Another stated that he also got his investment license immediately, but has since spent \$5,000 and four months dealing with sectoral agencies "and now they want to shut me down." Some sectoral licenses are clearly justified for health or public safety purposes, but many or most of those which are required have no evident public purpose. There is no standard form or uniform procedure for these approvals; each ministry and other agency has its own rules and approach, often unpublished and opaque; and the ministries and other agencies do not always communicate with each other. Some of these approvals are required as a precondition for a company's initial registration with the Ministry of Commerce and Industry (MoCI) or AISA, which means that a startup business cannot even take normal organizational steps until it has received these approvals.

*Source: USAID, Afghanistan's Agenda for Action (2007).*

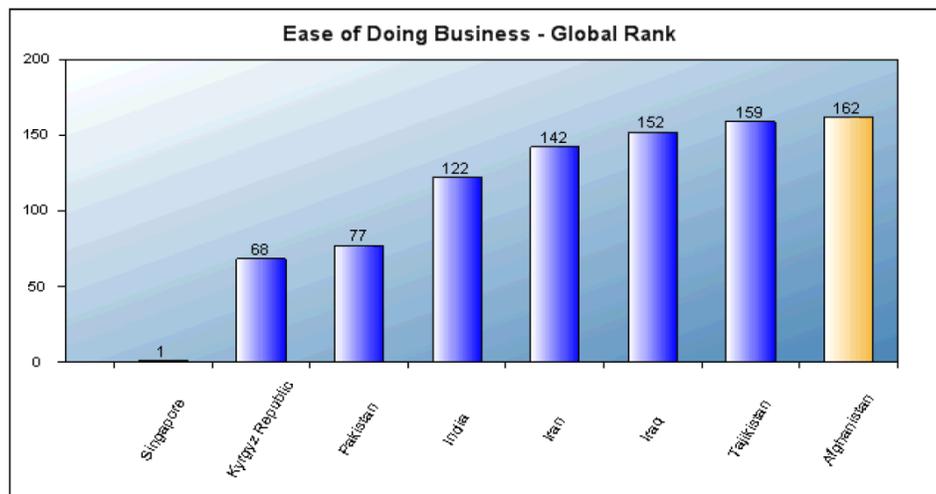
As the above excerpt indicates, the complete process required to start a business in Afghanistan can be costly, and even though registration and initial licensing can be accomplished quickly, the rest of the process can take a great deal of time. The large number of additional licenses and approvals currently required to operate a business and the government's inefficiency in issuing those licensing are serious concerns. The additional steps increase the complexity of starting a business and create opportunities for corruption, thereby deterring important economic activity.

A second problem is that entrepreneurs are often required to usher their own paperwork through the licensing process, but there is little public information about that process. It can be difficult for an investor to determine what steps must be completed in order to comply with the law. This makes it more difficult for investors to fulfill their legal obligations and subjects them to costly penalties for noncompliance. The risk of violating the law and incurring penalties in turn decreases the willingness of entrepreneurs to invest. The lack of licensing procedure transparency also creates opportunities for corruption: government officials can act without fear

that entrepreneurs will challenge them because the entrepreneurs themselves are unaware of the correct procedures. A few government agencies provide information about their respective licensing processes, but this needs to be done more widely.

A third problem is that many government agencies begin their approval process with senior officials rather than more junior agents, which further delays the process. And to make matters worse, the approval of one license may be contingent upon a separate license from another government agency. This means that a delay in one agency can stall the entire process.

Thus, instead of the World Bank's "Starting a Business" index, a better measure of starting a business in Afghanistan may be the World Bank's more comprehensive "Ease of Doing Business" index. Afghanistan ranked 162 out of 181 countries surveyed. The obstacles to starting a business discussed above are symptomatic of broader problems in Afghanistan's business environment.



Source: World Bank, *Doing Business 2009, Country Profile for Afghanistan*.

### Access to Capital in Afghanistan

Rajibullah lives on the outskirts of Kabul and manages a small brick factory. The bricks produced by the factory are low quality and sales are down despite booming construction in and around Kabul. Yet the owner of the factory refuses to invest in new equipment that could improve the quality of the bricks. Rajibullah is unsatisfied with the owner's decision and decides to research the market for construction materials in Kabul. His research leads him to the conclusion that he should open his own factory with better equipment that makes higher quality bricks. Demand for such bricks is very high, and he could sell them for a large profit. Unfortunately, the brick business does not pay its workers very well, and Rajibullah does not have the money needed to build his own factory and buy his own equipment.

How can Rajibullah put his idea into action and start his own business? He could ask family and friends for money since those who know him consider him to be intelligent and trustworthy. If his family is poor, they will not have the money to lend him. He could request a loan from a bank. How can he assure the bank that he will repay the loan? Or perhaps he could

find a wealthy business partner or investor willing to finance his business in exchange for a share of the profits.

No matter how Rajibullah seeks to raise money to open his brick factory, he will encounter commercial risk that will make it difficult to secure much-needed capital. A bank or private investor will be concerned that Rajibullah's business might not be profitable or that he might spend their money unwisely. Or Rajibullah's bricks could sell well, but he might have trouble collecting payment from his customers. Or once a profit has been made, Rajibullah could claim that he should receive a larger share of the profits because the business was his idea. These and any number of other concerns make providing capital to Rajibullah's business a risky endeavor. Commercial law can reduce many of the risks that capital providers might face in Rajibullah's situation.

How can commercial law help mitigate risk and encourage investment in Rajibullah's business? First, the legal form of a business organization and investment contracts will clarify who has what rights in the business and how the profit is shared. Contracts with customers will specify the price at which the bricks will be sold, thereby providing greater assurance of the profitability of the business.

Second, commercial law can also balance the need to protect investors, lenders, and contracting parties with the need to provide incentives for entrepreneurs to go into business in the first place. Just as investors want assurances about how their money will be used and what share of the profits they will receive, entrepreneurs are more willing to start a new business if they face less risk. For example, if Rajibullah is required to personally pay back investors and lenders if his business fails, he will be much less likely to start the business in the first place. Because businesses like Rajibullah's are the engines of economic growth in a country, it may be desirable for the law to limit Rajibullah's personal exposure to business risk.

Good commercial law is key to economic development and growth because it promotes entrepreneurship and facilitates complex economic transactions.

### III. ISLAMIC COMMERCIAL LAW<sup>2</sup>

#### Discussion Questions

1. What is the role of *Shari'a* law under the 2004 Constitution?
2. How does *Shari'a* law influence commerce in Afghanistan today?

Chapter 2 will discuss how *Shari'a* law has been an important source of commercial law in Afghanistan throughout the nation's history. Before embarking upon that discussion, it is important to explore basic principles of Islamic commercial law that are relevant in Afghanistan today. The following discussion is not intended to be a comprehensive treatment of the subject,

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<sup>2</sup> This Section draws heavily on Ali Adnan Ibrahim, *The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration*, 23 AM. U. INT'L L. REV. 661 (2008).

but rather a brief introduction to it. Each of the following chapters will explore *Shari'a* law in more detail in the context of specific areas of commercial law.

At present, the role of *Shari'a* is embodied in Article 3 of the 2004 Constitution, which requires that all commercial laws in Afghanistan be consistent with Islam. *Shari'a* is also a source of jurisprudence related to the interpretation of commercial law in Afghanistan. Article 130 of the 2004 Constitution states that when the Constitution or other laws do not provide guidance on a legal issue, then *Hanafi* jurisprudence (one of the four *Sunni* Islamic legal schools of thought) may be applied. Article 131 allows for the use of a *Shi'a* version of Islamic jurisprudence (generally implying the *Ja'fari* school of jurisprudence) when the legal issue deals with “personal matters of followers of the *Shi'a* sect.”

Statutes enacted prior to the 2004 Constitution also provide similar guidance for the application of *Shari'a* to commercial disputes in Afghanistan. The Civil Code of 1977 states that “where the law has a provision, the practice of religious jurisprudence is not permitted . . . .” When there is no such provision in the law, “*Hanafi* jurisprudence, public conventions, and precedent” are to be followed, so long as laws are only repealed or amended through express legislative action. The 2004 Constitution and the Civil Code of 1977 both place limitations on the issues that should be addressed directly through Islamic jurisprudence. Since law in Afghanistan has been drafted in compliance with Islamic law, the legal code is the primary source that courts should consult for resolving contract issues. But when the code is silent, Islamic jurisprudence is applied to the facts of the case. Subsequent chapters will highlight additional examples of *Shari'a* law and its influence on Afghan commercial law.

*Shari'a* law is the path shown by Allah for a Muslim to conduct his or her life. No power on earth has the authority to make or change *Shari'a* law because it is divine law. There are two primary and three secondary sources of *Shari'a*. The two primary sources are the *Qur'an*, God's revelation to the Prophet Muhammad, and the *Sunnah*, the way in which the Prophet Muhammad led his life and practiced his faith. The three secondary sources are consensus of the legal scholars, deduction from analogy, and the use of individual reasoning by those scholars. These sources are comprised of the interpretations of famous Islamic legal scholars. If followed, *Shari'a* informs nearly every aspect of a Muslim's daily life.

Islamic commercial law has a long history that dates back to the Muslim conquests of the seventh and eighth centuries. The Muslim world was crossed by important trade routes that contributed to economic growth during the long period of classical Islam. Long-distance trade, commerce, and banking were routinely carried out by Muslim merchants. During this period, Muslim bankers exchanged currencies, made loans, and assigned credit. Muslim jurists developed an efficient system of Islamic commercial law to govern this robust commerce. Yet, Islamic commercial law began to fall out of favor in the early to mid-nineteenth century. Napoleon introduced the French idea of a secular commercial code and separate commercial courts to Egypt when he conquered the country in the late eighteenth century. In 1850, the Ottoman Empire adopted large parts of French Commercial Code, thereby secularizing its commercial laws. Other countries followed suit and embraced a secularization of commercial law for almost a century, when a resurgent interest in Islamic commercial law swept through the Muslim world.

It is not surprising that Islam has a long history of embracing trade and commerce, as the Prophet Muhammad was a merchant and a trader. Muslims today continue to explore commercial opportunities in accordance with the dictates of their beliefs consistent with the history of their entrepreneurial business and financial transactions. The *Qur'an* contains numerous passages about commerce. Most *Qur'anic* passages on commerce and business ethics reflect common beliefs shared by other major world religions. The *Qur'an* specifically speaks of contracts, the requirements for them to be valid, the importance of business ethics and trade, and other topics related to commercial law. It makes repeated mention of the centrality of trade, the universal respect it carries in Muslim civilization, and the importance of commerce as the nerve of the city and of regional or international exchange. The free movement of goods is a key element in the intellectual structure of early Islam through the present period.

Property rights and freedom of trade by mutual consent are also central to Islam. Since Islamic law treats a person's wealth and life on equal footing, deprivation of wealth—or enrichment at someone else's expense through the use of forbidden means—is disdained. Economic progress is generally linked to risk, which is essential for all innovations. Bona fide, fair, equivocal, and risk-sharing transactions are the hallmark of Islamic finance. Islamic law also requires Muslims to honor their contractual obligations and commitments.

### Discussion Questions

1. What is *Shari'a* law? How did it develop?
2. What is Islam's traditional view of commerce and trade? How did Islam develop such views?
3. Does the *Qur'an* deal with commercial subjects? If so, which ones? What does it say?

Classical Islamic law defines property as an object that “must satisfy two conditions: (i) possibility of physical possession and (ii) having potential beneficial uses.” According to this definition, many scholars believe that commercial insurance violates Islamic law, for the object of sale is excessively uncertain or ambiguous. Classifications of property include valued or unvalued property (defined as public property or “properties with non-permissible uses . . . [such as] wine and pork”), immovable or movable property, and fungible or non-fungible property. Each classification is subject to detailed rules in the various schools of Islam. Differences of opinion include the eligibility of usufruct for sale or lease, taking possession before reselling, deferred prices, and prepaid forward sale. The classical view of ownership distinguished between total and partial ownership—for example, property plus usufruct or ownership of either. Modern scholarship, however, treats ownership as a “bundle of rights” that is distributable to a number of entities. This distinction has led to devising an Islamic bonds (*sukuk*) structure where the title of the transaction property, with its usufruct, is transferred to a special purpose vehicle that deals with all the subleases issued in respect of the property. Possession of property that gives rise to liability is generally either in the form of a trust or a guaranty arrangement. While in the possession of a trustee, only damage to the property caused by the trustee's negligence or transgression will result in liability for the loss. In contrast, a guarantor's possession implies liability for any and all damages. Liability and risk issues arising from these distinctions have

informed the practice of Islamic banking in dealing with the deposits and cost-plus financing issues, discussed further below.

Two basic types of contract exist in Islamic law: compensatory and charitable. Compensatory contracts are considered mutual dealings and are entered into by the parties for personal benefit. Charitable contracts lean toward the worship category of injunctions, and parties who enter into such contracts look to God for their reward. In compensatory contracts, the parties are expected to agree on “value equivalence” of the benefits in question and should have access to all relevant information to assess this value. Islamic contract law allows parties to freely stipulate any conditions they deem necessary, as long as express prohibitions are observed. Put differently, Islamic law of contract recognizes “party autonomy” in contracts that do not fall into the exceptional category of the prohibited. Mutual consent is the cardinal rule of Islamic law of contract. Classical Islamic jurisprudence enumerates additional “cornerstones” of a valid contract, which pertain to (i) parties of the contract, who must be eligible to conduct the contract, (ii) contract language, and (iii) object of the contract.

### Discussion Questions

1. How did classical Islam define property? How does modern Islamic scholarship differ?
2. How did classical Islamic law treat contracts? What are the major aspects of Islamic contract law?

The *Qur'an* and *Shari'a* law, however, place certain limits on commerce as well. Interest charged on money loans, ambiguous contracts, monopolies, and price fixing are banned under Islamic law. Muslims are to avoid accumulation of interest or usury, which is generally referred to and known as *riba* or “unjustified increase.” They are also supposed to avoid ambiguity in commercial transactions, which is commonly known as *gharar* or excessive “uncertainty, risk [or] speculation.” *Shari'a* law restricts commerce to religiously permissible or *halal* methods. *Shari'a* embodies a certain philosophy of risk sharing that considers the predetermined and fixed interest rate to be, by definition, exploitative on the borrower and, alternatively, prefers a profit and loss sharing arrangement between the creditor and the debtor. It also embraces a welfare philosophy that focuses on more than mere profit maximization. Unfair dealings and advantages are thus considered exploitative and are not permitted.

No single definition of *riba* exists in Islamic law. It is important to note that the *Qur'an* does not define the term *riba*. However, we may understand the basic concept of *riba* from the *Sunnah*. Due to the lack of certainty regarding the definition of *riba*, the Supreme Court of Pakistan remanded a decision of the Shariat Appellate Bench declaring interest in all forms unconstitutional on account of being un-Islamic in order for the Federal Shariat Court to conduct “thorough and elaborate research . . . of financial systems . . . prevalent in the contemporary Muslim countries.”

*Riba* was gradually prohibited, although only initially discouraged. Charging compound interest was prevalent in pre-Islamic Arabia and was the first to be forbidden. It was common practice to charge interest at a certain maturity date and then compound, or double and multiply,

that interest at future maturity dates. The final prohibition was more clear and categorical, which came through one of the last verses of the *Qur'an* and prohibited, in the view of some scholars, compound interest.

According to the *Sunnah*, *riba* is generally categorized in two forms: (i) “*riba* of deferment,” accruing over time through deferment of payments (in its worst form it takes the form of compound interest as practiced in the pre-Islamic Arabia); and (ii) “*riba* of increase,” occurring in the form of an increase in exchange of different quantities of good and commodities of same genus or kind. Both forms are discussed in the *Sunnah*. *Riba* of deferment refers to an increase that generally arises out of the money loans. One authentic *Sunnah* tradition prohibited *riba* of increase and outlined the general standard: “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, like for like, hand to hand, and any increase is *riba*.”

### Discussion Questions

1. What limitations on commerce does Islam establish?
2. What is *riba*? Why is it important?
3. What is *gharar*? Why is it important?
4. What are some of the difficulties when determining whether a specific commercial practice violates either one of these concepts?

## IV. COMMERCIAL LAW AND ECONOMIC DEVELOPMENT

The importance of commercial law reform in a nation emerging from conflict deserves serious consideration. While most scholars acknowledge a link between economic growth and establishment of the rule of law, they disagree over the direction of causality. Does the rule of law lead to economic growth or does economic growth lead to the rule of law? Answering this question is a difficult task and the subject of numerous books in the field of “development economics.”

For the purposes of our discussion of the commercial law of Afghanistan, we will rely most heavily upon the “neo-institutionalist” view, which argues that the quality of a country’s institutions is a direct determinant of its economic growth. The most important institution in a country is its legal system. Laws and legal institutions hold the government and its sub-units accountable to established rules. Government institutions will behave in a predictable and legal manner that respects the rights of its citizens only if the legal system sets clear standards and punishes violations of those standards.

Successful businesses are the main engines of economic development, but they suffocate under the weight of bad legal institutions and laws. Businesses not only need roads, railways, and ports to move their goods to market, but they also need efficient regulation, low and transparent taxes, and fast and effective legal systems to resolve their disputes. If government institutions are

slow, incompetent, or corrupt, businesses waste their time and resources instead of focusing on job and wealth creation. Good laws and strong legal institutions empower commercial actors and enable them to engage in sophisticated transactions by creating a system of enforceable promises. Enforceable promises encourage business partners to honor their bargains because they know that a court will enforce the terms of their commercial agreements. The lack of enforceable promises greatly increases uncertainty, risk, and costs associated with business transactions, thereby restricting commerce and growth.

Measures to improve commercial law, thus, are a key component of any plan for economic growth. Legal regulation expands markets, removes artificial limitations on commerce, opens new opportunities, and allows for sophisticated transactions using loans, deferred payments, and future commitments.

#### **A. Symptoms of Weak Commercial Law**

The absence or weakness of commercial law affects a country's economy and markets in observable ways. Entrepreneurs tend to bypass the formal sector in a system with weak commercial laws. This stunts economic growth in many ways. Assume businesses avoid registering with the government because of cumbersome licensing procedures, overly burdensome taxes, and excessive capital requirements. Informal businesses typically remain small because they are unable to formally access bank loans, certain donor assistance, and other state-provided benefits. The government loses tax revenue needed to support its infrastructure—the roads, electrical lines, and security that support a vibrant economy. Companies sell unregulated products that can be dangerous. Workers are deprived of health benefits, pensions, and protection from abusive working conditions. Lastly, business conducted outside the formal system encourages commercial actors to avoid the formal political system, thereby undermining democratic participation.

Without commercial law, complex transactions are impossible. Extremely simple transactions, such as point transactions, are the norm. A point transaction is an exchange in which no trust is necessary or that can be enforced by immediate violence. They are unified in both place (the buyer and seller are at the same physical location) and time (the good and payment are exchanged simultaneously).

For example, I want to buy a book. You have a book for sale. I can meet you, look at the book in your presence, and pay you money in exchange for it, even where there is no effective legal system. There will never be any need for either of us to take the other to court because I can inspect the book before I agree to buy it. If I attempt to take the book and leave without paying you, you can physically stop me. But what if we live in different parts of the country and I want to buy the book from you over the phone or through the mail? I would not agree to send you the money without you first sending me the book because I fear that you will not honor your promise (to send me the book). But you would not agree to send the book until I had sent you the money for the very same reason. Without a reliable system of commercial law that enforces such promises, the transaction would be impossible because the risk and uncertainty associated with it are too high.

Another common feature of weak commercial law is that business is conducted exclusively with family and friends or on the basis of personal relationships. It is too risky to trade with strangers because they might not honor their promises. If commercial agreements cannot be enforced, it is logical to transact only with people you know and trust. Personal bonds and relationships serve as a substitute to gauge reliability of a commercial partner so that deals are honored and enforcement is unnecessary. Yet an overreliance on personal relationships artificially limits with whom any one individual can do business. If the consumer is confident buying from strangers, she has access to more goods at lower prices because she can purchase goods from a larger group of people, including internet-based merchants halfway across the globe. Similarly, the Afghan entrepreneur benefits because he has a much larger market to sell his products; he is not limited to selling only to his family and friends.

Assume, for example, that after I buy the book from you and read it a few times, I want to sell it and buy a different book. My cousin, whom I have known since we were both young, offers to buy the book from me for the same price I paid for it. If I mail the book to him, he will pay me when we see each other again in two months. I explain this offer to my friend as we drink tea in the café. A stranger overhears our conversation and offers to pay me twice as much for the book. Before he can pay, however, he must return to his village to get the money. If I give him the book now, he promises to meet me at the café in two days to pay me. Without a system for enforcing commercial promises, I am likely to sell the book to my cousin (whom I trust) for less money, even though selling the book to the stranger would leave me better off.

One more symptom of underdeveloped commercial law is the lack of faith in marketing and advertising of products. Commercial actors do not trust any description or representation made about a product because there are no legal repercussions for making false or misleading statements. Distrust limits transactions to instances where the merchandise can be verified in person and harms competition. Vendors cannot distinguish their goods from those of their competitors and, thereby, attract new business. Moreover, transactions proceed very slowly because every representation must be individually verified. This impacts professional services industries because the suggestions of professional advisers are not trusted.

Now assume I decide to keep my book and look for a better deal. While reading the newspaper, I recognize an advertisement from a local bookstore offering to pay “top price” for used books. As I flip through the paper, I notice ten other ads from different bookstores. If I decide to discount the different ads, I would have to visit ten different bookstores to determine which one will offer me the best price. However, if I trust the ads, I can narrow down the list to the three bookstores that claim to pay “top price” for used books, such as mine. A commercial law system enables me to more efficiently use my time by distinguishing the most likely buyers of my book based on representations of their business made in the newspaper.

### **Reading Focus**

1. What are some symptoms of weak commercial law? How do weak commercial laws impact commerce and economic activity?
2. With whom do you normally conduct commercial transactions? Family? Friends? Strangers?

3. What is the most complex commercial deal that you have completed recently?

**B. The Evolution of Commerce and its Legal Regulation<sup>3</sup>**

Many economists, policymakers, and legal experts have studied how to promote economic growth. Their research and analysis show that there is not one single, best way to promote economic growth in a country. Economic growth is extremely context specific; it is tied to the unique circumstances and traits of a particular country. This same research also shows that key commercial law concepts, such as the protection of property rights, enforcement of contracts, and regulation of free markets, play an important role in economic growth. The challenge is to design effective institutions that deliver and implement these concepts in a way that meets local needs and promotes economic growth. Institutional design is, likewise, directly linked to local constraints and opportunities.

The following paragraphs are included in this chapter to get you thinking about the evolution of commerce and commercial law in Afghanistan. They are meant to give you ideas and help you creatively analyze the challenges facing Afghanistan and identify solutions to them. As you read the next few pages, think about what type of commercial institutions Afghanistan has and whether or not they deliver basic necessities and promote economic growth. Think about which institutions matter most and how they create incentives for positive behavior and disincentives for negative behavior. Above all, keep in mind that Afghanistan's unique circumstances will determine the most successful structure of its commercial law institutions.

*Trade and the Bazaar*

The public market or bazaar is a basic economic institution with a long history that remains a common sight in many countries, including Afghanistan. The following discussion will analyze the evolution of commercial transactions and regulations from the bazaar setting to a globalized world. This discussion will highlight the basic problems that commercial law seeks to overcome and how it has changed over time.

At the bazaar, the buyer and seller reach a verbal agreement and then exchange their goods or money. The quid (money) and the quo (goods) are exchanged simultaneously in both place (physical location) and time. What happens if the quid and quo are separated? They can be separated in time, such as when the buyer takes the goods with him now but promises to pay later. But what will give the seller the confidence that he will get paid as promised? In the absence of commercial law, the seller will likely refuse all deals that do not involve immediate payment. The same problem arises when the goods are customized or made to order with the seller requiring advance payment.

These problems are compounded if the quid and quo are separated because the buyer and seller live in different cities or in different countries all together. The buyer and seller could negotiate in writing or through a traveling agent, but the separation in place means that the goods would have to be delivered before payment could be expected—meaning that the seller would

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<sup>3</sup> This section draws heavily upon KENNETH W. DAM, THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT (2006).

have to risk that the buyer might change his mind. Or payment could be made before the goods were produced, in which case the buyer would be taking the risk. In most cases, the quid and quo are separated in both time and space. Goods were (and are) taken to distant bazaars and offered for sale by local agents. This practice gives the producer two sets of problems. First, if he was cheated at the bazaar, he would have to rely on local authorities to protect his rights and not discriminate against him as a foreigner. Second, he would have to rely upon a local agent to act as a salesman for him. If the agent simply took the goods or payment for the goods (or both) and fled without honoring his end of the bargain, the producer's remedies would be limited.

These types of problems were acute in long-distance trade throughout Europe and Asia in the Middle Ages. Many cities and trading hubs had domestic legal systems but could not enforce contracts in which their citizens were cheated when selling or buying goods in distant lands. As a result, long-distance trade was limited. Even where parties initially negotiated in good faith, the separation of the quid and quo could encourage one party to re-open the deal only after the other had already performed his half of the bargain. The incentive to renegotiate agreements after one party had performed is often labeled ex-post opportunism and remains a common occurrence in many countries. The enforcement of contracts by the legal system encourages voluntary performance and prevents inefficiencies caused by ex-post opportunism.

These problems existed across the entire spectrum of economic activity whenever a system of law was not in place or did not work effectively to give parties confidence that contracts would be honored. They extended beyond trade and its financing to financial contracts and insurance deals, which exhibited the same separation between the quid and quo.

Some trade can still take place if the quid and quo are separated if the parties have confidence in one another. That confidence may come from the reputation of the other party through repeated transactions, family bonds, or personal relationships, to name a few. One substitute for the rule of law is the community responsibility system. There, a community holds all members of a foreign community responsible when any other member of that foreign community cheats or fails to pay a debt to a local citizen. If the foreigner refuses to pay compensation, the goods of his compatriots are impounded as de facto collateral. The system works if it can motivate the debtor's community to force him to honor the foreign debt out of a fear of losing trade opportunities. The failure to honor the debt would lead to an embargo of the foreign community's goods and a cessation of financial transactions with them. In this sense, the system provided a sanction that was too powerful: Massive trade disruptions would result from minor disputes.

Another method of overcoming lack of local knowledge and poor communication between principal and agent was the creation of a network for foreign agents with strong reputations. The Maghribi Traders who operated around the Mediterranean in the eleventh century used a coalition of local agents to sell their goods. If an agent cheated a Maghribi trader, the agent's reputation would be destroyed and no Maghribi traders would do business with him in the future. Trust based on reputation had its limits, however, because it was usually confined to a distinct social group, not the trading community as a whole.

A different system was that of "law merchants." Trading communities, normally guilds, established private tribunals to enforce private law derived from common practice in commercial

transactions. The law merchant system was based in part on reputation because a merchant who disobeyed a decision by a private tribunal risked the destruction of his reputation and loss of trust to engage in long-distance trade or credit transactions. The law merchant system grew beyond basic sales to include credit, bills of exchange, insurance, and other trade-promoting legal devices.

### Discussion Questions

1. How does the bazaar function? What types of commercial transactions are most common? How did contracts function?
2. What is the impact on commerce of separating the quid and the quo in a commercial transaction? How important is trust?
3. How were the problems of separating the quid and quo historically overcome?
4. What is a law merchant? Are you aware of any similar institutions in Afghanistan?

### Rise of the Nation-State

The development of the nation-state provided a more centralized means to solve long-distance trade and commercial problems. Nation-states could create courts, coerce compliance with contracts, promote trade, and treat foreign traders fairly. At first, the problems of long-distance trade could only be overcome if the parties were citizens of the same nation-state. One serious limitation on the ability of a state to resolve commercial disputes was the reach of its power. Even though a king might have nominal sovereignty over large swaths of territory, regional leaders (such as nobles), rebels, and foreign actors limited the ability of the state to implement its laws. Justice in commercial matters remained mostly local for centuries in European nations. In France, for example, law was not fully unified until the beginning of the nineteenth century when Napoleon implemented his famous legal reforms. Italy and Germany did not become united nation-states until later in the nineteenth century. England had a number of competing court systems over many centuries that produced different outcomes in factually similar disputes. As long as justice remained local, the temptation to favor local merchants over all others impeded trade economic growth.

The rise of the nation-state also created a new threat to economic growth and the rule of law—a predatory ruler. Such a ruler ignores his own contracts or seizes the property of his subjects for his own purposes. Unfortunately, predatory rulers continue to rule countries in the present day in the form of authoritarian regimes. But how does a nation-state create a system where the ruler is strong enough to enforce contracts and protect private property, but does not engage in predatory practices? If citizens cannot trust their government not to steal their land, they are unlikely to invest in that type of property and instead keep their wealth in diamonds, jewelry, gold, and hard currency. Failure to resolve this dilemma impedes investment in wealth-creating property and stifles economic development.

### Discussion Questions

1. How did the rise of the nation-state impact resolution of commercial disputes?
2. Did it make long-distance trade simpler or more complicated? Why?
3. What is a predatory ruler? How does a predatory ruler affect commerce and commercial law?

### Contracts and Property

The absence of reliable contract law and independent judicial enforcement is a barrier to economic development. Commercial bargains are usually made without the need for legal enforcement. But even if businessmen prefer to solve their disputes outside of the courts, their bargaining and contract performance takes place in the shadow of the law. Knowing that courts stand ready to resolve contract disagreements based on some objective set of rules often leads to more reasonable negotiating positions and quicker compromise. Where courts do not exist to enforce commercial law, self-enforcement through violence is quite common.

The underdevelopment or unreliability of courts limits the effective use of long-term and complex contracts. As economies have developed, contracts have grown more important and more complicated. Many basic necessities are not provided unless contracts are relied upon and enforced, when necessary. For example, contracts are an integral component of the generation of electricity, the construction of roads, and the expansion of mobile phone networks. Likewise, when property rights are not protected, wealth is accumulated in more easily safeguarded forms (such as jewels or gold) as opposed to invested in financial instruments that can be fraudulently issued or sold, or even land that can be seized. Crime is a severe constraint on economic development because it jeopardizes property rights generally.

Most long-term contracts are more complicated than the basic bazaar transactions already discussed. Consider, for example, a typical construction contract where one of the parties performs her end of the bargain over a period of months. In a simple construction contract for a house, the buyer pays up front or at least makes a substantial down payment. The house builder may be tempted to engage in ex-post opportunism by using sub-standard building materials, for example. Once he has the money, he is less motivated to perform his obligations unless there is another element in play, such as a family connection (relational element) to the other party or the prospect of losing out on future transactions (repeat game element).

Yet relational or repeat game elements are inadequate when individuals are forced to deal with strangers or members of unfamiliar social groups in one-shot exchanges. The movement of people from traditional areas to new frontiers or to cities necessitates a commonly agreed law to settle commercial disagreements. Economic development today depends on long-term contracts where relational factors do not exist or cannot suffice. Large infrastructure projects, for example, multiply the complexity of the house example above one hundred times over. Such projects are so complex and costly that governments cannot undertake them by themselves. Infrastructure contracts contain thousands of provisions and involve problems that go well beyond late payment or nonpayment. Contract law and enforcement help ensure successful resolution of

disputes that are likely to crop up over the many months or years it takes to perform such a long contract.

These types of contractual problems are especially difficult when one of the parties is the government. Private parties will be hesitant if not completely unwilling to enter into a contract with a government that does not observe the rule of law or ensure the fair treatment of the private party should a commercial dispute arise. At a minimum, a government will have to pay significantly more for goods or services just to cover the perceived risks of predation. This is particularly so when no independent tribunals exist to resolve commercial disputes.

Private contractors have historically dealt with such risks in two ways: arbitration and corruption. Arbitration clauses are often found in contracts between foreign companies and government entities. They represent an agreement among the parties to resolve any business dispute in an independent, private tribunal in a neutral country. Local businesses are often unable to use arbitration in a third country in a contract with their own government. As a result, they may instead try to corrupt local officials to ensure that the government honors its commitments and does not cause any problems.

#### **Discussion Questions**

1. What is the relationship between commerce and the courts?
2. How are commercial deals enforced in the absence of courts?
3. What is an example of a contract that impacts your daily life?
4. How do complex, long-term contracts overcome the traditional limitations on commerce, such as dealing only with family or friends?
5. What is ex post-opportunism? Why is it a problem? How is it overcome?
6. How do private actors overcome corruption and inefficient bureaucracies?

#### ***Land and Legal Uncertainty***

What are the sources of legal uncertainty? The short answer is that legal uncertainty arises because the question of ownership often lies outside of the legal system. Ownership may be safeguarded by custom or social norms within a tribe or extended family or even by customary legal systems operating separately from formal, state-based law. Customary legal systems may dominate vast tracts of land where formal courts and administrative bodies of the state are absent, and hence, unable to protect property rights. This situation may not be a problem in a community relatively unvisited by outsiders. But rising populations and large-scale movement of people bring new actors. These new actors may be wealthy foreign merchants who seek an investment, large companies seeking to build a new factory, or even urban settlers. Either way, these new actors will be unwilling to purchase land where they are not certain that their property rights will be recognized or protected.

In many developing countries, land ownership is often shrouded in legal uncertainty. In cities, the situation is often worse because social norms and traditional bonds are much looser than in the provinces. Agricultural workers are obviously threatened by legal uncertainty because if their land ownership is not recognized, not only do they lose their property but their livelihood as well. There are larger costs to an economy from legal uncertainty, however. Where ownership is not recorded in a registry, farmers often are forced to spend their limited resources on fences, walls, trees, or other boundary markers because there is no other way to know where one family's property ends and another's begins.

More importantly, a farmer cannot mortgage his property where no legal infrastructure protects it or describes its boundaries. If he cannot mortgage his property, he cannot borrow money to improve it, buy more land, or start a new business. Investment in improving land, whether in irrigation, drainage, or new crops, is important to output, productivity, and the environment. Increasing legal certainty through land titling increases investment in improving the land, leading to higher productivity. For example, the World Bank has documented how in Thailand farmers with title to their land invested significantly more in the land and, as a result, their output was 14-25 percent higher than farmers working untitled land of the same quality.

Greater legal certainty also increases the value of land. The World Bank also documented how the value of rural land in Brazil, Indonesia, and Thailand increased anywhere from 43 to 81 percent after being formally titled. Creating security, thus, has a two-part reinforcing effect. Not only does it increase incentives to invest in land, but it also creates the ability for a farmer to do so by increasing his ability to borrow the required funds. Throughout the developing world, farmers with title are able to secure larger loans than those lacking title. Thus, lack of certainty makes it more difficult for an ambitious farm worker to become a farm owner. A barrier to social and economic progress hinders long-term growth potential.

Lastly, if legal ownership is uncertain, so is the ability to transfer land. Without legal certainty regarding transferability, it is impossible to create a market for land. Land will not move into more efficient and productive hands if there is not a market where buyers and sellers can engage in commerce.

### **Discussion Questions**

1. What are some sources of legal uncertainty? How are they connected to land ownership?
2. How often do you encounter legal uncertainty in Afghanistan? What about your friends and family? Does your family have title to the land on which it lives?
3. Why is legal certainty important in the context of land and real property? Can you give a concrete example?

### *The Financial Sector*

The importance of the financial sector is well-established. Numerous studies have documented the link between financial development and increased per capita GDP. The same studies indicate that banking and stock market development are strong predictors of economic growth. The link between a country's legal system and the development of its financial sector is also well documented. Law plays a vital role in financial sector growth.

The development of the financial sector creates the most severe problems of separating the quid and quo. The very definition of a financial transaction is one in which the time of performance of the two parties to the contract is different. In a credit transaction, the borrower receives money up front and the creditor is paid back later. In the absence of an effective legal system, trust has not proved sufficient to support the development of a robust financial sector. Just as long-distance trade developed slowly, so too did financial transactions and the financial sector in a slow, evolutionary process.

### *Equity Markets and Corporations*

Modern economies are heavily dependent upon the corporate form of doing business. The massive scale of modern commercial activity goes well beyond the single store or workshop and increasingly demands capital beyond that possessed by the individual entrepreneur. Although the establishment of partnerships sometimes meets capital needs, the partnership model is a relatively inflexible one and used primarily by small enterprises and certain professions. The use of companies to pool large sums of capital and raise capital for new commercial ventures has become increasingly common since the beginning of the seventeenth century.

The corporate form spread wildly because it offers many advantages beyond the pooling of capital. One of those advantages is the limited liability of shareholders, which means that the corporation and not its shareholders are liable for the corporation's debts. Another advantage is the legal personality of the corporation that enables it to enter into contracts without the signature or prior approval of its shareholders. A prime function of the financial system is to channel funds from those who save to enterprises that will invest those funds in productive uses. The corporation has proven a profitable model of this activity. Because corporations are purely legal creations, they cannot exist absent commercial law. This is one other way that commercial law promotes economic growth—by facilitating the creation of corporations.

### *Credit and Banking*

Credit markets are just as important as equity markets to financial development. In most countries, more finance is generated in credit markets than in public equity markets. In equity markets, most legal issues involve questions of commercial law and securities regulation. In debt markets, the bank is the central institution for large-scale lending. Banks play an especially important role in developing countries as the intermediaries between savers and the users of the savings, who invest in nonfinancial assets. The efficiency of the transmission of savings to the ultimate users is essential to economic development. As the principal channel of that transmission, banks play a central role in a nation's economic development.

## V. CONCLUSION

This chapter has begun our study of Afghan commercial law by exploring Afghanistan's economy and business environment. Understanding these two areas is crucial for a more detailed examination of the history of commercial law in Afghanistan, which begins in Chapter 2. It also began our consideration of Islamic commercial law, a topic of immense importance in Afghanistan that will receive attention throughout this text.

This Chapter also provided a basic overview of the connection between law and economic development. It presented different views from the law and development debate. Among them was the "neo-institutionalist" view, which argues that the quality of a country's institutions is a direct determinant of its economic growth. It also explained why enforceable promises are the key to commerce. The lack of enforceable promises greatly increases uncertainty, risk, and costs associated with business transactions, thereby restricting commerce and growth. Simple transactions, such as point transactions at the bazaar, do not require strong commercial laws (or any commercial laws, for that matter) because promises are enforced in person at the time of transaction. However, once the quid and quo are separated, commerce becomes more complicated. Commercial law evolved over time to empower commercial actors and enable them to engage in sophisticated transactions.

The next chapter will chart the evolution of commercial law in Afghanistan. As you read Chapter 2, think about the impact of Afghanistan's evolving commercial law and institutions on the country's economic performance.

## Glossary

### ***Capital***

One of the four basic categories of resources, or factors of production. It includes the manufactured (or previously produced) resources used to manufacture or produce other things. Common examples of capital are factories, buildings, trucks, tools, machinery, and equipment used by businesses in their productive pursuits.

### ***Commerce***

The exchange of goods or services for money or other goods or services.

### ***Commercial Law***

The broad set of legal rules that governs commercial and business relations in a country, including contracts, company formation and dissolution, property purchase and sale, bank transactions, loan and guarantee matters, tax matters, as well as dispute resolution.

### ***Formal Economy***

Economic activity that is taxed and included in a government's Gross Domestic Product (GDP).

### ***Goods***

Physical, tangible products used to satisfy people's wants and needs, such as vegetables, cars, or books.

### ***Gross Domestic Product (GDP)***

The total market value of all goods and services produced within a country during a given period of time, usually one year. The government's official measure of how much output its economy produces.

### ***Human Capital***

The sum total of a person's productive knowledge, experience, and training. The acquisition of human capital is what makes a person more productive. One of the most notable methods of building human capital is through formal education.

### ***Informal Economy (also Unofficial Economy)***

Economic activity that is neither taxed nor monitored by a government and not included in a government's Gross Domestic Product (GDP).

### ***Infrastructure***

Capital used for transportation, communication, and energy delivery. It provides the basic foundation needed by an economy before business capital can do its job.

### ***Per Capita – as in GDP***

Something measured per person.

***Services***

Activities that provide direct satisfaction of wants and needs without the production of tangible products or goods, such as information, entertainment, or education.

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## CHAPTER 2: HISTORY OF COMMERCIAL LAW IN AFGHANISTAN

### I. INTRODUCTION

It is impossible to understand commercial law in Afghanistan today without first learning how that system developed. This chapter will explore Afghanistan's rich legal history that stretches back across centuries. It will focus on the history of commercial law in Afghanistan from the eighteenth century through the present. This chapter is filled with numerous examples that highlight the importance of commercial law throughout Afghanistan's history. Changing patterns of global trade and commerce often drive political, economic, and legal developments in Afghanistan. As an introduction to the topic consider the following example: the rise of the Taliban.<sup>4</sup>

In the 1980s, a large trucking system was established to ferry aid and supplies from Pakistan to the Afghan resistance forces. This lucrative transportation system began shipping goods from Pakistan through Afghanistan to the rest of Central Asia. Afghanistan reemerged as an economic highway to landlocked post-Soviet states. Business was booming for thousands of Afghan merchants, auto mechanics, truck drivers, and refinery owners. The main obstacle to continued growth of trade and commerce was the lack of law and order. Checkpoints littered highways throughout Afghanistan and specialized in collecting exorbitant taxes, harassing drivers, forcing extortion payments, and physically abusing passersby. The roadblocks and checkpoints slowed the flow of goods and forced merchants to bear excessive costs. Merchant communities and transport owners quickly became fed up with these obstacles to commerce and began looking for solutions.

Three violent militia groups that forced merchants and truckers to pay fees as well as taxes to the Kandahar government controlled one notorious stretch of highway from the border town of Spin Boldak to Kandahar. In August 1994, armed militia commanders stopped at gunpoint a thirty-truck convoy on its way from Pakistan to Turkmenistan. Local communities in the area had grown exasperated with the lack of law and order on the highways. Mullah Omar, then head of a local religious school, called for his former resistance fighter brethren to rise up in the name of justice. The "Taliban" freed the truck convoy and then cleared the highway of roadblocks and checkpoints that had extorted money from traders and travelers alike. The Taliban served as an outlet for the grievances of mistreated locals and received significant support from merchants in both Afghanistan and Pakistan. The rise of the Taliban was, thus, directly linked to commerce, including the lack of adequate commercial law in Afghanistan.

#### Reading Focus

As you read about the history of commercial law in Afghanistan, consider how this legal history may shape Afghanistan today. Which particular historical period or event(s) most significantly impact(s) Afghanistan today? Why?

<sup>4</sup> The following draws heavily upon THE TALIBAN AND THE CRISIS OF AFGHANISTAN (Robert D. Crews & Amin Tarzi eds., 2008).

## II. EARLY COMMERCE, TRADE, AND LAW

### A. The Pre-Durrani Period<sup>5</sup> (1600-1747)

Afghanistan sits at the crossroads of major overland trade routes between Asia, the Arabian Peninsula, and Europe. Until the fifteenth century, Central Asia and Afghanistan held a near **monopoly** over transit trade between these continents. The discovery of maritime trade routes that were safer, cheaper, and faster undermined Afghanistan's dominant position in international commerce. The use of the new maritime routes decreased the volume of trade passing through Afghanistan, thereby threatening the prosperity of its urban centers. In many parts of Afghanistan, the economy contracted, weakening the merchant class and transferring political power from urban centers to the landowning aristocracy. The absence of a central authority in Afghanistan as well as uniform and clear customs further stunted trade.

European naval supremacy and control of maritime trade were reinforced by the emergence of **joint-stock companies**, such as the Dutch East India Company. The separation of saving, risk-taking, and management functions gave these companies a competitive advantage that enabled them to corner the market on long-distance trade. Afghanistan's position as a trade center was also diminished due to Russian expansion into Siberia and the opening of a new trade route to the East. Russia soon came to dominate trade in and around the Caspian Sea.

European competitors slowly surpassed Muslim merchants who had traditionally traded as individuals or in private partnership. Local merchants had difficulty competing because they lacked organized banking facilities, **credit** systems, government support and subsidies, commercial agencies, and permanent diplomatic missions in non-Muslim lands. International trade was impeded because the Mughal and Safavid empires claimed royal monopolies over foreign trade in lucrative items. Internal trade was difficult because of poor communications and transportation systems and lack of security. The poor condition of the roads meant that the trip from Peshawar to Kabul took forty-five days. Most goods were still carried on pack animals because wagons were very uncommon. Travelers and traders on the highways regularly fell victim to raids by bandits. The insecurity of trade routes and absence of central control forced merchants to travel in large caravans that could defend themselves. The lack of uniform customs systems compounded these other difficulties and was an additional obstacle to trade.

Despite these problems, a considerable volume of trade passed through Afghanistan in the early seventeenth century. An estimated 14,000 camel loads transited Afghanistan per year. Afghanistan's trade infrastructure was weak, however, and tested by the rising power of tribes in eastern Afghanistan. Those groups controlled the economic lifeline of Afghanistan's urban centers—Kabul, Kandahar, Jalalabad, and Ghazni—and collected significant taxes from merchants and travelers. From the seventeenth century onward, booming maritime trade, insecurity of the highways, and regional conflicts (e.g. the Persian-Ottoman and Mughal-Persian wars) greatly reduced overland trade through Afghanistan. Sugar, tea, and other commodities

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<sup>5</sup> This section draws heavily from VARTAN GREGORIAN, *THE EMERGENCE OF MODERN AFGHANISTAN: POLITICS OF REFORM AND MODERNIZATION, 1880-1946* (1969).

that had traditionally been shipped through Afghanistan began to be transported via the Persian Gulf.

The collapse of effective central power and the decline of trade undermined Afghanistan's economic development. Feudal lords and tribal chiefs subjected urban centers and the merchant class to arbitrary fiscal, judicial, and administrative measures. Muslim guilds were not strong enough to resist political and economic encroachments of feudal lords and tribal chiefs. The position of the guilds was especially weak because they had no legal foundation under Islamic law. Religious opposition to banking and usury limited membership in certain guilds, such as banking, to Jews, Hindus, and Christians. As the urban economy of Afghanistan grew weak, merchants, artisans, and craftsmen declined in number and lost the political power they had accumulated. The power of feudal lords increased and they proved to be a serious obstacle to attempts at political, legal, and economic reform.

### Discussion Questions

1. How did Afghanistan's geographic location influence its economic development?
2. How did the discovery of maritime trade routes affect trade with Afghanistan?
3. What were some of the obstacles to trade? How were they overcome?
4. What was the position of the guilds in Afghanistan's urban economy? What was the role Islam and religious minorities in these areas?

### B. The Durrani Period (1747-1800s)

Kandahar was historically the largest commercial center in Afghanistan. It was the most important city on the trade routes between India and Persia that passed through the southern part of the country. Kandahar was such an important center of trade that the Mughal-Safavid wars focused on gaining control over this single city. Kandahar was also the capital of Ahmad Shah Abdali who founded the Durrani confederacy in 1747. During the Durrani dynasty, trade and caravan traffic remained the focus of Afghanistan's economy.

During this period, Indian merchants became very active in urban centers throughout Afghanistan. They were active in many professions, especially banking and money lending. Kabul was known for its tolerance of Hindu traditions and its treatment of Hindu merchants as a respected religious minority. Hindu merchants amassed great wealth and were required to pay a special tax called the *jizya*, which was levied only on non-Muslim merchants.

Indian bankers extended lines of credit, made loans to both the private sector and the government (to fund the military and other state institutions), and were the primary suppliers of investment capital in Afghanistan. Hindu merchant-moneylenders also played an important role in the financial administration of the state. They collected taxes on behalf of the Durrani ruling elite, delivered goods to the army, and financed Ahmad Shah's campaigns. Indian merchants

were named to important positions in the state financial body and tax apparatus in urban centers as well as the provinces.

Commerce and trade in Afghanistan continued to decline in the early nineteenth century because of the Anglo-Afghan wars and other military campaigns led by Dost Muhammad Khan. Merchant caravans were deterred by exorbitant taxes collected by each individual tribe on key trade routes. Urban centers continued to lose income and the country's major commercial and administrative centers suffered serious decline. Kabul was less affected by the downturn in trade because of its location. It remained a favorite location for caravans commencing or ending journeys across the Hindu-Kush mountain range to warehouse and distribute their goods. Merchants who traveled from Kabul towards Central Asia normally traded in cloth, cashmere shawls, sugar candy, spices, and indigo. Those returning from Central Asia brought horses, gold thread, raw silk, and other goods. Afghanistan also received goods from Europe and Russia, which included: cast-iron pots, copper, steel, iron, tin, leather, needles, mirrors, eyeglasses, and paper. From India came luxury goods for Afghanistan's upper class—indigo, gold cloth, mixed silks, cotton goods, sugar, spices, salt, medicines, guns, and utensils. These goods were exchanged for Afghan horses, wool, and fruit.

Trade with Central Asia was increasingly threatened by rising transportation costs, violent conflicts, and chaotic tariff systems. Caravans from Central Asia and India, for example, were normally stopped eight to ten times before they reached Kabul or Ghazni, where more taxes were imposed. Yet, commerce in Kabul increased following the British conquest of the Punjab in 1849. The British sought to open the Afghan market and sell Afghan products in Europe. As a result, tariffs were reduced and the caravans were offered protective escorts. British goods increasingly flowed through Afghanistan into Central Asia. Afghan merchants held but a small share of this trade because Hindu, Jewish, and Armenian merchants oftentimes served as the agents of the wealthier British and Russian merchants.

### **Discussion Questions**

1. What was Kandahar's historical role in Afghanistan's commercial development?
2. Why was Afghanistan the target of repeated conquest by different empires?
3. What role did Indian merchants and bankers play in Afghanistan during this period?
4. How did armed conflict with Britain and other countries impact commerce?

### **III. THE CONSOLIDATION OF THE AFGHAN STATE**

#### **A. Amir Abd al-Rahman Khan (1880-1919)**

The history of commercial law in Afghanistan begins in earnest with Abd al-Rahman Khan. His reign marks the beginning of the modern Afghan state and many of the institutions that comprise the current judicial system. Many of the legal reforms undertaken by Abd al-Rahman continue to shape commercial law in Afghanistan today.

Soon after he became king in 1880, Abd al-Rahman began to cement his control over the state and unite its provinces. One of his priorities was the centralization and regularization of the court and legal system. A comprehensive court system was established in each district to enforce the laws of the government. There were three sources of law: administrative or civil laws, *Shari'a*, and tribal law. Royal edict superseded all other sources of law. The court system was divided into two branches: the religious courts and the state courts. The religious courts handled issues of family law, criminal law, and personal law. The state courts were in charge of cases relating to commerce, taxation, and government employees.

The commercial court, a form of state court, was an important innovation. It was known as the *Panchat* court and was established by the Amir in 1893 to resolve disputes between merchants. The *Panchat* court was initially composed of four Muslim and three Hindu magistrates, but the ratio of Muslim to Hindu members changed over time. Each member of the court was a trustworthy and influential merchant respected by his peers. The court adjudicated commercial disputes on the basis of commercial customs, contracts, and documentary evidence. The unique composition of the *Panchat* court is commonly attributed to Abd Al-Rahman's desire to encourage commerce by removing Hindu merchants from the jurisdiction of religious courts that follow *Shari'a* law.

In one trade dispute from 1895, an Afghan merchant petitioned the Amir for help in recovering money owed to him by the British government for supplies he provided to them during their army occupation of the Second Anglo-Afghan War. The Amir appointed six persons chosen from the leading merchants in Kabul, including one British citizen, to review the case. After reviewing the document submitted by the merchant, the panel determined he had no claim. The appointment of both national and international merchants to the tribunal was similar to the approach taken with the *Panchat* court where Muslims and non-Muslims served side-by-side.

The *khan-i 'ulum*, was the principal court in Kabul that both oversaw the courts located outside of the capital and served as the highest court of appeal in Afghanistan. Abd al-Rahman was the final authority over any case brought before any court. Individuals could personally appeal to him after the conclusion of their case if they thought the result was incorrect. Abd al-Rahman held a weekly audience during which petitioners could inform him of their case and argue for his resolution of it. The king even set up special days for female petitioners. Another fundamental change in the legal system was the standardization of both *Shari'a* law and process. He institutionalized the *Hanafi* school of jurisprudence as the law of Afghanistan. He also issued a judge's manual called "The Fundamentals for Judges" (*asas al-quzat*), which instructed judges on court procedure and rendering judicial decision.

The Amir considered trade "the greatest source for enriching" Afghanistan. Trade between Afghanistan, India, Russia, and Persia expanded under his reign due to his reforms. The Amir ensured a relatively free flow by rationalizing customs and abolishing the complicated system of tolls between provinces. He created a caravan bureau headed by a *kafila bashi* (chief of caravans). With a small militia task force and the cooperation of the commerce, treasury, and revenue department, the caravan bureau oversaw the safety, supply, and transportation needs of travelers and merchants. The Amir established a standard 2.5 percent **ad valorem tax** on all

imports and exports to simplify the customs system and facilitate trade. He also created local trade councils that granted loans to local merchants and a state loan fund that functioned as a bank.

Despite the growth in trade during this era, its volume fluctuated greatly. The Anglo-Russian economic rivalry and prohibitive tariffs instituted by the Amir were most directly responsible. In the 1880s, Russia instituted many trade measures to exclude British and Indian goods from Central Asian markets. These measures severely damaged Afghanistan's position in the transit trade. The Amir sought to encourage Afghan exports but limit the outflow of Afghan capital to foreign countries. He banned the importation of salt and many manufactured products. He extended his personal monopoly over the timber industry and consolidated his control over the Afghan economy by lending interest-free money to Afghan merchants. Afghanistan's merchants lost out on certain lucrative aspects of trade because Afghanistan did not have many trade agreements with foreign governments. The lack of trade agreements coupled with high protective tariffs and transit taxes hurt the Afghan economy. Despite the Amir's focus on road building, moreover, transportation infrastructure was still lacking. The major route between Kabul and Peshawar was only open two days a week, and, even then, passage had to be purchased from the tribes who guarded the pass.

### Discussion Questions

1. How did Amir Abd al-Rahman Khan reform the Afghan legal system?
2. What types of laws existed? How were the courts structured?
3. What was the *Panchat* court? What were its responsibilities? What was special about its composition? How did it resolve disputes? Would a similar court serve Afghanistan well at present? Why or why not?
4. What were the Amir's views on trade? What policies did he pursue to increase trade in Afghanistan? Did these policies benefit merchants? Why or why not?

## B. The Early Twentieth Century and Aman-Allah Khan

Amir Abd al-Rahman Khan was succeeded by his son, Habib-Allah Khan, in 1901. Habib-Allah retained the basic features of his father's court system, but introduced some of his own reforms. The governor of each province was given judicial powers and jurisdiction over both civil and criminal cases. All disputes among merchants, as well as most civil suits, were referred to the *Panchat* courts. Before his death in 1919, Habib-Allah also attempted to modernize Afghanistan's transportation and communication infrastructure, banking facilities, and trade policies.

By the early 1900s, a small Afghan merchant class had emerged. It consisted of large landowners and a handful of wealthy nomads who had invested part of their profits in trade. Trade remained primarily a transit trade conducted through foreign middlemen. Following the Third Anglo-Afghan War in 1919, Afghans were able to choose their trading partners for

themselves. Trade agreements signed with Britain in 1921 and 1923 allowed them to export and import goods directly from Indian ports, thereby bypassing agents and middlemen. The transportation and road network expanded during this period, and by 1923 it was possible to drive by car on the Chaman-Kandahar road. This confluence of circumstances encouraged the creation of an Afghan merchant class with sufficient capital to control a significant portion of long-distance trade.

Habib-Allah Khan was followed by his son, Aman-Allah Khan. Little economic progress was achieved under Aman-Allah because he had no systematic plan for economic growth. No major industrial or agricultural projects were completed in the 1920s. The strongest sectors of the Afghan economy were trade and government workshops. **Customs duties** remained an obstacle to commerce because they were so inconsistent. Aman-Allah eliminated those taxes most prone to abuse by customs officers. One particularly notorious tax that he abolished was *chilyaka*, which imposed an assessment of one-fortieth per load, per weight, per cost price, per number article, or per piece, and offered considerable temptation to customs officials that enforced it. Customs officials reportedly collected ten percent in illicit commission (e.g. bribes) on the import duties they assessed. Corruption was further facilitated by the absence of a uniform system of weights and measures.

Aman-Allah took several steps to encourage trade and combat corruption in the customs service. All imports were divided into one of three categories: (i) religious literature, war material, and a few miscellaneous items, which were duty free; (ii) European-made luxury items, including cards, marbles, cigarettes, pictures, sugar, and honey, which were subject to 100 percent duty; and (iii) non-luxury items, which were taxed at different rates. The last category included tea (40 percent tariff), clothes (15 percent tariff), and a broad category of “useful items,” such as shoes, kerosene, oil, and gas that carried a 25 percent tax. The Amir also sacked many customs officials, replacing them with respectable merchants who were required to keep detailed receipts and make frequent reports.

Aman-Allah is most famous for the ambitious legal and political reforms he pursued during his rule. He drafted and enacted Afghanistan’s first constitution in 1923. The Constitution significantly limited the influence traditionally held by religious and tribal elders by concentrating political power in the government of the king. It reduced the power of the religious courts by banning all courts except formal, state courts. Article 55 effectively banned *shuras*, *jirgas*, and all other dispute resolution bodies outside of the formal court system. The Constitution also required that courts give secular law precedence over *Shari’a* law. The 1923 Constitution, however, proved to be too much of a challenge to traditional power bases in Afghanistan, and local leaders and members of the *ulema* began to rebel against the king. In 1925, the Constitution was amended by the *Loya Jirga* to reduce the power of the central government and give Islam a more prominent role in the affairs of the state, including the judiciary.

*Shari’a* had traditionally dominated certain areas of legal and judicial practice in Afghanistan. Property law and contract law are two prominent examples. Nonetheless, Afghan religious and secular courts often fought over jurisdiction in an attempt to hear a greater number of cases. Whether a dispute over wages between farmers and laborers fell within the jurisdiction

of the *Shari'a* courts or commercial courts was a common judicial conflict. Aman-Allah attempted to overcome such disputes by fashioning a court system with four levels. The lowest level court was the Court of Reconciliation (*mahkama-e-islaha*), followed by the Court of First Instance (*mahkama-e-ibtedaya*), then the Provincial Court (*mahkama-e-murefia*), and finally the Court of Cassation (*mahkama-e-tamiz*).

The Courts of Reconciliation were courts of summary jurisdiction whose decisions were based entirely on the agreement of the parties. They were only competent to hear civil and commercial cases, not criminal ones. Their decisions could not be appealed because their decisions could not be issued unless agreed to by all parties. Courts of Reconciliation functioned through the mid-1930s, but lost jurisdiction over commercial disputes when separate commercial courts were established.

Religious leaders were historically critical of the *Panchat* court given its secular focus and membership comprised of religious minorities. The *ulema* that participated in the 1924 *Loya Jirga* urged the government to abolish the court and transfer jurisdiction back to the *Shari'a* courts. The *ulema* put forward a motion to this effect, which passed. Aman-Allah subsequently passed a law to create a separate chamber within the *Shari'a* courts to hear commercial disputes. Another law was passed that regulated proceedings of the new *Shari'a* commercial courts.

During the same period, Afghan criminal laws were codified and a comprehensive Penal Code issued in 1924. A number of its provisions dealt with commercial topics, including civil and property rights. Private property was to be protected against extortion and bribes by government officials (Articles 229-33). Article 22 contained a vaguely worded clause that attempted to exclude a range of commercial activities from the control of the religious establishment. It read, “[i]n situations where the carrying out of a business breaks a law, or causes someone to break a law, canonically prescribed punishments are not to be applied.” This provision effectively prevented commerce-related criminal infractions from being punished according to *Shari'a* law.

### Discussion Questions

1. What was Aman-Allah's impact on Afghanistan's legal system?
2. What trade reforms did he pursue? How did he combat corruption? Would similar reforms help Afghanistan today?
3. What was important about the 1923 Constitution? How did it restructure the legal system? Were these changes positive or negative?
4. Why was the Constitution amended in 1925? How was it amended? How did those amendments impact commercial law?
5. What were the Courts of Reconciliation? Do they remind you of any modern-day judicial institutions in Afghanistan?

## IV. THE FOUNDATION OF THE CURRENT SYSTEM

### A. Nadir Shah

The next stage in the evolution of Afghanistan's commercial law took place under Muhammad Nadir Shah, who became King in 1930. He was determined to create a new constitution but to avoid the fate of Aman-Allah. The Constitution of 1931 was based on the French, Iranian, and Turkish constitutions of that period, but was heavily influenced and shaped by the *ulema*. The Constitution declared the religious law of the *Hanafi* school of Sunni Islam as the official law of Afghanistan. *Shari'a* law superseded legislation passed by the newly-created parliament. All courts were required by Article 88 to decide cases in accordance with the Holy *Hanafite* creed. The courts, however, were organized under secular law and secular law controlled, to a large extent, how they functioned.

In 1931, the Commercial Disputes Tribunal was established in Kabul. Similar tribunals were then set up in Kandahar and Mazar-i-Sharif. The Chamber of Commerce of Kabul heard appeals of the tribunals' decisions. The Commerce Ministry Council was the court of last resort and heard appeals from the Chamber of Commerce. Unfortunately, both the Chamber of Commerce and Commerce Ministry Council lacked the necessary judicial expertise. New laws, such as the Act on Bankruptcy, the Brokerage Act, and the Act of Commercial Register were passed in the 1940s in an unsuccessful attempt to provide legislative guidance to both bodies.

### B. Bank-i-Melli, Da Afghanistan Bank, and the Birth of Afghanistan's Financial Sector

A European visitor to Afghanistan in 1916 noted that banks did not exist and paper money was scarce. Rupees were hauled up from India on horses for payday. This is not surprising given Islam's concerns about banking, prevalent social norms, and the lack of a legal system able to support business transactions and enforce contracts. During the 1920s and 1930s, Afghanistan underwent significant changes. By 1932, Kabul had become linked by roadway to Peshawar, Kandahar, and Mazar-i-Sharif. Most important for our purposes, Afghanistan's financial sector was born during this period and its first comprehensive commercial laws enacted.

The history of banking and modern commerce in Afghanistan is intimately linked to the activities of a handful of entrepreneurs: Abdul Majid Zabuli (from Herat), Loe Sher Khan and Nashir Ghilzai (from Qarabagh), and Abdul Aziz Londoni. Londoni began the karakul industry, which brought in the majority of Afghanistan's hard currency before and after World War II. He was instrumental in improving trade relations between Afghanistan and Russia and opening up Russian markets to Afghan goods. He later became a major player in agricultural reform, attracting foreign investment, and Afghanistan's emerging industrialization.

In 1924, Zabuli founded the first joint-stock company in Afghanistan with other associates from Herat to engage in trade with Russia. Upon returning to Afghanistan in 1929 following a prolonged trade mission to Russia, Zabuli was summoned by the new King, Nadir Shah. The King was concerned that all export, import, transportation, brokerage, and other

commercial services were carried out by foreigners. He asked Zabuli to prepare an economic plan that would encourage Afghans to become involved in such activities. Zabuli also wanted to establish Afghanistan's first bank. The Minister of Justice, who was charged with the enforcement of *Shari'a* law, objected on religious grounds. Nadir Shah also opposed the scheme because he was afraid of suffering the same fate as Aman-Allah. Instead, the King gave Zabuli permission to establish a new joint-stock company, *Shirkat-i-Sahami-i-Afghan*, to regulate foreign trade and develop the domestic economy. Zabuli and his associates were given a monopoly over sugar, gasoline, motor vehicle imports, cotton, karakul, and wool exports. The government provided 1.7 million of the initial 2.5 million Afs of capital for the joint-stock company.

As Afghanistan's economy worsened in 1931, Zabuli resurrected his plan to create Afghanistan's first bank that could issue paper currency, provide credit, and, above all, promote entrepreneurship in the country. The following year, *Shirkat-i-Sahami-i-Afghan* was reorganized and, in 1933, it formally became Bank-i-Melli. The Bank immediately set about raising capital. Its capital reserves increased from 7.1 million Afs in 1933 to 60 million Afs in 1937. Nonetheless, Bank-i-Melli encountered problems almost immediately because of Islam's prohibition on *riba*. The Bank began to issue interest-free loans that required the borrower to purchase a *pule tiket* (money ticket), which was to be attached to each repayment receipt. This provided the Bank with profit as opposed to interest and satisfied *Shari'a* considerations. In its first six years of operation, Bank-i-Melli was extremely successful and increased its capital a hundredfold. Such growth was unprecedented against the backdrop of the Great Depression.

The Bank expanded rapidly during the 1930s because of support from the Afghan government. It was granted control over **foreign exchange** dealings in Afghanistan and adopted a fixed exchange rate in 1935. The Bank agreed to buy 100 rupees for 396 Afs and sell for 400 Afs. Bank-i-Melli soon thereafter led the charge to disband the Kabul money bazaar. It managed to take over a large share of Afghanistan's foreign trade from bazaar dealers. This move was motivated, in part, by the government's desire to diminish the domination of foreign trade by religious minorities (Hindus and Jews). Bank-i-Melli also assisted the government with the issue of Treasury currency notes beginning in 1936. The paper currency could be converted into silver Afghani at the Bank.

Afghanistan's foreign trade and general economic activity greatly expanded during the Great Depression because of Bank-i-Melli's dynamic policies. The Bank offered loans to traders, introduced checking systems, and utilized transfer drafts. But, its most important contribution to Afghanistan's growth was its support of industry. Between 1932 and 1934, thirty joint-stock companies were organized under the Bank's auspices. The Bank extended credit and loans of all types at a twelve percent interest rate. Bank-i-Melli had a very close relationship with the government of Afghanistan that began to sour by the late 1930s.

### Discussion Questions

1. How did Nadir Shah reform the courts? What new commercial laws did he pass? What foreign models inspired the new Afghan Constitution?

2. Who were Abdul Majid Zabuli, Loe Sher Khan Nashir Ghilzai, and Abdul Aziz Londoni? What was their role in Afghanistan's commercial system?
3. What was the *Shirkat-i-Sahami-i-Afghan*? What is its historical importance?
4. What is Bank-i-Melli? When was it created? How was it created? What obstacles did it have to overcome? Was its creation important for Afghan commercial law? Why or why not?

### **Origins of the Money Supply in Afghanistan**

The Afghani was introduced as the monetary unit of Afghanistan in a law passed on March 14, 1925. It was a silver coin weighing 10 grams and replaced the Kabuli Rupee. Under the same law, two gold coins weighing 6 and 3 grams, respectively, were also issued with values of 20 Afs and 10 Afs.

The Law on Banknotes in Circulation in Afghanistan was enacted ten years later on October 26, 1935. It authorized the issue of currency notes by the Ministry of Finance itself or through Bank-i-Melli. A previous attempt to issue paper money in the 1920s had failed. Before the issue of paper notes in the 1930s, Afghan merchants would normally utilize foreign currency (English gold, treasury notes, etc.) or checks drawn on Indian banks to complete larger transactions.

In 1939, Da Afghanistan Bank was founded with the right to issue banknotes. Article 19 of its statute stated that the Bank "in order to cover its short-term liabilities, shall be in possession of at least 30% of their face-value in the form of gold, silver, free foreign currencies, commercial bills payable within 15 days and bank-notes delivered by the "Committee of Bank-note Reserves." The Committee on Bank-note Reserves was comprised of: two members of Parliament, one member of the Cabinet, the President of the Supreme Court, the Governor of Da Afghanistan Bank, the Chief Treasurer, and the Government Auditor at the Bank. Committee Members served for two year periods and were charged with: inspecting newly-printed bank notes, safe-keeping the notes and ensuring that the Bank maintains its legally-mandated reserves, destroying notes withdrawn from circulation, and controlling the account regarding cover for the Bank notes.

*Source: Maxwell J. Fry, The Afghan Economy 112-13 (1974).*

### **Discussion Questions**

1. When was the Afghani officially introduced as the legal currency of Afghanistan?
2. How was Afghanistan's money supply regulated under the law?

In 1939, a central bank—Da Afghanistan Bank—was established in Kabul. It was given the "monopoly and privileges of issuing bank notes throughout Afghanistan" and served as banker to local and national government offices. Bank-i-Melli assisted the government in the

creation of the central bank and many Bank-i-Melli employees (as the only trained bankers in the country) joined its staff. Da Afghanistan Bank opened its first branch in 1942 in Kandahar and five more during the 1940s. It grew to over fifty domestic branches and two foreign offices (New York and London) by the early 1970s. Despite the steady increase in the number of branches, the bank made very few loans, accepted very few savings accounts, and had no check clearing system.

Around the same time, the government grew suspicious of Bank-i-Melli's activities and began formal investigation of its books. Bank-i-Melli lost its monopolies and ceded control over foreign exchange to Da Afghanistan Bank. Abdul Majid Zabuli weathered the political dispute and was appointed Minister of National Economy in 1939. He ensured peaceful co-existence between the two banks throughout the 1940s.

### **Foreign Exchange and the Money Bazaars**

The history of foreign exchange in Afghanistan dates back centuries because of the ancient trade routes that passed through the country. Prior to 1930, the money bazaars of Kabul and Kandahar handled all foreign exchange in Afghanistan because there were no banks. At that time, there were about 30-40 dealers in the Kabul market and 10-15 in Kandahar. The establishment of the Shirkat-i-Sahami-i-Afghan and subsequently Bank-i-Melli greatly undermined the money dealers. The fixed exchange rate adopted in 1935 gave a monopoly over all foreign exchange transactions to the Bank and prohibited all private foreign exchange dealings.

By 1938, it had become clear to Bank-i-Melli that it could wipe out the money dealers in Kabul and Kandahar. These dealers received a brief respite when Bank-i-Melli lost its foreign exchange power, but Da Afghanistan Bank targeted the dealers again when it instituted new exchange control measures in 1939. The new system of "centralized control" failed as market exchange rates survived. In 1947, the central bank returned to the 1938 system having realized that the free market system could not be eliminated. Then, in 1951, the Government promulgated Decree No. 2632, which codified the 1947 return to the 1938 system. The Decree was a dead letter given the complexities of some of its requirements.

In 1963, the majority of the multiple exchange rates were eliminated. Two years later, Da Afghanistan Bank entered into an agreement with the International Monetary Fund (IMF) to maintain a free exchange rate that quoted the rate in the Kabul money bazaar. 1965, thus, marks the renaissance of the money bazaars. Prior to that date, foreign exchange dealers had been primarily Hindus and Jews. Following the 1967 Arab-Israeli conflict, no Jews were granted the necessary trade exchange licenses. As banking stagnated in Afghanistan in the 1960s and 1970s, the money bazaars expanded. The volume and complexity of their trades increased dramatically. Unfortunately, the Government was unable to derive tax revenue from the booming trade because the 1951 decree made their activities technically illegal. As such, money dealers were prevented from registering their businesses or possessing formal bank accounts.

*Source: Maxwell J. Fry, the Afghan Economy 234-36 (1974).*

### History of Tax Revenue in Afghanistan

During World Wars I and II, the Government of Afghanistan had insufficient revenue. The primary cause of this problem was its tax system that was defined by *ad valorem* taxes on land and livestock, *de facto* taxes on most imports, and excessive reliance on foreign trade taxation. In 1926, Aman-Allah substituted cash payment for taxes in kind. Land and livestock taxes grew to contribute 62.5% (or 30 million Afs) of the State's annual revenue. In 1948, such taxes comprised 26% of State revenue and only 1% by 1972. The 1931 Constitution made it illegal for new taxes to be imposed or existing taxes altered without the consent of the *Loya Jirga*. During this period, tax delinquency was a major problem. The Government made concerted efforts in 1956, 1965, and 1972-73 to improve tax collection and reduce delinquency. These efforts were not successful.

Foreign citizens and firms operating in Afghanistan were the only communities that consistently paid their taxes. One major shortcoming of the tax system was that revenue collection was extremely decentralized. Each of the 28 provinces had its own collection and enforcement system. The systems were not based on existing legislation, but rather traditional practices. Knowledge of and respect for laws and regulations relating to income, land, or business taxes was almost non-existent. The lack of knowledge of Afghanistan's tax laws led to arbitrary and unpredictable decisions by tax officials. Powerful landowners escaped paying taxes by using their influence on tax collectors.

The Government was overly reliant upon foreign trade taxes in the form of import and export duties. Corruption within the Kabul Customs House was another serious problem. Baksheesh was a basic requirement to obtain needed documents and signatures for customs clearance. In the early 1970s, the system operated openly on a fixed-price basis.

*Source: Maxwell J. Fry, the Afghan Economy 155 (1974).*

### Discussion Questions

1. What is Da Afghanistan Bank? When was it created? Why was it created? What were its original powers? How was it structured?
2. What is the historical importance of Afghanistan's money exchange dealers? How did establishment of formal banks in the 1930s impact them? How did government policy change vis-à-vis the activities of the money exchange dealers?
3. Historically, what were the primary sources of state revenue in Afghanistan? How did law regulate collection of such revenue? What were some of the obstacles faced by the institutions involved in revenue collection? Do the same problems exist today?

### **C. The 1940s and 1950s**

Shah Mahmud (1946-1953) ushered in the first period of true representative governance in Afghanistan where an elected parliament voted for laws rather than their being put into effect directly by the King. The next stage in the development of Afghan commercial courts took place in 1949 during his rule. A three-tiered court system was established under the supervision of the Ministry of Justice. Two new courts—the Court of Commercial Appeal and the Cassation Court of Commerce—were established in Kabul and were empowered to hear commercial appeals from throughout the country.

In 1953, Daoud ousted Shah Mahmud and became Prime Minister. Perhaps the most significant domestic reform during this period was the opening of public education to women. Daoud also embarked on a major project of codification of the law. Commercial laws were consolidated and codified with the enactment of the Law of Commerce in 1955 and the Law of Commercial Procedure in 1963, both of which were based on European models (mainly Swiss). Following the promulgation of the 1964 Constitution, commercial courts were integrated into the new judiciary under the supervision of the Supreme Court.

The Commercial Code of 1955 was designed to apply to all commercial transactions, as determined by the provisions of the Commercial Code. The Commercial Code has served as the primary source of commercial law in Afghanistan ever since. One of the key provisions of the Commercial Code specifies that disputes are to be resolved through reference to “the meaning and implication of existing commercial laws.” In other words, commercial law should be the first source that is used to determine the proper outcome of a dispute. “In the absence of a law, local and special customs” were used, with preference given to local custom over general custom.

Although the Commercial Code is the primary source for resolving disputes related to commercial transactions, application of the Commercial Code is specifically limited to commercial transactions. Articles 18 and 19 of the Code provide lists of transactions that qualify as commercial transactions. They include: agreements to provide movable property, establishment of several types of businesses, transportation services, and distribution services.

The Government of Daoud instituted a new economic policy based on stringent state control of business. It took aim at Bank-i-Melli and its lead role in promoting expansion of the private sector in Afghanistan. The new Minister of Finance, Abdul Malik, began to limit Bank-i-Melli’s activities in 1955. For example, the Bank was forced to sell to the government its stock in numerous businesses. Da Afghanistan Bank became the fiscal agent of the Ministry of Finance and took over responsibility for issuing currency, regulating bank credit, controlling foreign exchange dealings, and promoting investment.

#### **Discussion Questions**

1. What was Daoud’s impact on Afghanistan’s commercial laws? Why is the 1955 Commercial Code important?
2. How did Daoud’s economic policies impact commercial law in Afghanistan?

3. How did the roles of Bank-i-Melli and Da Afghanistan Bank change during this period?

### **The Helmand Valley Project**

The Helmand is the longest river in Afghanistan and originates in the Hindu Kush mountains. In 1945, the Afghan Government embarked upon a large infrastructure project to control the seasonal flows of the river. The Helmand watershed drained forty percent of Afghanistan's land area and affected over one fifth of the entire population. Gaining control over the river via the construction of dams and canals would "make deserts bloom again" and provide a stable water source for numerous Afghan cities and towns.

The Government initiated negotiations with Morrison-Knudsen and formed Morrison-Knudsen Afghanistan Inc. (MKA). An initial \$10.7 million US was needed to complete surveys, build roads, and begin construction of two dams and an extensive canal system. The total cost was estimated at \$63.7 million US, including \$53.7 million US in foreign exchange.

The project encountered bureaucratic and human problems from the start. Misunderstandings over the areas of responsibility of each party were common. By 1949, costs had mushroomed. Minister of National Economy Zabuli requested a \$55 million US loan from the US Export-Import Bank, and was ultimately granted a \$21 million US loan later that year. By 1951, the Afghan Government asked MKA to take over all engineering responsibilities previously assigned to it. In 1952, the Government belatedly created the Helmand Valley Authority (HVA) to oversee implementation of the project. The president of the HVA was given Cabinet rank. Two dams were completed ahead of schedule, but the canals proved a tougher challenge. In 1953, the Export-Import Bank issued another \$18.5 million loan.

The Daoud regime was disturbed by reports of poor administration, graft, and corruption within the HVA. It shook up the HVA and dismissed some of its staff. Criticism of the HVA was common, but little further action was taken to improve it. A talented Afghan team was undermined by limited funds and apathy from the Government. Bad floods in 1957 and 1959 complicated the project. In 1959, MKA's contracts were cancelled. MKA was replaced by a system of American and third country technicians that advised the newly formed Afghan Construction Unit (ACU).

*Source: Louis Dupree, Afghanistan.*

### **Discussion Questions**

1. What was the Helmand Valley Project? Why are infrastructure projects important for a country's development?
2. Who were the major actors involved in the project? How did commercial law (domestic, foreign, and international) influence the project?

3. What problems did the project encounter? Were they legal, technical, or labor problems? How were they resolved?
4. What does the history of the Helmand Valley Project suggest about modern-day infrastructure projects?

Despite its economic policies, a banking boom took place under the Daoud administration. Each government ministry wanted and soon established its own bank. The Ministry of Public Works already had the **Mortgage** and Construction Bank (1948), but the Ministry of Commerce, Ministry of Agriculture, and Ministry of Mines and Industry all established their own banks between 1954 and 1957. In a single decade, one commercial bank, the Pashtany Tajaraty Bank, and three specialized banks had opened alongside Bank-i-Melli and Da Afghanistan Bank.

Although banks dominated Afghanistan's limited financial sector, they were not the only financial institutions in the country. The Pension Fund, credit cooperatives, and money bazaars also merit mention. Prior to the formation of the Afghan Insurance Company in 1963, there were three small insurance agencies in Kabul: the Sterling Insurance Company of New Delhi, Northern Insurance Company, and Ingosstrakh (the overseas branch of the Soviet Insurance Trust). The Pension Fund was established in 1944 and financed government pensions through the 1970s. The money bazaars of Kabul and Kandahar anchored a large non-institutional credit network in Afghanistan. They provided higher interest rates and nearly the same services as the formal commercial banks.

#### **Financial Institutions of Afghanistan**

<u>Institution</u>	<u>Date of Establishment</u>
Bank-i-Melli (private)	1932
Industrial Development Bank (private)	1973
Da Afghanistan Bank (government)	1939
Mortgage & Construction Bank (government)	1948
Pashtany Tejaraty Bank (government)	1954
Agricultural Development Bank (government)	1970
Afghan Insurance Company	1963
Three Insurance Agencies	unknown
Kohdaman Credit Cooperative	1969
Baghlan Credit Cooperative	1971
Kabul Money Bazaar	unknown
Kandahar Money Bazaar	unknown
Pension Fund	1944

*Source: Maxwell J. Fry, The Afghan Economy 93 (1974).*

### Discussion Questions

1. What were the prominent financial institutions in Afghanistan during the first Daoud era? Which institution was most important? Why?
2. Why were banks the dominant financial institutions?

#### D. The 1964 Constitution and Subsequent Legal Reforms

Daoud resigned in 1963 and was replaced by Dr. Muhammad Yousuf who announced that a planned economy would continue, but that “private enterprise will be further supported and encouraged.” Yousuf and the King quickly embarked upon a comprehensive effort to draft a new constitution. They organized a Constitutional Review Committee that presented a draft constitution to the 455-member *Loya Jirga* in May 1964. The *Loya Jirga* approved most of the articles of the draft constitution without significant debate. However, the status of the courts attracted significant attention. Dr. Yousuf was forced out of office as Prime Minister in 1965 and replaced by Dr. Muhammad Hashim Maiwand. The period from 1965 until the monarchy was abolished in 1973 was the most productive in the legal history of Afghanistan. This period marked the culmination of the codification process started by Daoud and the enactment of comprehensive criminal, civil, and criminal procedure codes. Many of the laws drafted during this era remain in force at present.

In contrast to the 1931 Constitution, the 1964 Constitution made statutory law more legally binding than the *Shari'a* law once it was passed by the parliament and accepted by the King. The courts were required by Article 102 to apply first the provisions of the Constitution and then the statutory laws of Afghanistan when deciding a case. *Shari'a* law was only to be used to decide a case if there was no statutory law on the subject. This contrasted with the 1931 Constitution that required courts to base their decisions on the *Hanafi* school of Islamic jurisprudence. The judiciary was led by the Supreme Court, which was empowered to decide whether the laws passed by the parliament were in accordance with the constitution and was named an independent, co-equal branch of government.

While the Constitution of 1964 provided the general framework for Afghanistan’s new court system, the 1967 Law of Judicial Authority and Organization (LJAO) established its more detailed structure. The Supreme Court was the “highest judicial authority in Afghanistan” and it supervised the newly unified judiciary. The three Cassation Courts were merged into one and became an integral part of the Supreme Court. The Cassation Chamber of Commerce (CCC) acted as the court of final appeal in “all commercial and labour disputes.” The term “commercial disputes” comprised industrial disputes and all disputes in the areas of transportation, patents, and insurance.

The LJAO introduced uniformity in court administration at the provincial level. The commercial courts, which had previously operated separately, were merged into the newly organized Provincial Court in the form of a Commercial Chamber. Because commercial disputes were more common in urban settings and there was a lower volume of such disputes in rural

areas, commercial courts were initially established only in major urban areas. Their number increased gradually over time as commercial courts were established in smaller cities.

Under the 1964 Constitution, the Commercial Court had a great deal of authority and autonomy even though it was part of the judiciary. A Law on Commercial Court Procedure was passed under the 1964 Constitution that gave the Court the power to oversee settlement upon agreement of the parties, to make preliminary rulings, to initiate suits, motions and pleadings, and to conduct trials, hear evidence, make decisions and hear appeals. The Commercial Court was also authorized to make arbitration award rulings. The law limited the role of the Supreme Court in Commercial Court cases. The Supreme Court could make rulings on court fees but few other issues.

### Discussion Questions

1. How did the Constitution of 1964 change Afghanistan's legal system? Which reform was most important? Why?
2. How did the 1964 Constitution restructure the judiciary? What was the hierarchy of law it established? Was this change positive or negative? Why?
3. What is the LJO? How did it impact commercial law in Afghanistan?
4. How were the commercial courts different from other, civil courts?

Disputes between courts over their respective jurisdictions continued despite the newly streamlined court system. The Supreme Court was faced with one such dispute over the jurisdiction of commercial courts in 1968. The case involved a dispute arising from *salam* (advance sale), *shirkat* (business partnership), and *mudaribat* (profit-sharing). These transactions were recognized by the Hanafi *fiqh*, and, as such, the courts for ordinary civil and criminal affairs (CCCA)—the successors to the previous *Shari'a* courts—typically heard disputes arising in these areas even though commercial courts had existed since 1931. Maulawi Safi, the head of the Supreme Court Chamber for Conflicts of Jurisdictions, raised the issue before the Supreme Court. He urged the Court to leave jurisdiction over “*Shari'a* contracts” and “*Shari'a* claims” with the CCCA. He argued that the basis of jurisdiction should be determined by whether or not commercial documents contained *Shari'a* terms or provisions. The Supreme Court disagreed:

1. *Mudaribat* is a contract that authorizes a person to use the capital of another for trade on the condition that the profit and loss be shared by both. This is clearly a commercial transaction and a matter that falls under the jurisdiction of commercial courts.
2. In accordance to article 19(8) of Commercial Law (*qanun-e tijarat*) transactions of commercial partnerships are commercial regardless of the intention of the parties.

3. *Salam* is basically not a commercial transaction . . . but wherever goods of *salam* are purchased for the purpose of trade, claims emanating there from may be regarded as commercial claims.<sup>6</sup>

A similar case for the transfer of jurisdiction arose in a dispute among farmers. The LJAO provided that labor and commercial disputes are to be dealt with by the commercial courts. The Provincial Court of Kandahar raised the issue of whether or not farmers constituted “labor” under the meaning of the LJAO in a memorandum to the Supreme Court. The Court decided that disputes of all factory workers and those working in government workshops, or in semi-governmental, and private enterprises are to be settled in commercial courts. Because the legal status of farmers and farmer-landlord relations had not been clarified or regulated by law, the claims of farmers and agricultural wage earners would be settled in primary courts in accordance with *Shari’a* law.

### Discussion Questions

1. What is a jurisdictional dispute between courts? Why were they common in the 1960s in Afghanistan?
2. How do jurisdictional disputes affect commercial law?
3. How did the Supreme Court clarify the jurisdiction of the commercial courts in its 1968 decision described above? Do you agree with this decision? Why or why not?
4. What types of jurisdictional disputes would you guess are common in Afghanistan today?

### Law & Free Enterprise

On February 22, 1967, Afghanistan promulgated a new Private Investment Law. The Law sought to encourage free enterprise in Afghanistan by departing from the command economy model embraced by previous governments. The Law promotes private sector investments, both foreign and domestic, by providing more robust legal protections for them.

The Government of Afghanistan attempted a similar feat in 1955 when it passed a law designed to encourage the investment of foreign capital in enterprises, which would “increase the country’s foreign exchange earnings or result in the saving thereof.” That law was revised in 1958 and 1960, but had little effect because of an invasive bureaucracy and poor tax structure.

The table below summarizes certain similarities and differences between the two laws briefly discussed. Critically analyzing the differences between the laws will help demonstrate the link between commercial law and economic growth.

*Source: Louis Dupree, Free Enterprise in Afghanistan.*

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<sup>6</sup> Supreme Court Circular No. 1234/24.II.1347/1968

<b>Law Encouraging the Investment of Private Foreign Capital in Afghanistan (1958)</b>	<b>Foreign and Private Investment Law (1967)</b>
Covers only foreign investment	Covers both foreign and domestic investment and guarantees equal treatment for both
Art. 1 – Defines foreign private capital	Art. 1 – Purpose of law is to encourage and protect private enterprise
Art. 4 – Encourages investment in certain industries; priority given to investment which increases or saves foreign exchange	Art. 2 – Investors must have project approved by Investment Committee, incorporated under Commercial Code; encourages investment in certain industries
Art. 5 – Three year corporate income tax exemption not to exceed 15% per annum of registered capital; three year exemption on import duties of essential items; three year income tax exemption for investors	Art. 3 – Five year tax holidays on all profits; five year holiday from import duties on items not available and necessary for operation; five year income and corporate tax holiday for investors
Art. 5 – No discrimination between Afghan and foreign investments	Art. 7 – No discrimination between Afghan and foreign investors and investments
No mention of this issue	Art. 12 – Any Afghan or foreign national can own shares
No arbitration legally possible (although informal arbitration was common)	Arts. 18-19 – Foreigners can seek arbitration under the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States or demand private arbitration per specified procedures

### **Discussion Questions**

1. What are the most important differences between the two laws? How do you think those differences impacted private enterprise?
2. What additional changes to the 1958 law would you recommend?

### **E. The Financial Sector Faces Challenges**

During the late 1950s and early 1960s, it became clear that the Afghan financial sector was not competitive. The rapid introduction of Western-style financial institutions was difficult because there was very little tradition of finance in Afghanistan. Traditional financial instruments were essentially non-negotiable and unfamiliar to the majority of the population, as were the differences between a loan and a grant. As a result, total deposits in the banking system were quite small, and government had to provide regular infusions of cash to prop them up. The lack of foreign competition permitted Afghan banks to retain many of their inefficiencies.

Problems in the financial sector were exacerbated by government policy. The government placed restrictions on the amount of domestic credit allocated to the private sector. Private

enterprises that needed capital were forced to borrow from other sources and pay higher than market rates. Economic growth slowed during this period because domestic financial resources available to the private sector were so scarce. Rates of interests on loans from financial institutions had remained unchanged over two decades. In the money bazaars, however, rates had increased sharply. High rural interest rates deterred the movement from subsistence to cash crop farming. Few borrowers could meet the minimum requirements of credit worthiness required by the banks. These requirements were linked to the banks' own failure to collect loans and seize collateral upon default.

The volume of credit and variety of loans offered in Afghanistan contracted in the 1960s. The primary cause of this financial slowdown was the difficulty experienced by banks in collecting loans on maturity. Banks were reluctant to loan money to new borrowers or extend credit to industry and agriculture because of inadequate protection under existing laws. The rights, duties, and obligations of both borrower and lender were not clearly defined by law. The lack of a strong civil code, credit security law, and a general banking law, coupled with the inexperienced staff of the banks and commercial courts, undermined the financial sector. Legal problems surfaced because of the influence owners held over disposal of their collateral, slow and inefficient court procedures, the political and social influence of the borrower, incompetent court officials, and corruption.

### **Discussion Questions**

1. What happened to the Afghan financial sector during the 1950s-1970s?
2. What was the connection between Afghanistan's commercial law and these financial developments?

### **The Agricultural Development Bank (AgBank), 1971-1972**

Several reports from the AgBank from 1971-72 highlight how weak commercial laws prevented the development of Afghanistan's financial sector and slowed its economic growth. The text of those reports is reproduced below in its entirety. Reading the text below provides fascinating insight into Afghanistan's financial sector and commercial laws and concrete examples of the importance of many issues covered in this textbook.

It also illustrates how the theoretical overview provided in Chapter 1 is extremely relevant to Afghanistan's future economic growth. As you read the next few pages, think about the role of agriculture, land-titling, and commercial law in promoting economic growth in Afghanistan.

#### *II. Existing Problems Faced by the AgBank*

##### *A. Problems Related to the Distribution of Credit*

The AgBank in following the general principles of banking and its own regulations does not extend loans to borrowers who cannot meet certain requirements. As security, the AgBank has accepted the following items: immovable property (land, shops, houses, etc.); movable property such as agricultural products, including animal products, merchandise and bonds; and guarantees from financial institutions and agro-business firms. To safeguard its loans, the AgBank has generally required immovable property as security for medium and long-term loans.

The provision of such security is still based on Government regulations concerning guarantees, which were prepared by the Ministry of Finance and ratified by the Cabinet. To mortgage land, the owner swears in the presence of two witnesses in a court of law (*mahkama-e-wasayeq*) that he is placing a particular piece of his land under mortgage against the loan which is being provided by the Bank. On default, the Bank has the right to sell the mortgaged property without recourse to further judicial procedure.

In practice, a number of defects in this system do not encourage banks to accept such security (*wasiqqa*) for the following reasons:

1. Since the cadastral survey has not been completed, the actual size and nature of the security is uncertain.
2. Incorrect land registration results in uncertainty as to whether the possessor of the title is in fact the owner of the land.
3. The variety of customary rights in different parts of the country over water use (*haqaba*) which is a major factor in determining the value of the property adds to the uncertainty of the security.
4. Various standards of measurement (*tukhum raiz, paikal, qulba*, etc.) further add to the problem.
5. Finally, legal promissory notes do not conform to the Bank's requirements. Unclear handwriting of court officials can easily prevent the document from being officially accepted.

#### *B. Difficulties in Settling Loan Contracts*

1. Loans are extended in accordance with the conditions laid out in the contract, which after the provision of adequate security is signed by both parties. The contract sets out the rights and duties of both sides. The Commercial Law establishes that disputes arising from such contracts should be taken to the commercial courts. However, as a result of various problems such as the non-attendance of borrowers or the bank's attorney, contracts have not been registered in the courts. This, of course, created additional problems.
2. The absence of commercial courts in many parts of the country in any case makes registration of contracts impossible.
3. Registration departments (*wasayeq*) create obstacles preventing speedy registration.

#### *C. Collection Problems*

Although the borrower vests the right to sell his security with the bank and his neighbors promise to buy the land in the case of default, the bank is often unable to sell the security because:

1. The inhabitants of the district refuse to buy the land through fear or compassion.
2. The immediate neighbors are not in a position financially to buy the land or they also want to help the borrower.
3. The judicial authorities will not transfer the security to the bank without the consent of the borrower. Even if it is transferred to the bank, the bank will not be able to manage the property: the establishment of a management team is too costly.
4. Loan collection is another area in which the bank does not possess any authority and at present this is undertaken by Government agencies. This has created many additional problems.

*D. Borrower's Difficulties*

In the absence of cooperatives, land titles and other securities, a large number of farmers are deprived of receiving agricultural loans. Even farmers with land titles who want to borrow are faced with severe difficulties arising from the costs of legal promissory notes and psychological factors.

*Source: Maxwell J. Fry, The Afghan Economy 139-40 (1974).*

## **Problems Regarding Security for AgBank Medium-Term Loans**

Medium-term loans are generally given to farmers to help them buy immediate needs such as improved seeds, fertilizer, chemicals to combat insects, small tools, animals, and to help them improve their marketing. In these cases, immovable property is held as security. In this instance, the AgBank faces the following difficulties:

1. Preparation and distribution of credit for individual farmers possibly exceeding a million in number is a problem.
2. Granting loans to farmers against their agricultural and animal products is not problem-free, both because the cooperative system is not common and also because the marketing system has not been developed, except for a few items such as sugar, beet, and cotton. Otherwise the sale of agricultural products is not controlled and the collection of loans is difficult.
3. Preparation of promissory notes for mortgages for short-term loans and also registration of the contracts related to these loans in the commercial courts create some problems in that they make the distribution of loans, which are increasing day by day, impossible. In particular, fertilizer will be needed by over half a million farmers in the next season. Although the Afghan Fertilizer Company has been established to satisfy the needs of farmers, there are not enough storehouses throughout the country and therefore fertilizer cannot be distributed to all the farmers.

### *3.2 Securities*

At present, the only utilized form of security is mortgage on land. Land security is established through a legal act undertaken in the courts. A mortgage on land can be given only to the landowner. The Bank also accepts land mortgage of a person other than the borrower. The procedure involved in getting a land mortgage confirmed by the court is time-consuming and troublesome. From the security document finally issued by the court on the basis of the 'Qabal,' which does not show the actual status of ownership, AgBank cannot be certain that the land mortgage obtained a valid guarantee, from which prosecution can be started without any difficulty.

It is the desire of AgBank that steps should be taken to simplify the legal documents and procedures involved in order to give further encouragement to the farmers and enable AgBank to expand its loan activities. If the farmer does not pay the loan when it falls due, the Bank's only remedy is the possibility of selling the mortgaged land. Under the present security system the sale of land not only involves legal problems but also problems in the practical aspects of the sale. Since the security is based on the signatures of neighboring landowners, who have to state that they would be willing to purchase the land in the case of prosecution, this normally results in the neighbors' refusing to comply, claiming they have no cash available, that they maintain a good relationship with the present landowner and therefore do not want to take away his land, and that in cases where a neighbor signed the mortgage and has since died, his heirs are not willing to fulfill the obligations agreed to by the deceased. If it actually comes to a sale it is also very difficult for an outsider to buy the land as he will face difficulties in the future with the

neighbors. The AgBank's taking over the land under the present system would add more problems to the already existing ones.

Generally, besides land, farmers do not have anything else—such as shares in companies, government bonds, warehouse receipts for goods placed in government warehouses, guarantees obtained from other banks, or other moveable property—of great enough value to serve as security of AgBank. In addition to the difficulties arising from the legal procedures in obtaining land securities, the actual number of landowners in a position to obtain these securities on land is very limited, the reason being that only a minority of landowners has the land actually registered in their names and therefore can produce land titles. In many cases, the land belongs to several members of a family who have inherited the land from their father, grandfather, etc. In such cases, it would take the consent of all the family to put the land under mortgage. As experience has shown, this is also very difficult.

### 3.3 *Collection*

#### 3.31 *Short-Term Loans*

The collection rate of short-term credits disbursed to cotton companies, the PACCA [Project on Agricultural Cooperatives and Credit in Afghanistan], and to agro-business enterprises with rates between 90 and 100 percent is satisfactory. The collection rates for credits extended for fertilizer, however, are not at all satisfactory. For the disbursements of 1350, which were due on Mizan 1, 1351, up to Hoot 29, 1351, the average rate of collection was 63 percent in the whole country, with variations from 28 percent in Kabul Province to 100 percent in Bamiyan. The reason for this poor result is the fact that not enough efforts to collect have been made and more pressure should come from the RGA [Royal Government of Afghanistan].

#### 3.32 *Medium-Term Loans*

The collection rates of AgBank of individual loans are also not satisfactory. In the first nine months of 1351, for instance, the recovery rate of medium-term loans fallen due in that period was only 76 percent. The loans not collected when they fell due are transferred to the category of "loans overdue" where the collection rate is even lower. The difficulties AgBank is having with the system of securities as described above result in farmers knowing exactly that prosecution on land mortgages is more or less fruitless for AgBank. Additionally, it is widely known that the Government does not take a strong position in the collection of fertilizer credit. This naturally has side-effects on AgBank's collections.

*Source: Maxwell J. Fry, The Afghan Economy 141-42 (1974).*

### **Discussion Questions**

1. What types of problems did AgBank face?
2. Why was it difficult to distribute credit? What characteristics of the legal system contributed to these problems?

3. Why was it difficult to settle loan contracts? How did this problem relate to Afghanistan's commercial laws?
4. What types of problems did AgBank face regarding collecting loans and seizing security on the loans? Could Afghanistan's commercial laws have resolved these problems? If so, how? If not, why not?
5. What problems did AgBank face with medium-term loans?
6. What was the issue with security and loan collection?
7. What does the experience of AgBank suggest regarding banking in present-day Afghanistan? Can commercial laws reshape local customs and traditional borrowing practices?

The Mortgage and Construction Bank suffered similar challenges as AgBank. It made various attempts to collect on debt, but received very little help from the Ministry of the Interior. The Ministry issued summonses to defaulters but did little else to enable the sale of the property. As a result, borrowers did not repay their debts. In 1969, the Supreme Council of the Bank wrote all defaulters and demanded repayment within one month. Non-compliance would result in seizure and sale of their property by the Law Department of Kabul Province. The Council also hired a lawyer to facilitate such actions, but no other action was ultimately taken and the problem remained unresolved.

The 1971 Annual Report of the Mortgage and Construction Bank highlighted the serious problem of defaulting borrowers to shareholders. The compounded interest on many loans reached the point where debt exceeded the value of the mortgaged property. When sales were attempted, third parties would claim an interest in the properties, thereby preventing their sale. In 1970, the Cabinet further complicated matters when it approved a motion that prohibited the Bank from holding the titles (*qabala*) of mortgaged property. The Bank had not taken out insurance on the mortgaged property so when uninsured mortgage property was destroyed, borrowers tended to believe that their obligations to repay were likewise dissolved.

The 1972 Annual Report also focused on collection problems. The Parliamentary Committee on Public Works and Communications had considered the Bank's problems and directed it to force the sale of the mortgaged property immediately. Two representatives of the Bank were assigned to work with the Collection Department of the Ministry of the Interior. The Ministry had been instructed by Cabinet Decree 962—which received royal assent in June 1966—to collect the Bank's outstanding loans. It had made no efforts to follow this order. The Parliament again instructed the Bank to make the sales by itself, at which point the Bank appealed for help from the Minister of Finance. No one in the government ever assumed responsibility for collecting the loans. The commercial banks also experienced excessive loan defaults. Many exhausted their resources and were in difficult financial positions by the early 1970s, as a result. The one exception was Bank-i-Melli, which had very cautious lending practices and financed almost exclusively its own companies.

### **Legal Reforms Desired by Afghan Bankers in the 1970s**

1. Law on securing bank loans
2. Registration Office for legal registration of all bank loans
3. Special court for enforcing repayment of bank loans
4. Legal provisions for chattel mortgage
5. Legal provisions for lien on crops
6. Legal provisions for loans against letters of credit
7. A definitive cadastral survey
8. Legal provisions for all financial instruments
9. Detailed regulations considering the absolute rights over and automatic transfer of ownership of collateral
10. Detailed regulations on the expropriation of property upon default
11. Legal provisions for real estate mortgages
12. Specification of responsibilities of customs officials to release imports under bank security only against all necessary documents and a time period after which goods become property of the bank
13. Specification of how loans for barter imports should be secured
14. Detailed regulations for repayment of loans for exports
15. Detailed regulations concerning loan repayment in cases of bankruptcy
16. Detailed regulations obliging courts to seize property in all cases of default

*Source: Maxwell J. Fry, The Afghan Economy 145-46 (1974).*

Afghanistan's non-bank financial institutions remained few in number and importance in the 1960s and 1970s. Insurance was extremely uncommon even when compared to other agrarian economies at a similar stage of development. The Afghan Insurance Company held small equity interests in the Coca-Cola Company of Afghanistan (CAM) and the Inter-Continental Hotel in Kabul. All property—from cars to houses—was almost never insured. As a result, no insurance salesmen lived or worked in Afghanistan. The Pension Fund received 43 percent of its annual income from payments made by civil servants, each of whom contributed 3 percent of his salary to the Fund. The remaining 57 percent came from an annual allotment from the government. The Baghlan and Kohdaman Cooperatives were small pilot projects that involved just over 1,000 farmers. They took the form of an “integrated operation supplying credit, technical assistance and marketing advice” to participants.

### **Financing Foreign Trade**

Since their establishment, a major function of Bank-i-Melli, Da Afghanistan Bank, and Pashtany Tejaraty Bank has been export finance. The absence of security and efficient court procedures deterred such lending. Export loans against exports to barter countries were one exception because earnings had to pass through the Da Afghanistan Bank. Import financing was more common, with the banks preferring to extend import loans against letters of credit opened by them. Yet, foreign exchange cost more in the banks than in the money bazaars. Import credit from the money bazaars took the form of loans against *hawalas* or *sanat hindui* (or *banat*).

There were a number of trade agencies in Kabul acting on behalf of suppliers from their own countries. The credit standing of an agency normally permitted it to obtain supplier credit on a 25% down payment, with the balance on receipt, or three months after shipment. The Afghan-International Trade Agency received a guarantee from a Swiss bank that enabled it to import on these same terms. Trade agencies acting on commission insisted upon full payment before imported goods were released to the trader. Trade agencies would not act on commission for the public sector without full payment in advance.

*Source: Maxwell J. Fry, the Afghan Economy 231-34 (1974).*

### **Discussion Questions**

1. What types of legal reforms did bankers seek? Why did they seek these reforms? Which was most important? Why?
2. Do the report of AgBank and the information from the Mortgage and Construction Bank support the need for such legal reforms? If so, how many specific examples can you give? If not, why not?

### **F. Revolution and Civil Turmoil (1973-2001)**

The period of 1973 to 2001 marked the decline of the Afghan judiciary and the beginning of three decades of conflict. The only major commercial law development during this time was the 1977 Civil Code (discussed below). For these reasons, the chapter does not focus as heavily on this time period as it does others.

In 1973, Daoud led a coup with the support of Marxist groups in Afghanistan against the King. He abolished the monarchy and named himself Prime Minister. He ruled via decree with absolute power over the government until he issued a new constitution in 1977. The 1977 Constitution was different from the earlier constitutions. It made explicit mention of the rights of women and diminished the role of Islam. It focused on socialist economic principles. Articles 17 and 18 encouraged government regulation of the economy, and Article 13 nationalized all natural resources of the state. Daoud's other major initiative during this period was his campaign of land redistribution to expand the reach of private property to rural areas. Daoud abolished the Supreme Court but maintained the structure of lower courts, including commercial courts, under the 1967 LJAO. The 1977 Constitution reestablished the Supreme Court but diminished the independence of the Judiciary.

### **The 1974 Customs Law**

The 1974 Customs Law specified import duties, fees, and charges levied on international trade and transactions. It established 25 tariff bands with rates ranging from 7 percent to 150 percent spread across 888 tariff categories. Duty was calculated on the Afghan value of imported goods using an artificially low exchange rate. The Law also covered a number of fees on imports, including a 2.5 percent fee collected by the Chamber of Commerce for the valuation of

imported goods. The Chamber of Commerce, and not the Customs Administration conducted the customs valuation. The 1974 law was superseded by the 2005 Customs Law.

*Source: Maxwell J. Fry, The Afghan Economy (1974).*

Before the Supreme Court was reestablished, Daoud was overthrown in a coup led by communist forces. The Revolutionary Council of the People's Democratic Republic of Afghanistan became the new government, which was led by Nour Muhammad Taraki. The government ruled by decree and administrative regulations issued by the Revolutionary Council. It declared all previous laws and regulations, except the Constitution of 1977, still in force as long as they were in compliance with the aims of the Democratic Republic. Soon thereafter, the government undertook to rewrite many of the existing laws. The powers of the Supreme Court were transferred to the Supreme Judicial Council headed by the Minister of Justice. A Civil Code, which remains in force today, was passed in 1977 and addresses many commercial issues, including contracts. One problem with the code is its use of many Arabic legal terms that are not common in the Dari or Pashto languages and are not defined in the text of the code. The interpretation of the code is, thus, uncertain.

In December 1979, the Soviet Union invaded Afghanistan. The USSR assassinated President Hafezullah Amin and installed Babrak Karmal as the new President of Afghanistan. In 1980, the Revolutionary Council issued a provisional constitution, the Fundamental Principles of the Democratic Republic of Afghanistan.

Law was modeled on Soviet institutions and lawmaking. Local *jirgas* were made responsible for local economic, political, and social administration, but could not act without the approval of the central authorities. Karmal was soon replaced by Dr. Najib Allah to help calm the growing insurgency against the communist government. In January 1987, a new constitution was adopted by the *Loya Jirga*. It instructed the judiciary to make its decisions in accordance with the law but did not specify whether that law was the law of the state or *Shari'a* law.

### Discussion Questions

1. How did Afghanistan's system of commercial law change between 1973 and 1979? Were these changes positive or negative? Why?
2. What was the influence of the Soviet invasion on Afghanistan's legal system?

### A History of State-Owned Enterprises (SOEs) in Afghanistan

The state's active involvement in the Afghan economy dates back to the early attempts to "modernize" the country, under Nadir Shah (1929-33). The typical format for this intervention was for the king to grant a monopoly, known at the time as a *sherkat*, to the enterprise of a favored businessman and for the state to then take a minority shareholding in this enterprise. One of Bank-i-Melli's first investments was in the cotton ginning enterprise located in Kunduz Province. This is one of the very few SOEs that has recently been "privatized" in Afghanistan. A

truly state-planned and guided approach to economic development began under Prime Minister Daoud (1953-63). During this period, a number of wholly state-owned enterprises were set up with foreign loans and technical assistance, producing textiles, cement, sugar and wheat products. This period included the construction of silos in Kabul and Pul-i-Khumri with loans from the USSR.

By the mid-1960s, public-sector industry was experiencing losses and in 1967 a Foreign and Domestic Private Investment Law was initiated to promote private investment and enterprise. Daoud returned to power in 1973, in the role of President, and re-oriented Afghanistan's economy towards the public sector. All banks, including Bank-i-Melli, were nationalised in 1975. As a result, all enterprises in which Bank-i-Melli had a majority shareholding became part of the public sector. After the assumption of power of the communist Peoples' Democratic Party of Afghanistan (PDPA) in 1978 and the Soviet intervention in 1979, state sector industry became the focus of economic development, with Soviet loans and technical help.

By 1982, many national economic projects were carried out in cooperation with the USSR, including searching for and exploiting mineral deposits, developing a gas processing plant at the Khwoja Godertak gas field (now operated by Afghan Gas Enterprise but barely functioning) and a major enterprise to service Kamaz trucks. By 1986, the Kabul government proclaimed that Afghan-Soviet cooperative projects accounted for 75 percent of state industry and 60 percent of the country's production of energy. More than 90,000 experts and skilled workers had been trained in these projects or in the USSR itself. There was a strong focus on the public sector until the Najibullah regime, which from 1986 made some overtures to the private sector in line with its attempts to introduce some measure of liberalization into the economy. In 1987, Najibullah called for private, public and mixed sectors to participate together in economic growth, and hoped that the public sector would not monopolize the economy. In 1991, as the Soviet Union was collapsing, and amid a financial crisis, the government announced plans to privatize some state corporations and to abolish most state monopolies. The end of Soviet military aid and the collapse of the Najibullah regime in 1991-92 overtook these plans.

During the Mujahideen period from 1992 to 1996, the collapse of the central state and in many cases, capital neglect and physical damage, led many SOEs to cease or significantly reduce operations. During the Taliban period, from 1996 to 2001, there was little reconstruction of commercial operations or industry, no banking services, and enterprises continued to be idle or to operate at reduced capacity. The Mujahideen and Taliban periods added significantly to the confusion over ownership of wholly state-owned and mixed ownership enterprises, as the running of many enterprises was taken over by self-appointed "managers." The mixed-ownership Hoechst pharmaceuticals enterprise in Kabul, for example, intermittently produced small amounts of medicines during the Mujahideen and Taliban periods, although the original German investor in this factory (which opened in 1968) had withdrawn all its representatives in 1991. Thus in 2002 the factory, which has now been partially privatized, had a "board of directors" that had been running the enterprise and hence had a strong vested interest, but lacked legitimacy because it had not been appointed by the enterprise's legal owners. Ownership of SOEs was further clouded during the Mujahideen and Taliban periods as an unknown amount of land belonging to SOEs was used for informal settlement or appropriated for other purposes.

The complex history of Afghan state-owned and mixed-ownership enterprises makes it difficult to assess who owns what and therefore who should be compensated when the enterprise is divested. This poses significant problems for privatization. Many enterprises have been through several incarnations in terms of ownership, management and relationship to the state, leaving the door open for numerous claims for compensation in any sale. Compounding these problems is the absence of legal ownership documents in many cases, and inadequate financial reporting showing the activities of SOEs over time. Moreover, there is no accessible public register of share ownership in Afghanistan, which makes it even more difficult to ascertain who owns what in SOEs. It is unclear what, if any, specific provisions there are for dealing with disputes over ownership as part of the privatization process.

*Source: Anna Paterson, James Blewett & Asif Karimi, Putting the Cart Before the Horse? Privatisation and Economic Reform in Afghanistan.*

### Discussion Questions

1. When did state-owned enterprises (SOEs) first become part of the Afghan economy? How did they evolve over time? When were Afghanistan's banks nationalized?
2. Why did SOEs increase in both numbers and size by the 1970s?
3. What happened to most SOEs after the Soviets left Afghanistan in 1989?
4. How does commercial law impact SOEs? Should Afghanistan privatize its SOEs or keep them in state hands? Why?
5. What are some of the obstacles to privatization under Afghanistan's current commercial laws?

The Soviet Union withdrew its troops from Afghanistan by 1989 because of incessant attacks by Mujahideen forces. Najib Allah, however, remained in power until 1992 and issued a new Law on the Organization and Jurisdiction of Courts in 1990. The law had little effect because the Taliban repealed it a few years later. By 1992, Afghanistan was in the throes of a civil war between different Mujahideen factions. An interim government was formed in 1992 and declared the creation of the Islamic State of Afghanistan, even though it controlled little territory outside of Kabul proper. When Burhan al-Din Rabbani seized power later that year, he drafted a new constitution that was never implemented. *Shari'a* was the sole legal basis for resolving disputes; secular laws held no force.

In 1994, the Taliban was created by a group of religious students who had become fed up with the lack of security in southern Afghanistan. Led by Mullah Muhammad Omar, the Taliban quickly took control of major swaths of Afghan territory and, by September 1996, captured Kabul. At the beginning of Taliban rule, the government rooted out corruption and established law and order. Afghanistan became a theocratic state ruled by edict and based on a radical

interpretation of *Shari'a* law. Law was enforced sporadically and unequally. There was little written law and few formal legal processes such as regularized criminal trials.

### **Taliban Changes to the Income Tax Law**

The 1965 income tax law provides for a progressive personal income tax ranging from 4 to 60 percent with a flat 20 percent tax on corporate income. The precise details and contours of the law are difficult to ascertain because the law was amended by at least 18 separate decrees over the past forty years. The Ministry of Finance has struggled to produce a comprehensive consolidated version of the law that reflected all of these amendments. Moreover, the Ministry and its regional offices (*mustufiats*) held different views about the tax provisions and did not apply them consistently. In 1999, a Taliban decree reformed the personal income tax by creating three rates of taxation: 1, 8, and 20 percent along with a series of exemptions. It is unclear if that decree was ever enforced.

The tax law has been criticized for many reasons. First, the law imposed personal income tax on Afghans worldwide wherever they lived. Expatriate Afghan citizens wanting to return to Afghanistan would face a potentially crippling tax liability on income they earned abroad. This provision of the law, thus, creates a disincentive for Afghans to return home and contribute to the nation's economic growth. The top marginal rate for personal income (60 percent) was criticized as high by international standards. High rates hamper voluntary compliance with the tax law and encourage tax fraud. Lastly, the tax rate structure was too complex and difficult to administer because it consisted of 32 different rates.

*Source: Adam Bennett et al., Reconstructing Afghanistan.*

### **Discussion Questions**

1. What is the 1965 Tax Law? How did it change in the 1990s?
2. Why has the law been criticized? Do you agree with those criticisms? Why or why not?

Prompted by the September 11, 2001, terrorist attacks on the United States, international military forces invaded Afghanistan and defeated the Taliban. To begin the reconstitution of the legal system, leaders of Afghanistan and the international community met in Bonn, Germany, in November 2001. On December 5, 2001, the Bonn Agreement for the Transitional Administration of Afghanistan was concluded. It laid out the process through which Afghanistan would form a new government and write a constitution. As part of the agreement Hamid Karzai was named interim President of Afghanistan and officially elected President in 2004. The Bonn Agreement also called for the convening of the *Loya Jirga* and the writing of a new constitution. In 2004, the *Loya Jirga* approved the Constitution, which remains in force at present. The current commercial law and legal institutions in Afghanistan are discussed at length in the next chapter.

By 2001, there was no functioning banking sector in Afghanistan. The 1994 Law on Money and Banking controlled Afghanistan's banking sector until it was replaced with new

banking laws in 2003. Although six commercial banks retained their licenses, no loans had been made since 1995. The banking system was nationalized during the communist and Soviet era (1973-1989) and suffered further during subsequent civil strife. The government interfered with bank management, directed lending, and administered interest rates. During the Taliban era, banks were prohibited from charging interest on their loans or paying interest on deposits. Da Afghanistan Bank had been transformed into a Soviet-style dirigiste institution that interfered in the allocation of credit and setting of interest rates. It had ceased to function as a traditional central bank. It was serving primarily as cashier to the Ministry of Finance and issuing banknotes. The government struggled to pay the wages of civil servants, invest in infrastructure, collect taxes and customs duties, and effectively utilize donor assistance because its financial system had collapsed.

### **The 1994 Law on Money and Banking**

The 1994 Law on Money and Banking was both a law of a central bank and a more general banking law. It was in force from 1994 through September of 2003, when it was replaced by Afghanistan's current banking laws. The law was poorly drafted, overly ambiguous, and contradictory. Part I of the law defined the legal tender of Afghanistan, the Afghani, and the minimum reserves that Da Afghanistan must hold in reserve against banknotes it had issued. Part II of the law covered the objectives Da Afghanistan Bank: its responsibilities, powers, and organization. It states that the Bank is responsible for implementation of the government's monetary and credit policy as well as maintenance of the value of the Afghani to facilitate banking and commercial transactions. The Bank was empowered to supervise the activities of other banks and credit institutions and regulate and carry out foreign exchange transactions. The final section of Part II detailed the composition of the Bank's organs, including the Supreme Council, the Monetary and Credit Committee, the Executive Board, the Board of Supervisors, and the Banknote Reserves Supervision Board. The highest organ was the Supreme Council, comprised of eight ministers, including the Prime Minister, and the Governor of Da Afghanistan Bank. Part III of the law related to private banking and the requirements for establishing a bank.

*Source: Adam Bennett et al., Reconstructing Afghanistan.*

### **Discussion Questions**

1. What was the purpose of the 1994 Law on Money and Banking?
2. How many sections did it have? What did each section of the law cover?

### **Six Licensed Banks in Afghanistan**

1. **Bank-i-Melli** was established in 1933 and is the oldest and largest commercial bank in Afghanistan. The Bank expanded aggressively both domestically and internationally during its first 40 years of operation. It was nationalized in 1974 and since then has been fully owned and managed by Da Afghanistan Bank. It effectively ceased financial intermediation in 1992.

2. The **Pashtany Tejaraty Bank** was created in 1955 to provide financial services to the growing trade business community. The Bank was owned primarily by the Afghan Government (Da Afghanistan Bank and the Ministry of Commerce), but had a Board of Directors with an even number of sector and public sector members. The Bank performed well until its nationalization in 1974. By the early 1990s, its operations had shrunk to receiving payments for certain government utilities and small-value deposits.
3. The **Agricultural Development Bank [AgBank]** was established in 1954 to provide financial services to small farmers and handicraft producers. After an unsuccessful start, the Bank was reorganized and renamed in 1969. The restructured bank refocused its efforts on financing the agricultural supply chain from producers to processing and export. The Bank essentially became inoperative in the post-Soviet era.
4. The **Export Promotion Bank** was established in 1976 by the Ministry of Finance, the Chamber of Commerce, and local producer cooperatives. It primarily financed letters of credit. The Bank survived into the Taliban period when its activities were suspended.
5. The **Industrial Development Bank of Afghanistan** was founded in 1973 as a private financial institution with domestic shareholders and international investors. The Bank provided short and long term secured and unsecured loans to the private sector, state-owned enterprises, and joint private-government enterprises. Most projects financed were for the production of carpets, shoes, medical products, and textiles in Kabul. The Bank was nationalized in 1977 and halted activities during Taliban rule.
6. The **Mortgage and Construction Bank** was established in 1948 to finance residential and commercial construction. It was nationalized in 1974 and extended its last loan in 1995. As of 2003, its main activities were collecting rents on repossessed buildings and on some loans.

*Source: Adam Bennett et al., Reconstructing Afghanistan.*

## V. CONCLUSION

The history of commercial law in Afghanistan is a rich and complex subject. Commerce and trade have played a central role in the history of the country from the pre-Durrani period through the present. Afghanistan's modern commercial law system, especially its commercial courts, can be traced back to Amir Abd al-Rahman Khan. He consolidated the Afghan state and laid the groundwork for Aman-Allah Khan's reforms, including the country's first Constitution. Nadir Shah, Daoud, and their successors all shaped Afghanistan's commercial law system by restructuring the commercial courts, enacting new commercial legislation, and re-focusing the state's economic policy. The birth, growth, and subsequent decline of Afghanistan's financial sector illustrate the challenges that Afghanistan's commercial law system faced in the twentieth century and continues to face today.

Many of the most important themes from this chapter continue to ring true in Afghanistan today. As you read the next chapter, keep in mind how previous Afghan leaders managed challenges, such as lack of physical security, regional tensions, rivalry between *Shari'a* and secular law, changes in trade routes, etc. Afghanistan's current commercial law system continues to face many of the same challenges and will only succeed in promoting economic growth if it takes into account what has worked in the past and what has not.

## Glossary

### ***Ad-Valorem Tax***

A tax that is specified as a percentage of value. Sales, income, and property taxes are three of the more popular ad valorem taxes devised by governments.

### ***Credit***

The promise of future payment in exchange for money, goods, services, or anything else of value. Car loans, mortgages, credit cards, corporate bonds, commercial paper, and government securities are all forms of credit.

### ***Customs Duties***

Taxes levied on goods entering or leaving a country.

### ***Fixed Exchange Rate***

An exchange rate established at a given level and maintained through government (usually central bank) actions. To fix the exchange rate, a government must be willing to buy and sell currency in the foreign exchange market in whatever amounts are necessary.

### ***Foreign Exchange***

Any financial instrument that gives one country a claim on the currency of another country and which is used to make payments between countries. The most important type of foreign exchange is currency itself, that is, the currency of other countries.

### ***Joint-Stock Company***

A type of business entity: it is a type of corporation or partnership involving two or more legal persons. Certificates of ownership (or stocks) are issued by the company in return for each financial contribution, and the shareholders are free to transfer their ownership interest at any time by selling their stockholding to others. A joint-stock company offers the protection of limited liability; a shareholder is not liable for any of the company's debt beyond the face value of their shareholding.

### ***Monopoly***

A market structure characterized by a single seller of a unique product with no close substitutes.

### ***Mortgage***

A mortgage is the transfer of an interest in property (or the equivalent in law—a charge) to a lender as a security for a debt—usually a loan of money. While a mortgage in itself is not a debt, it is the lender's security for a debt. It is a transfer of an interest in land (or the equivalent) from the owner to the mortgage lender, on the condition that this interest will be returned to the owner when the terms of the mortgage have been satisfied or performed.

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## CHAPTER 3: COMMERCIAL LAW IN PRESENT-DAY AFGHANISTAN

### I. INTRODUCTION

Since 2001 and the fall of the Taliban, Afghanistan has struggled to rebuild its economy and its legal system. The 2004 Constitution highlights the importance of economic growth to Afghanistan's future. Article 10 states that the Government "shall encourage, protect as well as ensure the safety of capital investment and private enterprises in accordance with the provisions of the law and market economy." This provision is one of many that illustrate the importance of commerce and commercial law for present-day Afghanistan.

After reviewing the links between commercial law and economic growth and exploring the history of commercial law in Afghanistan, we are now ready to turn to the focus of this textbook: commercial law in present-day Afghanistan. The knowledge you gained from reading Chapters 1 and 2 will prove extremely helpful as we navigate the complexities of Afghanistan's existing commercial law system. This Chapter will strive both to describe Afghanistan's system of commercial law as it is supposed to function and how it actually does in practice. By the end of this chapter you will have a better understanding of how commercial law in Afghanistan actually works and how this differs from the way the system has been designed to work.

Afghanistan is a state defined by legal pluralism. As such, this Chapter will begin by reviewing the multiple sources of commercial law in Afghanistan. It will focus on legal codes currently in force and the institutions that constitute the formal state system, such as the government ministries and commercial courts. It will also discuss sources of commercial law outside of the formal system or on its fringes. *Shari'a* law, *jirgas*, and *shuras* all have played a central role in Afghanistan's legal development and continue to greatly influence commercial law. *Hawala* banking and informal credit are two additional institutions that merit close attention in this chapter.

### II. LEGAL PLURALISM AND THE SOURCES OF COMMERCIAL LAW IN AFGHANISTAN

Legal pluralism refers to situations in which there is more than one source of law in a country. Afghanistan is a society defined by legal pluralism because it has several sources of law, including commercial law. In addition to formal written law, such as the commercial code, Afghanistan also has informal (customary) and religious *Shari'a* law.

Any discussion of Afghanistan's commercial legal system would be incomplete without addressing the role played by these informal institutions, such as *shuras* and *jirgas*. These informal institutions are based upon local custom, tradition, and religious practices and have existed in Afghanistan for centuries. *Shuras* are local councils, either religious or secular, that are typically convened on an ad hoc basis to resolve disputes, or decide issues of community governance or resource management. The three principal types are: *shuras* of the *Ulema* (Islamic scholars), *shuras* of elders, and *shuras* of local commanders. *Jirgas* are similar to *shuras* and more prevalent among Pashtun tribes. A *jirga* refers to a gathering of elders or leaders who sit in

a large circle to resolve a dispute or make collective decisions about an issue of community-wide importance. These informal institutions do not enforce the civil or criminal laws of Afghanistan, but rather Islamic *Shari'a* law, customary tribal law, or the collective wisdom of elders.

Too often, “informal” is interpreted as “unsophisticated.” And while it may be true that local justice systems rely on oral tradition rather than written rules, the local processes are, in fact, highly sophisticated. This sophistication is visible in both the decision-making processes of local systems, as well as the structures of those systems. In a typical *jirga*, for example, decisions are made in accordance with well-developed understandings of morality and justice (such as *Pashtunwali*). In some cases, there is even an established system for appealing *jirga* decisions to a higher group of elders. Thus, Afghanistan’s local adjudicatory systems share many of the “formalities” of codified legal systems and can rightly be viewed as institutions applying customary law. And while legal scholars may disagree as to the outcomes reached by the local adjudicatory systems—one major criticism is the manner in which women are treated by customary law—the dismissal of the local systems as primitive and crude is both inaccurate and unhelpful; it is this type of law that still governs the daily lives of most Afghans today, especially in areas outside the major cities.

These practices still flourish today, and are important sources for the settling of commercial disputes. In areas where the Primary Court has very many cases and not enough judges, these alternative processes can help speed along the resolution of disputes so that people can move forward. Further, in some towns the Primary Court is not yet operating, so alternative processes are the only way that individuals can settle disputes at all. Many citizens of Afghanistan, especially in rural areas, turn to *shuras* or *jirgas* to resolve disputes because they are considered more fair, efficient, accessible, and cognizant of local values than the state system. Corruption, lack of accessibility, and slow response are three common complaints about the formal justice system. Finally, these alternative processes are community-based and can help solve disputes in a cooperative manner where at the end individuals are ready to accept the decision and the two disputants can live peacefully together. These are some of the many benefits of the informal system in Afghanistan.

This textbook, however, does not focus on these informal institutions and commercial law. It may be unclear why that is because if this system works well, why is the formal, state-based legal system so important? The goal of this textbook is to inform you, citizens and future leaders of Afghanistan, of the current formal commercial legal institutions in Afghanistan and how they work. This will be important when you start a business or practice as a lawyer because you will be operating within the formal legal system every day. It is important to know how to use the formal legal system because it is the basis on which the State of Afghanistan is founded. There are unique benefits to this formal system, which will be discussed later in this chapter and throughout the remainder of the textbook. Further, there are some drawbacks to the informal system. Informal institutions lack the procedural safeguards, uniformity, and oversight present in traditional courts, and they sometimes suffer from a lack of transparency.

Still, as an ethical lawyer or businessman, it is important to be mindful of these alternative systems for two reasons. First, a lawyer must always keep in mind every method of settling a dispute for his or her client. Sometimes, it may be that the best way to settle a dispute is

through one of these informal methods because it is less costly or will be better accepted by the other party to the dispute. Second, it is important to know about these other dispute resolution systems simply because of their prevalence, as discussed above. This text encourages you to think about these alternative dispute resolution systems as you know them and weigh their effectiveness and desirability against that of the formal institutions you study.

### Discussion Questions

1. What is legal pluralism? Why is it an important trait of Afghanistan's legal system? What are the different sources of law in Afghanistan?
2. What is a *jirga*? What is a *shura*? Why do citizens choose to settle their disputes before a *jirga* or *shura* as opposed to the formal court system?
3. What are the potential advantages of the formal court system? What are the potential advantages of the informal system?
4. If you were party to a commercial dispute where would you go to settle it?

### Formal v. Informal Systems

Imagine a situation in which three people move from the provinces to Kabul. One is from Lashkar Gah, one from Torghundi, and one from Mazar-i-Sharif. While in Kabul, they pool their money to start a small business. Two weeks later, one person takes all of the business's property and moves the business to his home-town without the others' permission. Assuming that local adjudicatory systems in Lashkar Gah, Torghundi, and Mazar-i-Sharif resolve commercial disputes differently, and there is not yet an accepted standard of punishment in Kabul, how should the individual be treated? In a system of local adjudicatory bodies applying customary law, this is a difficult question to answer. The authority of a local system rarely extends beyond its territory, so it is difficult to determine which law applies.

Now consider how this would impact commerce. A businessman from Herat is less likely to trade with a merchant from Khost if he is not confident that a local *shura* in Khost would rule fairly if he were to experience a commercial dispute. The same is probably true for a businessman from Khost interested in investing in Herat. The businessman from the other region will likely believe that the local *shura* will protect the interests of the local person even if the facts of the dispute favor the outsider. The lack of confidence in local customary justice would inhibit commerce and trade.

In a system of codified law, there is no question as to which law applies—people can rely on the published commercial code. This can be important in cases when a person is unsure if a particular act is considered illegal. With a published commercial code, such a person can find an answer without having to convene a *jirga* or consult an expert. In other words, the law becomes both easily accessible and standardized, which are important advantages for those making business, family, or personal decisions that may involve commercial law questions.

Finally, codification of laws—including commercial law—can be an important aid in attracting foreign investment, as well as simplifying international relations. Potential investors and foreign governments can rely on published laws when making investment decisions, thereby avoiding the expense of consulting experts in the local systems.

### Discussion Questions

1. Why are informal institutions so prevalent in Afghanistan? Does their existence strengthen or weaken Afghanistan's legal system?
2. If you were involved in a commercial dispute, would you seek a remedy from informal institutions? What are the advantages of using local custom instead of codified law as the basis for resolving commercial disputes? What are the drawbacks?
3. What is the best way to ensure uniformity of results within informal institutions? Should informal institutions be supervised by government authorities? How would such a system work?

Despite protections offered by international law, the 2004 Constitution, *Shari'a*, and various provisions of the criminal statutes of Afghanistan, many local systems still deprive women of equal protection under the law. The systematic abuse women suffer as a result of customary law is perhaps the strongest reason to favor the courts. Another argument in favor of the state system is that as Afghanistan continues to develop, travel will become easier and people will become more mobile. This will inevitably lead to differences between local systems becoming more apparent as the population shifts. In this scenario, regional and/or national standardization of law and procedure will be increasingly important as the lines between local systems become blurred.

Perhaps the greatest challenge for the legal system as a whole will be addressing this dilemma in a way that satisfies the concerns of both the state and local systems. One possible solution discussed earlier would be to adopt principles of the alternative system, such as mediation and collaboration, into the state system. Another possible solution is to “formalize” the local systems by explicitly recognizing them through statute, reforming their treatment of women, and giving them competency to deal with certain issues. Many other methods of integrating the two systems have been proposed, but despite all the proposals, little progress has been made towards integration. The continuing existence of two separate justice systems—three, if one considers *Shari'a* courts as separate from the state courts—is an ongoing problem, and one that is unlikely to be resolved without a serious commitment from all stakeholders. Overall, the divisions between the different systems are causing the judicial system in Afghanistan to be adrift. This argues for limits on legal pluralism because the different, competing dispute resolution mechanisms in Afghanistan have combined to mean that there are really very few options for effective dispute resolution, the opposite result that would be expected where there is more than one choice of method. It is certainly possible for these systems to exist together in a

harmonious system of dispute resolution, drawing on the strengths of each, but thus far no such solution has been found.

### **III. THE FORMAL COMMERCIAL LAW SYSTEM**

As Chapter 2 discussed, Afghanistan has derived its commercial law from multiple sources. Each source has been created or adopted during a certain period of Afghanistan's history to solve whatever problems were apparent at the time. There have frequently been local, tribal and national customs that speak to the formation and fulfillment of agreements between people; Islamic legal texts also provide guidance on a variety of commercial interactions between people that have often been applied to contracts; and statutes put in place under previous governments in Afghanistan provide legal rules.

Despite the rich interplay between traditional and modern sources of commercial law, both the 2004 Constitution and the Civil Code of 1977 place clear limitations on the issues that should be addressed directly through Islamic jurisprudence. Article 130 of the 2004 Constitution states that when the Constitution or other laws fail to provide guidance on a legal issue, then *Hanafi* jurisprudence (one of the four Sunni Islamic legal schools of thought) may be applied. Article 131 also allows for the use of a *Shi'a* version of Islamic jurisprudence (generally implying the *Ja'fari* school of jurisprudence) when the legal issue deals with "personal matters of followers of the *Shi'a* sect." This hierarchy of authority as articulated in the 2004 Constitution also finds support in statutes enacted prior to the Constitution.

#### **A. The Constitution**

On January 4, 2004, a constitutional *Loya Jirga* approved Afghanistan's current Constitution. The 2004 Constitution is the supreme law of the Islamic Republic of Afghanistan; all laws contrary to its provisions are invalid. It codifies Afghanistan's tripartite system of government and specifies the powers of the Presidency, National Assembly, and Judiciary, as well as those of the provincial administrations and the *Loya Jirga* itself. The Constitution also enumerates a wide array of fundamental rights guaranteed to all citizens of Afghanistan, including the right to own property. It provides the overall structure for Afghanistan's system of commercial law. Articles 10-13 address Afghanistan's market economy and are directly relevant to any study of commercial law. Please review those articles in your document supplement.

#### **B. Statutory Law**

Under Article 94 of the Constitution, statutory law is law passed by both houses of the National Assembly and signed by the President. It is the controlling law of Afghanistan. Article 3 of the Constitution stipulates that "[n]o law shall contravene the tenets and provisions of the holy religion of Islam." Any law passed by the National Assembly after October 2005 (when it was elected) is the binding law of Afghanistan until it is repealed by another vote of the National Assembly or until the time for which it was enacted expires.

Determining which statutory law is actually in effect in Afghanistan is more complicated, however. Afghanistan retains many codes and statutes from the 1950s, 1960s, and 1970s that are

arguably still in force under the Bonn Agreement (signed in December 2001). The Bonn Agreement provided for Afghanistan's provisional government structure and stated that all previous laws remain valid unless inconsistent with the Agreement itself, international legal obligations, or Afghanistan's Constitution. Edicts from the Taliban era were certainly not consistent with the agreement or international law, but it is unclear whether other laws from the communist and civil war periods are valid or invalid. As Afghanistan's National Assembly begins to pass new laws to update or supersede old ones, a clearer picture of statutory law will emerge.

There are several key commercial statutes and codes that you will be exposed to in great detail throughout this textbook. Together, they provide the framework for Afghanistan's commercial law system. Below is a brief description of the laws.

### Commercial Code of 1955

The Law of Commerce or Commercial Code of Afghanistan was passed under Daoud and remains in force over fifty years later. It contains more than 900 hundred articles and was designed to apply to all commercial transactions. Certain sections of Code have been repealed and superseded by more specialized statutes. For example, the new Corporations and Limited Liability Companies Law and the Partnership Law both explicitly render void the portions of the Commercial Code that deal with these topics. The most relevant portions of the Code are contained in your document supplement.

### Civil Code of 1977

The Civil Code of 1977 addresses a handful of commercial issues, particularly contracts. Chapter Two of the Code covers "Legal Transactions" and is the primary source of Afghan contract law. The Civil Code suffers many shortcomings in the commercial sphere. Its approach to contracts institutionalizes risk by making it very difficult to enforce contractual promises. A new Law on Contracts was drafted in 2003-04 but has not yet been approved by Parliament or signed by the President. The new law seeks to provide clear definitions of key terms, clarify the validity of contracts, ensure their just enforcement, and specify rules for contract interpretation. Another problem of the code is that it uses many Arabic legal terms that are not common in the Dari or Pashto languages and are not defined in the text of the code. Therefore, the interpretation of the code is uncertain.

### **Discussion Questions**

1. How does the 2004 Constitution relate to Afghanistan's system of commercial law?
2. What are some of Afghanistan's major commercial laws? Why are they important?

### Procedural Codes

Courts of law in Afghanistan, as in other civil law systems, operate according to a set of rules and regulations that are set forth in a code. In Afghanistan, the 1990 Code of Civil

Procedure provides an extensive set of formal rules that must be followed throughout the course of litigation. Like most countries, Afghanistan has adopted separate rules and procedures to govern the criminal and civil judicial systems. It governs all phases of the legal process, from how to bring a case to court and how to file court documents, to whether the court has the authority to consider a particular case, to the procedure for filing an appeal. The Code of Civil Procedure also attempts to put limitations on the legitimacy of customary dispute resolution through the *shuras*. According to Article 490, “the decisions and rulings of non-judicial gatherings in civil matters and public rights are not valid.” In practice, however, the *Huqooq* and the courts accept and confirm *shura* decisions on a regular basis.

The Code of Civil Procedure also reinforces the Code of Commercial Procedure, which specifically governs the commercial courts and sets forth an essentially common-law style of adjudication. Instead of a multiple hearing system common under civil law jurisdictions in which the judge drives the case and is responsible for establishing material truth, the two procedure codes set up a more restricted role for the judge within limited hearings and a single-event trial. The Code of Civil Procedure expressly states that “the court is a venue and not a proving party” (Article 500). Finally, the Code of Civil Procedure identifies the sources of law that should be used to settle claims

The Code of Commercial Procedure of 1965 regulates proceedings in the commercial *dewan*. That Code establishes a limited series of pleadings by which parties can set forth and refine their claims and defenses. After making pleadings and entering evidence, the judge is to hold a hearing and set a trial date. According to the provisions of the law, most cases should take no more than six months, absent legitimate, approved delays. Yet, in practice, most claims last years in commercial court. Once a judicial opinion is issued, additional delays are normal because of ineffective enforcement proceedings. Commercial procedures lack a system of scale. Claimants are not required to have counsel, so very few do. In larger, more complex cases, the lack of legal professionals undermines the quality of legal adjudication. There is no initial fee required for filing a lawsuit. Fees are awarded upon judgment as a percentage of the award, and are levied against the losing party. The size of the fee (eleven percent of the award for a successful plaintiff; one percent of the claim for an unsuccessful plaintiff) has no relationship to the costs or quantity of the judicial services rendered.

### **Discussion Questions**

1. What is the purpose of a procedure code?
2. What codes control proceedings in Afghan commercial courts?
3. What are some of the strengths of these codes? What about their weaknesses?

### *Other Commercial Laws*

The 1955 Commercial Code (Articles 116-470) governed Afghan contract law until very recently. On January 28, 2007, President Karzai signed a new Company Law during Parliament’s recess. The Law has since been presented to, but not approved by Parliament. The new Company

Law is, thus, in effect by executive decree but may be amended by the Parliament. The Law removes company law issues from the Commercial Code and divides them into two new statutes: the Corporations and Limited Liability Companies Law and the Partnership Law.

Afghanistan recently passed laws on mediation and arbitration in 2007. The Arbitration Law melds international practices with local tradition. It specifies that each party may appoint an arbiter, and those two arbiters then jointly elect a third arbiter. The three arbiters comprise the arbitral tribunal. Only the third-party arbiter (the one chosen by the two party-appointed arbiters) is neutral. Awards are made by majority vote of the tribunal's three members. An award made by the arbitral tribunal is enforceable in court if the losing party does not comply. There are few ways to appeal an arbitral ruling because the purpose of arbitration is reaching finality in a quick and efficient manner outside of the court system. Appeals are limited to flaws in procedure (e.g. the arbiters failed to follow certain rules), not flaws in substance (e.g. the arbiters made the wrong decision based on the facts) (Articles 9.4, 10.2).

The Law on Commercial Mediation defines mediation as a process "whereby the Parties request a third person or person (the "Mediator") to assist them in their attempt to reach an amicable settlement of their dispute" (Article 4). The Law sets forth a framework by which parties can voluntarily seek to resolve disputes through outside assistance without concern that their discussions will be used against them should they eventually end up in litigation or arbitration (Articles 21, 34). The voluntary nature of mediation is what distinguishes the procedures from arbitration and litigation, where the third party imposes an enforceable solution to the dispute. Should the parties come to an agreement with the help of mediation, they can then elect to make the agreement enforceable as part of the contract (Article 37). Mediation is an important tool for helping parties overcome conflicts without resorting to litigation or arbitration.

### **Discussion Questions**

1. What laws comprise Afghanistan's system of commercial law?
2. What is arbitration? What law governs arbitration in Afghanistan? How are arbitral decisions made? Are they enforceable in court? What are the advantages of arbitration?
3. What is mediation? What law governs mediation in Afghanistan? How is mediation different from arbitration? What are the advantages of mediation?

The Law on Private Investment in Afghanistan was passed in 2005 to: maximize private investment, both domestic and foreign, in the economy; create a legal regime and administrative structure that will encourage and protect foreign and domestic private, and; promote economic development, expand the labor market, increase production and export earnings, promote technology transfer, improve national prosperity, and advance the people's standard of living (Article 2). It grants fewer incentives to investors than previous investment laws, but it clearly specifies the responsibilities of all parties (including the government) in the event of a dispute. The Law provides for the creation of a High Commission on Investment (HCI) and charters the Afghan Investment Support Agency (AISA). The HCI is comprised of the Minister of Finance, Minister of Foreign Affairs, Minister of Economy, Minister of Mines and Industries, Minister of

Agriculture, Animal Husbandry & Food, President of Da Afghanistan Bank, and two non-voting representatives from the private sector. The Commission is chaired by the Minister of Commerce. The AISA carries out the administrative functions of the HCI.

### **Law on Private Investment in Afghanistan**

#### **Article 8: Responsibilities of the Commission**

- (a) At its first meeting, the Commission shall adopt, by majority vote, bylaws establishing procedures for conducting its meetings and for making and recording decisions.
- (b) The Commission shall monitor the state of Investment in the country and shall propose any modifications to this Law that it deems advisable.
- (c) The Commission shall establish the Office (AISA) for carrying out its administrative duties.
- (d) The Commission shall have authority to issue rules for the implementation of this Law and may instruct the Office to draft such rules for review and promulgation by the Commission. These rules may include, if necessary, provisions designed to create additional incentives for Investment in particular economic sectors or regions of Afghanistan whose development is of particular importance. Notwithstanding the foregoing, the Commission may not provide more attractive fiscal incentives than those provided here without the consent of the Ministry of Finance.
- (e) The Commission shall initially establish a threshold value (the “Threshold Value”). The Commission shall have the sole authority, after receiving advice from the Office, to recognize Registered Enterprises where Investment is reasonably expected to be greater than or equal to the Threshold Value. The Office shall have the authority to recognize Registered Enterprises where Investment is reasonably expected to be less than the Threshold Value, subject to Article 5 above. The Commission may, at its option, set up a procedure to hear appeals from decisions by the Office not to recognize a Registered Enterprise.
- (f) The Commission shall have the sole authority to recognize Registered Enterprises in all other cases where, according to this Law, decisions to approve must be made by the Commission.

### **Discussion Questions**

1. How is private investment regulated in Afghanistan?
2. What does the Law on Private investment in Afghanistan say?
3. What is the High Commission on Investment (HCI)? What are its powers?

The Law of Da Afghanistan Bank Law and Law of Banking in Afghanistan were both passed in 2003. The Law of Da Afghanistan Bank defines the role of Afghanistan’s central bank

and empowers it to supervise and regulate the banking system without undue Government influence. The Law of Banking in Afghanistan defines a bank as an entity engaged in the business of accepting deposits or other repayable funds from the public and using such funds either for extending loans or for making investments for its own account. The Banking Law establishes a two-stage process for receiving a banking license. The Law reflects international best practices by requiring sound corporate management, prudent risk management, and transparent accounting.

### **C. The Executive Branch**

The President is the head of state and the executive of government. He represents Afghanistan to the world and governs at home. First and second Vice Presidents aid the President in the fulfillment of his duties. The President, among other duties, is responsible for commanding the armed forces of Afghanistan, convening the *Loya Jirga*, and appointing members of the Supreme Court as well as Ministers. The President often acts as the policy-making body in Afghanistan, suggesting laws and reforms; although laws must be passed by the National Assembly to be binding. The President is charged with, and must abide by, the limitations of the Constitution.

The executive branch is comprised of ministries each responsible for a different substantive portfolio. Each Ministry is led by a Minister, nominated by the President and confirmed by the *Wolesi Jirga*. There are currently twenty-five different ministries in the executive branch, each of which is charged with carrying out laws passed by the National Assembly in its respective area of responsibility, and drafting regulations to implement such laws. The most important ministries for the purposes of this book are: the Ministry of Justice, Ministry of Finance, Ministry of the Economy, and Ministry of Commerce. These ministries are important because they are responsible for the day-to-day operations of the Afghan Government.

#### *Ministry of Justice*

The Ministry of Justice (MOJ) is the executive branch institution responsible for upholding the rule of law in Afghanistan. It is responsible for much of the government's judicial affairs and has a broad mandate that includes drafting, publishing, and distributing legislative documents, promoting legal awareness, protecting state properties through the court system, and managing the prisons, detention centers, and juvenile rehabilitation centers throughout the country. Excluding corrections staff, as of May 2007 the MOJ had roughly 1,300 employees, with approximately 375 in Kabul. Over eighty percent of the MOJ's personnel have undergraduate diplomas, and thirteen percent have higher education or graduate degrees.

One of the most important functions performed by the MOJ is in the *Taqnin* division, which drafts laws to be considered and passed by the legislature. Further, before a law may be considered by the National Assembly, the *Taqnin* division must review the text of the draft law to make sure it conforms with the principles of the Constitution and *Shari'a*, and does not contradict existing statutory law. This function is fundamental to lawmaking because it ensures that the laws that are considered by the National Assembly have been thoroughly researched and determined to be in accordance with Afghanistan's system of government.

Another important division in the Ministry of Justice is the *Huqooq*, or rights division. The *Huqooq* is an executive agency with power over the intake and enforcement of judicial matters. It promotes alternative dispute resolution and provides basic legal services to the population. The *Huqooq* was established under the Ministry of Justice to receive and review complaints of a judicial nature. Although it is technically optional (e.g. not mandatory) to submit a complaint through the *Huqooq* (Article 12 of the Code of Civil Procedure), in practice, all complaints go through the *Huqooq* before being sent onward to courts. There are *Huqooq* offices in 357 of Afghanistan's 365 districts, with a total staff of 950. *Huqooq* officials review complaints, help complainants fill out forms or write up their requests, and determine what court, if any, should handle the case. They frequently summon the defendants to discuss the case, and often require the parties to take their disputes to a *shura* or otherwise mediate them outside of court. If the cases cannot be settled through alternative means, or if they otherwise determine that the cases should go to court, *Huqooq* officials will then assign the claims to a court and send them forward. In Kabul, the *Huqooq* has actually performed very little commercial enforcement, and has yet to seize movable property, although such functions are foreseen. This is not altogether surprising: nationwide, approximately five percent of all cases are commercial in nature. There is not yet much demand for judicial involvement in commercial conflicts.

### Discussion Questions

1. What are the responsibilities of the Ministry of Justice?
2. What are two of the most important departments of the Ministry? What are their roles? Why are those roles important?
3. What role does the Ministry of Justice play in Afghanistan's system of commercial law?
4. Which do you think is more important: the *Huqooq* or the *Taqnin*? Why?

### Ministry of Commerce and Industry (MOCI)

The Ministry of Commerce and Industry (MOCI) is the lead private sector policy-making agency in Afghanistan. It is developing a coherent private sector development policy framework and will select the most appropriate policy instruments (e.g. legislative and regulatory reform, institutional strengthening and procedural reform, financial incentives, and public education) to achieve its strategic objectives. It strives to create an environment that enables business. It, thus, plays a central role in crafting commercial legislation and regulation that complies with international standards, implemented by institutions with the capacity to apply laws and regulations fairly and transparently and committed to minimizing compliance costs.

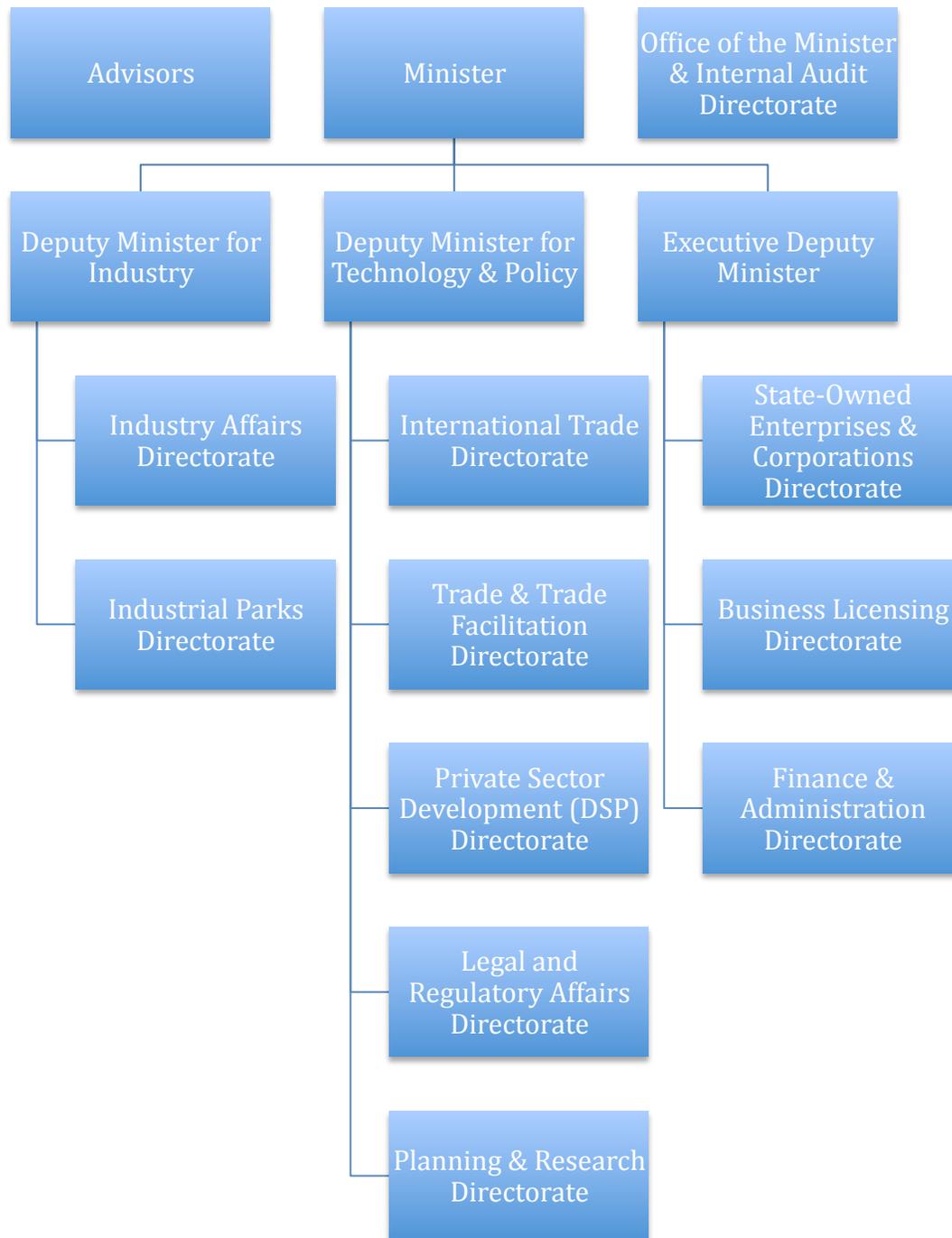
The MOCI serves as the focal point for the Commercial Law Working Group Project to develop an updated and sustainable Commercial Code for Afghanistan based on its existing Commercial Code of 1955. Under this project, the MOCI has drafted the following measures for submission to the Ministry of Justice: Private Investment Law, Arbitration Law, Mediation Law,

Partnership Law, Corporation Law, Contract Law, Copyright, Trademark, and Patent Laws, Agency Law, and Standards Law.

The MOCI provides input on all legislative matters related to the business environment including customs, mortgage, insurance, leasing legislation, and accounting standards. Additionally, as the lead Ministry for World Trade Organization (WTO) accession, the Ministry works to ensure that new commercial or trade legislation is compliant with WTO regulations. Over the past three years, the commercial legislative process has faced serious challenges including a lack of capacity in the relevant Ministries (such as the Ministry of Justice), a lack of cohesive government strategies and policies, and difficulties in coordination among donors and the international community in regards to legal reform. Thus, the initiatives currently being completed at the MOCI represent only the beginning of a new effort to facilitate the adoption and implementation of commercial laws. This is priority for the MOCI.

The MOCI is a principal “facilitator” that enables new trading companies to register with the commercial court. It shares this function with the AISA. The MOCI arranges the registration of trading companies, issues investment licenses, and maintains a database of the companies it has helped to register.

### Ministry of Commerce and Industry: Organizational Chart



### **Discussion Questions**

1. What is the Ministry of Commerce and Industry (MOCI)? What are its responsibilities?
2. How does it influence commercial law in Afghanistan?
3. What role does it play regarding business registration?

### *Ministry of Finance*

The Ministry of Finance (MOF) is responsible for the management and execution of the budget, collection of taxes, organization and control of public expenditures, and payments to the government, as well as the management of Afghanistan's customs regime. It is also responsible for public finance and expenditure and coordination and management of international financial assistance to Afghanistan.

The Afghanistan Customs Department (ACD) is responsible for the collection of customs revenues and enforcing the provisions of the 2005 Customs Law. ACD is the lead border agency that provides fifty-three percent of Afghanistan's self-generated revenues. The Ministry of Finance recently released revised total domestic revenue totals for the period of March-June 2005. The total from all sources was \$77.16 million, a forty percent increase from the same period in 2004. Of the \$77.16 million, Customs collections represent fifty-three percent of the total figure, with \$41.45 million collected within the initial three-month period. These figures constitute a trend of reduced reliance on customs duties as the primary source for national revenues.

### **Customs Law of 2005: Major Functions of the ACD**

- Determining the value of goods and collecting the related Customs revenue
- Supervising, detecting, reporting and preventing smuggling
- Detecting and evaluating violations of the Customs law
- Participating in preparing and signing international agreements and conventions in Customs matters, in accordance with Customs legislation
- Preparing, collecting and, upon agreement of the Minister of Finance, distributing foreign trade statistical data to the Ministry of Commerce and other public institutions
- Supervising Customs goods, throughout the entire Customs territory of Afghanistan
- Exercising Customs control over Customs areas
- Maintaining Customs records
- Carrying out all other activities determined in Customs legislation

To perform these duties, ACD employs approximately 1,597 civilian customs officers. The ACD is headquartered in Kabul, and it operates fourteen official border crossings and eighteen provincial Customs Houses where goods are entered, duties paid and released. A great

deal of aid and technical assistance is in place or being provided by international donors.

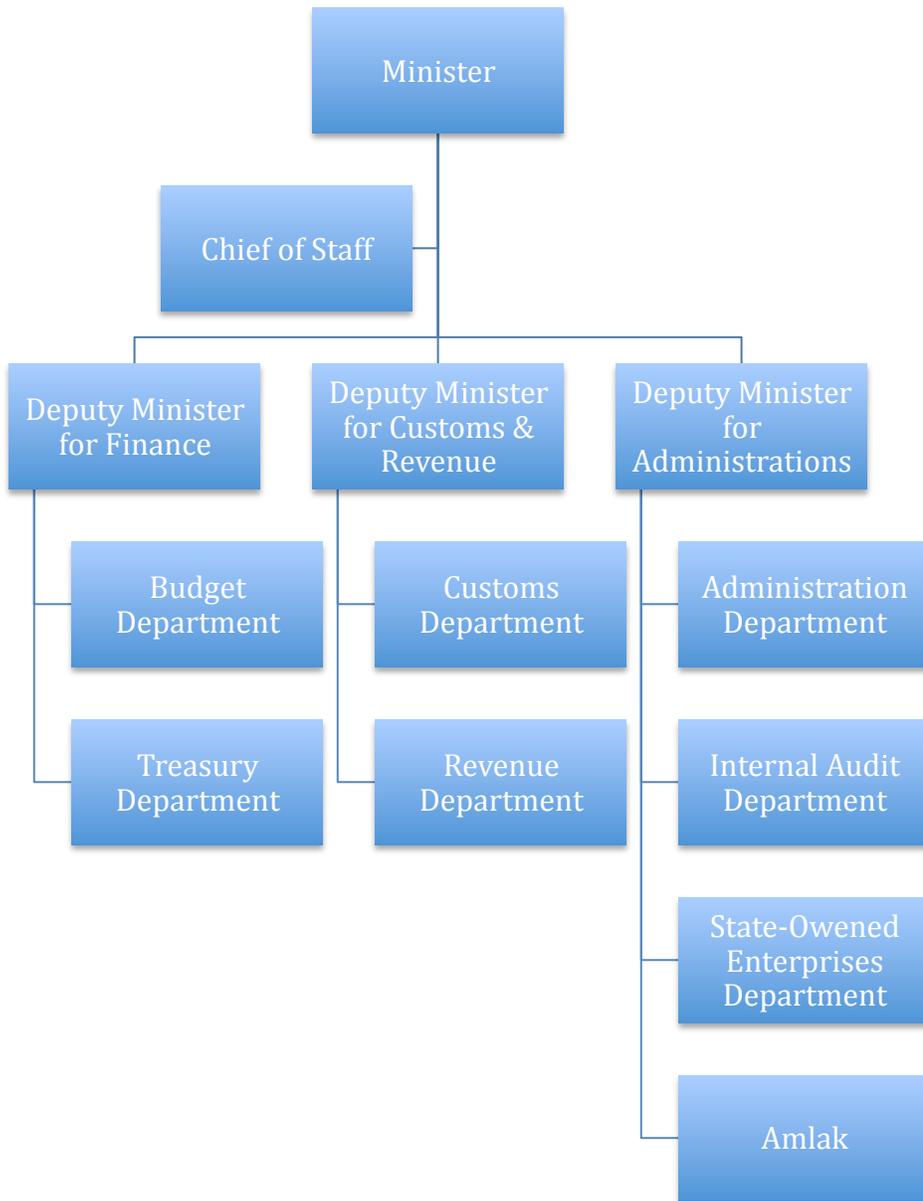
The Ministry of Finance is also responsible for privatization of Afghanistan's many state-owned enterprises (SOEs). There is no specific privatization law in Afghanistan, only a series of amendments to the State-Owned Enterprises Law of 1991. This law was amended by presidential decree, and approved by the Cabinet in November 2005, granting the Ministry authority to recommend methods of divestiture of SOEs and to implement the divestiture under the oversight of an SOE Evaluation Commission. This commission consists of the Ministers of Finance, Commerce, Economy and the Senior Economic Advisor to the President. Based on the amendments to the SOE Law, when an enterprise is to be divested, the Ministry submits a proposal to the Cabinet for the enterprise's liquidation or privatization. After approval, the Ministry appoints a committee to implement the process. Advisors have consistently recommended the creation of an independent agency to oversee the privatization process to little avail.

The public bodies created for implementing privatizations in other developing countries have differed. Some countries, such as Russia, Bangladesh, and the Philippines have created independent commissions, whereas Malaysia, Morocco, and Tunisia have opted for ministerial commissions, similar to that chosen by Afghanistan. In Chile, Jamaica, and Mexico, privatizations were implemented on an ad hoc basis by decentralized bodies.

#### **Discussion Questions**

1. What is the Ministry of Finance (MOF)? What are its responsibilities?
2. Why are tax and customs revenue important?
3. What is the Afghan Customs Department (ACD)? What is its relationship to the Ministry of Finance?
4. What role does the Ministry play in the privatization of state-owned enterprises (SOEs) in Afghanistan? What law governs this process? What are some of the problems with the process as it actually functions?

### Ministry of Finance: Organizational Chart



## D. The Judicial Branch

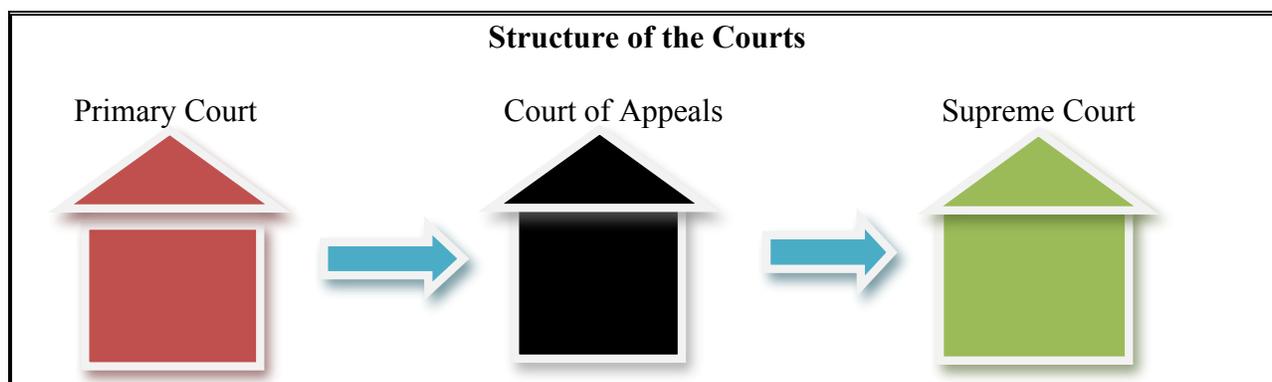
### Reading Focus

Turn to your supplement and read the Law on Organization and Jurisdiction of Courts of the Islamic Republic of Afghanistan to start this section.

The judicial branch is an independent and coequal branch of government. The Supreme Court is the highest judicial organ in Afghanistan and oversees the lower courts. It is composed of nine members who are appointed by the President with the consent of the *Wolesi Jirga* for ten-year terms. The Supreme Court, like the other courts in Afghanistan is divided into four *Dewans*: general criminal, public security, civil and public rights, and commercial law. Each *Dewan* is headed by one justice who is in charge of all the cases in that subject area. The powers of the Supreme Court are enumerated in the Constitution and in Article 24 of the Law on the Organization and Authority of the Courts (LOAC). Every decision made by the Supreme Court must be justified with a public opinion that everyone can read. It decides cases based on the Constitution and laws of Afghanistan. If no statutory provision is on point, the court may utilize *Hanafi* school of Islamic jurisprudence to resolve the legal dispute.

Before a case reaches the Supreme Court, it must be brought in the Primary Court before a panel of three judges in the district in which it originated. Primary Courts are divided by subject area. There are five primary courts: Central Provincial Primary Court, Juveniles Court, Commercial Primary Court, District Primary Court, and Family Primary Court. Overall, primary courts see forty-two percent of their cases as criminal cases, thirty-seven percent as civil cases, fourteen percent as national security cases, and seven percent as commercial cases. The losing party may appeal that decision to the Court of Appeal of the province. However, there are some decisions of the Primary Courts, according to Article 53 of the Law of the Courts, that are final: when both parties agree with the decision, when the time for appeal has expired, when the disputed property is worth 100,000 Afghanis or less, and when a cash fine of 50,000 Afghanis or less is issued.

If the situation allows an appeal, the losing party may appeal to the Court of Appeal. Again, these courts are split along subject matter so that an individual must appeal to the court which fits the subject of their case. There are five *dewans* in the Court of Appeal: general criminal, public security, civil and family, public rights, commercial, and juveniles. The Court of Appeal may affirm, reverse, or remand the case to the Primary Court based on that court's legal reasoning of the decision and the facts of the case. If the losing party in the case after the Court of Appeal's decision wishes to appeal, he or she may do so to the Supreme Court, although the Supreme Court will only review the decision for its compliance with the law.



### **Discussion Questions**

1. How are Afghanistan's courts structured? How many *dewans* are there? How many levels of appellate review are possible?
2. What is the Law on the Organization and Authority of the Courts (LOAC)? How does it influence the structure of Afghanistan's courts?

### *The Commercial Courts*

The primary forum for contract and commercial disputes in Afghanistan is the Commercial Court. Article 45 of the Law of the Organization and Authority of the Courts provides that a Commercial Court should be created in every province. Administratively, the Supreme Court of Afghanistan has divided the provincial Commercial Courts into eight zones. Only two of the eight zones (Mazar-i-Sharif and Kabul) currently have functioning Commercial Courts. The Commercial Court in Kabul and a few other large cities actively hear cases, but presently the Commercial Courts in the other provinces are not yet active. In the absence of commercial courts, the Chamber of Private Law has jurisdiction over commercial disputes. The procedure of Commercial Courts is different from that of other civil courts and is embodied in a separate law. Cases that deal with commercial leases of property are likely to be heard in the Commercial Court. However, cases dealing with other property issues or transactions, such as title, transfers, and mortgages, are generally handled by courts of general jurisdiction.

### *Reform of the Commercial Courts*

The majority of all commercial disputes in Afghanistan are resolved outside of the commercial courts. In fact, most business people actively avoid interaction with the commercial courts. The commercial courts suffer several problems that must be addressed if they are to play an important and effective role in the legal system of Afghanistan. Judicial decisions need to be made public and readily accessible so that future judicial decisions can receive public scrutiny and outcomes can become more predictable. Additionally, the facilities and staffs of the existing commercial courts need to be improved and new commercial courts need to be established. Courts lack bailiffs and recorders, and many judges have not received training in the complex

commercial transactions and disputes on which they must make rulings. Some steps have been taken toward creating a judicial training program to prepare commercial court judges for their duties, and six additional commercial courts are being planned in the six administrative zones that lack an operational court. Once these courts are functional and begin making rulings that are predictable and transparent, investment in these regions is likely to become more appealing.

However, funding of these courts remains a problem. Creation of the commercial court system requires a large investment from either the government or foreign donors. Even under the present structure, fees for use of the court's services may be acting as a substantial deterrent to businesses or individuals who might otherwise utilize the commercial court.

There would likely be greater incentive to use the court if the government were able to make available the necessary funding for the commercial court from taxes on commercial activity because such commercial activity would probably be enhanced by the establishment of a reliable and efficient means of enforcing contracts and solving commercial disputes. It is unclear that enough trained judges and funding will be available to fully implement a countrywide commercial court system. Therefore, in provinces lacking commercial courts, cases may continue to be resolved by the primary courts or by informal means such as local *shuras*. It is important to increase the number and capacity of qualified commercial court judges with specialization in the areas of banking, energy, corporate, and bankruptcy law. In addition, the courts will develop practical and efficient procedures for resolving small commercial claims.

Even in provinces where commercial courts are established, it is not clear that businesses have come to view them as an efficient forum for resolving disputes. In a 2005 survey, the World Bank found that only three of 335 firms reported using the commercial courts to resolve a payment dispute during the past two years. Although the situation seems to have improved in some respects since 2005, it is unclear how much faith businesses have in the commercial courts. Efficiency seems to be an issue that will need to be addressed. Of the three firms that reported using the commercial courts, it took an average of thirty-four weeks for the cases to be decided, and only one of the firms was satisfied that the decision was properly enforced. Given the problems of the commercial courts, it is unsurprising that some studies indicate that as many as eighty percent of disputes are settled by means of the *shura* or other informal systems.

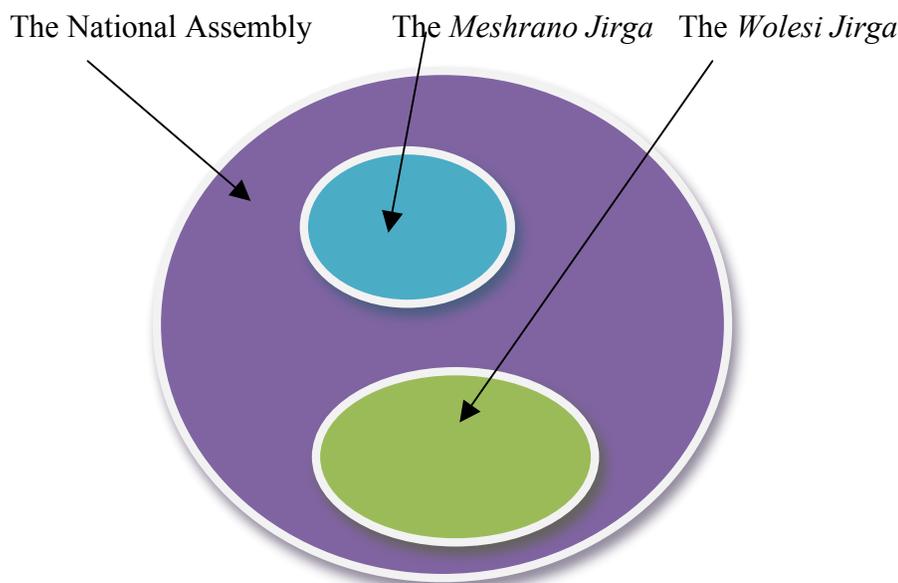
### Discussion Questions

1. What is the structure of Afghanistan's commercial courts?
2. What differences exist between the commercial courts and other civil courts in Afghanistan? How important are these differences?
3. What are some of the problems facing the commercial courts? How do these problems influence the decision of businesses whether or not to utilize the courts to resolve their commercial disputes?
4. How would you remedy these problems?

## E. The Legislative Branch

The National Assembly is charged with passing, modifying, and abrogating laws, and with approving the governmental budget. It is divided into two branches, the *Wolesi Jirga* and the *Meshrano Jirga*. The National Assembly is the lawmaking power of modern Afghanistan. A law must be accepted by both houses and signed by the President for it to enter into force. The President may enact a law by executive decree during a parliamentary recess. The National Assembly may modify or repeal the decree once it reconvenes.

The *Wolesi Jirga* is elected every five years and the number of representatives is proportional to the population it serves. There are a total of 249 members in the *Wolesi Jirga*. There 102 members of the *Meshrano Jirga*, one-third of which are elected by the provincial counsel, one-third appointed by the President, and the remaining third elected by the district. The *Wolesi Jirga* has the special power of accepting or rejecting presidential appointments for the ministries and Supreme Court. Both houses have various committees that deal with topics related to commercial law.



### Discussion Questions

1. What is the National Assembly? How is it structured? What are its powers?
2. What role does it play in the formulation of Afghanistan's commercial laws?

## F. Da Afghanistan Bank

Da Afghanistan Bank is the central bank of Afghanistan. Article 12 of the 2004 Constitution states:

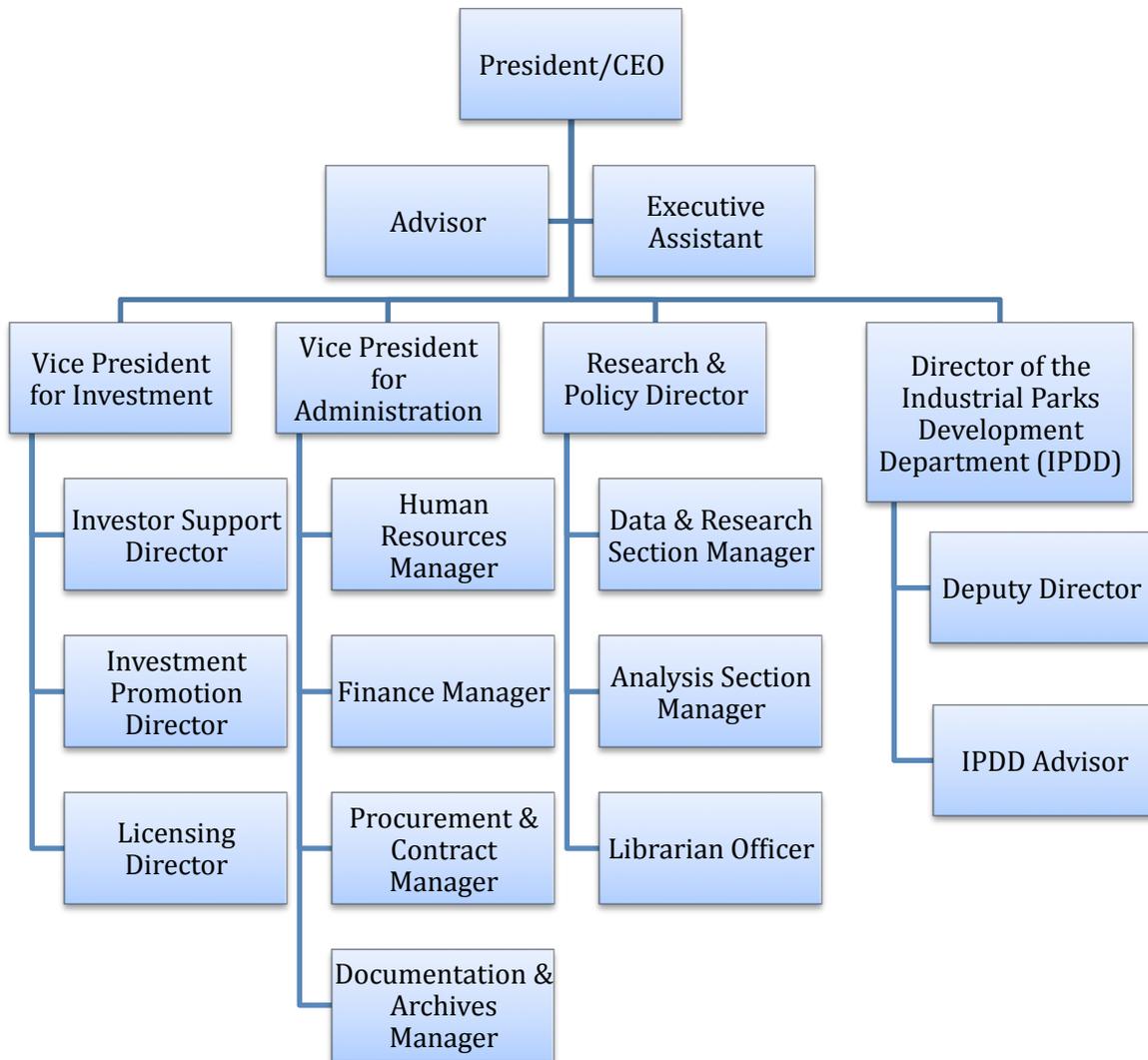
Da Afghanistan Bank shall be independent and the central bank of the state. Currency issuance as well as formulating and implementing the monetary policy of the country shall be, according to provisions of the law, the authority of the central bank. The central bank shall consult the economic committee of the House of People about printing of money. The organization and operation method of Central Bank shall be regulated by law.

The 2003 Law of Da Afghanistan Bank authorizes the Bank to define, adopt, and implement Afghanistan's foreign exchange policy; issue banknotes and coins; hold and manage official foreign exchange reserves; act as advisor and fiscal agent of the government; and license, regulate, and supervise all other banks throughout the country. Da Afghanistan is granted complete legal, operational, and administrative autonomy from the state in the pursuit of its objectives. The Bank is required to make periodic reports to both the public and Parliament to ensure accountability.

#### **G. The Afghan Investment Support Agency (AISA)**

The Afghan Investment Support Agency (AISA) is the primary agency responsible for registering and establishing every foreign and domestic business in Afghanistan. The AISA was established by the 2005 Law on Private Investment in Afghanistan and answers to the High Commission on Investment (HCI) (see above). The AISA arranges registration of most companies with the commercial court, issues investment licenses, and maintains a license database. The AISA's mandate is to create a single point of interaction between investors and the government of Afghanistan. Its responsibilities include: providing businesses with permits, licenses and clearances; providing information on investment opportunities; providing information to investors on investment, tax, labor, insurance and environmental laws, and regulations as well as Afghanistan's unique social structure; providing information on banking, labor costs, and the availability of investment incentives; assisting businesses with real estate acquisitions and leases; facilitation of customs clearance for investment related imports; and promulgating news related to investment opportunities in Afghanistan through conferences, symposiums, foreign embassies in Afghanistan, and embassies of Afghanistan abroad.

### Afghan Investment Support Agency (AISA): Organizational Chart



#### Discussion Questions

1. What is Da Afghanistan Bank? What are its powers? What is the legal regime that governs the Bank?
2. What is the AISA? What is its mandate? How is it structured?

#### IV. INFORMAL COMMERCIAL INSTITUTIONS

According to most sources, between eighty and ninety percent of the economic activity in

Afghanistan is in the informal sector, and almost all credit and other financial transactions are carried out in the informal sector. The informal economy usually refers to economic activity that is not registered for the purposes of taxation and/or regulation by the state. But it can also mean particular activities carried out within the formal sector that escape state regulation. The key issue in the definition is the degree to which the activity is registered or regulated—not that the informal activity is seen in any way to be far removed from the formal sector.

#### **A. *Hawala* Banking**

After more than twenty years of conflict, Afghanistan’s formal financial sector continues to rebuild. Conflict resulted in the disruption of the domestic and international payments system, the virtual cessation of all lending activities within the country, a significant reduction in deposit-taking activities, and the elimination of most international banking relationships. The disruption to the provision of financial services was most acute during the reign of the Taliban government, when Afghanistan was subjected to international economic sanctions. A large and vibrant informal market has developed in the absence of a robust, formal banking system. Afghanistan has, in fact, relied on the informal sector to access financial services for hundreds of years.

Money exchange dealers, or *Hawaladars*, provide a well-organized, informal banking and financial services system throughout Afghanistan. In Arabic, *hawala* simply means “transfer.” A *hawala* transaction involves financial transfers made by principals, or customers through *hawala* service providers in their respective countries.

The Kabul money exchange market, where most of the city’s *hawaladars* operate, has an eighty-year-old history. The money exchange dealers have traditionally provided traders with a range of banking conveniences, including currency conversions, international and domestic money transfers, deposit-taking services, and more recently communication facilities—for example, satellite telephone, fax, and e-mail. There are presently more than 300 registered money exchange dealers in the market. Estimates of the number of unregistered money exchange dealers in Kabul and around Afghanistan vary widely from 500 to 2,000. Money exchange dealers are required to register their businesses with the international affairs department of Da Afghanistan Bank.

Unfortunately, the *hawala* system is vulnerable to abuse by money launderers and those seeking to finance terrorism. Recently, the abuse of informal remittance systems by those who would finance terrorism has received a great deal of attention in the press. The anonymity built into *hawala* means that it is vulnerable to use by criminals or terrorists to move or launder money and commit crimes. The primary difference between the formal and informal systems lies in the amount of documentation required of each. Laundering money through the formal financial system leaves a paper trail, making it vulnerable to detection by law enforcement agencies during an investigation.

#### **B. Informal Credit Practices**

For a variety of social, political, and historical reasons, the Afghan economy is an overwhelmingly informal one, dominated by institutions, networks, and relationships that are

largely unrecorded and unregulated by the state. Up until now, this textbook has emphasized the formal system over the informal because it is the basis upon which the State of Afghanistan was founded. However, the credit sector is a prime example of an area in Afghan society where the formal and informal systems cannot be so easily untangled.

The concept of formal credit is most simply understood as credit that is delivered and then repaid within a set system of rules. Sources of formal credit may include financial institutions such as banks, non-governmental organizations (NGOs) that issue microcredit, and even the government. Informal credit, on the other hand, is credit borrowed and lent beyond the boundaries of formally regulated systems, and as such is largely unmonitored. Informal credit transactions occur most commonly between friends, relatives, and other social relations, and these transactions are the means by which the vast majority of Afghans gain access to credit. Informal credit is characterized by a high degree of flexibility, both in terms of the form that deals can take as well as their terms of repayment.

One dynamic that informs the availability of informal credit in Afghanistan is the religious and moral obligation embedded in Islam to help those in need. Moreover, informal credit is so heavily based on the nature of the social relationship that exists between the transacting parties that repayment terms are frequently not set, and typically there are very few repercussions that come with defaulting on the loan. Generally, the maintenance of the social ties between the parties takes precedence over the actual business substance of the transaction as a means of guaranteeing future help should the need arise. As a result, borrowers will repay the loan when they can, and lenders accept this arrangement with the expectation that should they face similar constraints in the future as borrowers, they will receive the same lenient treatment.

The widespread belief among international aid organizations that there is a strong and unmet demand for credit in Afghanistan has led to the growth of one particular form of formal credit: microcredit financing. However, it is important to note that the belief that formal microcredit would be a suitable substitute for informal credit is overly simplistic. Whereas microcredit is issued for the purposes of funding entrepreneurial innovation and initiative, a series of studies conducted by the Afghanistan Research and Evaluation Unit has revealed that informal credit is mostly used to meet consumption needs that are immediate and personal, as opposed to for purposes that we would consider to be wealth-enhancing for the country, such as starting a small business. In their use for consumption smoothing, especially in preparation for specific events such as marriage, informal credit fulfills a diverse range of household survival functions that often have little to do with income generation. Therefore, given this finding, it seems unlikely that informal credit systems will disappear even with the advent of formal credit.

Second, the idea that a formal credit system is a substitute for the informal system overlooks some of the systemic advantages that informal credit offers over the formal system. Its flexibility, its availability, and its relative risk-neutrality are all significant features. Indeed, as you may recall from our earlier discussion of secured transactions, the requirement of collateral in order to secure a loan under a formal lending system effectively precludes the poor, and in particular, the landless, from accessing credit.

Moreover, this finding also debunks the idea that the informal and formal credit system work in parallel by responding to disparate needs. There is evidence to suggest that the formal microcredit system is actually parasitic upon the informal credit system. Borrowers of microcredit who are under pressure to repay under the strict timetables imposed by issuers of formal credit often turn back to informal credit in order to meet those obligations, which ironically puts them in more debt rather than less.

#### Discussion Question

1. Do you think that it is possible to reconcile the informal and formal credit systems in Afghanistan?
2. Can you think of other areas in Afghan society where such clashes between formal and informal systems exist?
3. Do the points raised in this section about the complicated relationship between these two systems change your perceptions of formal versus informal institutions in Afghanistan? In what ways?

#### V. CONCLUSION

This chapter has reviewed Afghanistan's commercial law framework, as it currently exists. It has focused primarily on the formal sector—that is, Afghanistan's commercial courts, ministries, and parliament. Afghanistan's Constitution and laws govern these institutions. Yet, an estimated eighty percent of all disputes are resolved outside of Afghanistan's formal legal institutions. This statistic illustrates the importance of traditional commercial practices—*Shari'a* law, *hawala* banking, and informal credit—in Afghanistan.

Subsequent chapters will analyze in greater the depth the material presented in this chapter. Understanding how Afghanistan's commercial laws and institutions are supposed to work and how they actually do will enable you to better understand contract law, company law, and the other topics covered in this book.

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## CHAPTER 4: CONTRACTS

### I. INTRODUCTION

#### Reading Focus

What is the role of a contract in a commercial transaction? Why might this role be important in developing an economy? Why is the enforceability of a contract important?

Asad is a baker who lives in a small village in Herat. He owns a small shop together with his brother, Hamid, and his nephew Rajibullah. The three of them worked well together—Asad did all of the baking in the kitchen, Rajibullah attended to the customers, and Hamid delivered flour every day from the small flour mill that he owned nearby. Asad relied on both his brother and his nephew in order to keep the bakery running. He was glad that he did not need to rely on strangers to run his business. One day, however, Hamid decided that he wanted to move back to his home village in Kandahar. He sold his flour mill and used the money to buy a house in Kandahar for him and Rajibullah to live in. Because it would be impossible for him to keep running the shop all on his own, Asad was faced with a decision—he had to either find a new flour supplier and a new person to work in his shop, or he would be forced to close it altogether.

He decides to try to find a new supplier of flour. Hamid refers him to Abdul, who is the new owner of the flour mill. Because Asad does not know Abdul, he does not know whether he is reliable. Failure to make a delivery could mean severe damage to his business, forcing him to lose a day's business and angering his customers. Although Abdul insists that he is a trustworthy and honest merchant, Hamid still has some reservations about entering into business with a complete stranger.

#### Discussion Question

Imagine that you are Hamid. Think of at least five concerns that you would have about entering into business with Abdul. If you were in Hamid's position, what would you do to protect yourself in this transaction?

Fundamentally, Asad feels uncertain about doing business with Abdul without some way to ensure that Abdul will perform his obligations as promised. Also, Asad is worried about the problems that may arise from simple misunderstandings. For example, Asad must receive the flour before he closes his shop every night, so that he can use it to bake fresh bread early the next morning. If Abdul is even just a few hours late making the delivery, then Asad will not be at the store to receive it. As a result, the next day's business will be lost because he won't have any goods to sell. Asad is also concerned that if Abdul does in fact fail to perform as promised, he would not be able to hold Abdul accountable for the loss.

In their village, *shuras* are commonly used to settle disputes between parties. In these circumstances, it is up to the local leaders who comprise the *shura* to hear the case brought by

the parties, and to decide whether an agreement had been entered into in the first place, whether or not one of the parties had failed to fulfill their obligations under the agreement, and what the solution should be if they find that one of the parties had failed to meet his or her obligation. Asad rightly realizes, though, that if this were to occur, it would be his word against Abdul's, and because Abdul is originally from Herat and has many local connections, Asad has little confidence that a *shura* in Herat will make a decision in his favor if he is in a dispute with a local businessman.

Because Asad has reason to believe that the *shura* is likely to protect the interests of a local even if the facts of the situation favor him, the outsider, he decides to write up a sales contract that will govern their business relationship. In this way, the obligations of both parties are stated and agreed on before the business relationship formally begins, and should disagreement arise in the course of business, the contract between them will be the basis for the dispute resolution, instead of Abdul's word against Asad's.

Asad also realizes that the existence of a sales contract would also make clear the expectations that he, as the buyer, has of Abdul as the seller. For example, if Abdul did fail to make the daily flour delivery, he could argue that they had only agreed that flour would be delivered every day, and that a specific time was not part of the agreement. In a properly written contract, these misunderstandings can largely be eliminated, giving both parties the security to enter into profitable business relationships because they know that their agreement is enforceable.

Put simply, contracts are the basis for almost all commercial transactions. When people enter into commercial transactions, contracts are used to determine exactly what each party expects to receive from the bargain. When contract law is clearly elaborated and consistently applied, all parties to the transaction know what their rights under the contract are, and the parties also know that their rights under the contract will be enforced in a relatively predictable way. Without contract law, parties to a transaction cannot be assured that they will receive the benefits of the agreement. It might be unclear whether or not a valid agreement has even been struck, or the parties may have different interpretations of the actual terms of the agreement even if they can agree that they made an agreement.

For instance, you and I might agree that I will sell you all of the wheat harvested from my farm for a fixed price. If bad weather destroys almost all of the wheat before it is harvested, do we still have a contract? Must I still pay you the agreed upon price even though I am now only receiving a small portion of what I expected? Such doubt tends to make parties less willing to enter into transactions and tends to limit economic opportunities for all. Contract law reduces this doubt by creating rules that parties to a contract can use to answer these questions.

This chapter will first provide an overview of the sources and historical authorities on contract law in Afghanistan, and also highlight which laws are in force in Afghanistan today. Next, the chapter will explain key contract law concepts that are found in the legal systems of other countries. Afghanistan is a country that has the potential to experience substantial economic growth from international trade. Therefore, in addition to the contracting principles contained in Afghanistan's law, it is important to understand contract law from the perspective of

other countries' legal systems as well since many cross-border transaction agreements will be drafted in accordance with foreign contract law. Each section will begin with a theoretical overview of the concept, followed by a treatment of the relevant governing provisions. Finally, the chapter will address the particular issue of government contracts and explore some common types of contracts that you will likely encounter in business transactions.

## **II. SOURCES OF CONTRACT LAW IN AFGHANISTAN**

### **A. Afghanistan's Legal System: An Overview**

As mentioned previously, Afghanistan is a civil law country. Civil law, the predominant type of legal system in the world, relies on an abstract code of law—often divided between civil and criminal portions—to dictate how legal disputes should be settled. In such a system, judges resolve disputes by applying the principles of legal codes that are written by the legislative branch. The civil law system is one of two predominant types of legal system in the world, with the other being common law, a system under which abstract laws are derived from the resolution of specific cases.

The Bonn Agreement of 2001 states that Afghanistan's legal framework shall be rebuilt "in accordance with Islamic principles, international standards, the rule of law, and Afghan legal traditions."<sup>7</sup> Afghanistan effectively has no formally adopted, clearly elaborated and consistently applied contract law. As of 2008, a new Law on Contracts has been drafted by outside advisors through the Afghanistan Transitional Commercial Law Project.<sup>8</sup> This new draft law is a comprehensive treatment of contracts with principles drawn from both Afghan legal tradition and from international best practices. The adoption of a unified formal law on contracts is an important step to creating productive and efficient social and economic conditions. It is expected that when the new law does become integrated into Afghanistan's legal culture, it will provide a vastly simplified environment for the creation and enforcement of contracts in the country. Formal contract laws bring greater certainty to personal interactions and business transactions.

Currently, contract law in Afghanistan is scattered throughout the Civil Code of 1977 and the Commercial Code of 1955, both of which were recognized and reinstated by the Bonn Agreement of 2001.

### **B. Hierarchy of Authority**

Historically, Afghanistan has derived its contract law from multiple sources. Each source has been created or adopted during a certain period of Afghanistan's history to solve whatever new problems have emerged. There have frequently been local, tribal, and national customs that speak to the formation and fulfillment of agreements between people; Islamic legal texts also provide guidance on a variety of interactions between people that have often been applied to

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<sup>7</sup> Agreement on Provisional Arrangements in Afghanistan Pending the Re-Establishment of Permanent Government Institutions art. II(2), U.N. Doc. S/2001/1154 (Dec. 5, 2001), *available at* <http://www.afghangovernment.com/AfghanAgreementBonn.htm> [hereinafter Bonn Agreement].

<sup>8</sup> USAID, AFGHANISTAN'S AGENDA FOR ACTION: DEVELOPING THE TRADE & BUSINESS ENVIRONMENT 32 (2007), *available at* <http://www.bizclir.com/galleries/country-assessments/Afghanistan.pdf>.

contracts; and statutes put in place under previous governments in Afghanistan provide contracting rules that guide interpretation of what current contract law should be. The variety of sources from which Afghanistan derives its contract law demonstrates that contract law tends to evolve over time to meet the needs of the current circumstances.

Despite the rich interplay between traditional and modern sources of contract law, both the 2004 Constitution and the Civil Code of 1977 place clear limitations on the issues that should be addressed directly through Islamic jurisprudence. As discussed in prior chapters, Articles 130 and 131 of the 2004 Constitution dictate when the use of Islamic jurisprudence is appropriate.

Moreover, the supremacy of legal provisions is apparent as Article 1(1) of the 1977 Civil Code explicitly states, “In cases where the law has a provision, the practice of religious jurisprudence is not permitted.” In the absence of a legal provision, Article 1 delegates authority to the fundamental principles of *Hanafi* jurisprudence with the goal of securing “justice in the best possible way.” Finally, should neither a legal provision nor a fundamental principle of *Hanafi* jurisprudence apply, Article 2 accords authority to a court-issued verdict that is in accordance with the “public convention, provided the convention does not contradict the provisions of the law or principles of justice.”

Since law in Afghanistan is drafted in compliance with Islamic law, the legal code is the primary source that courts should consult for resolving contract issues. Recognizing that a thorough treatment of the customary and religious approaches to dealing with commercial law issues is beyond the scope of this textbook, the focus of this chapter will be to provide you with an understanding of the legal framework for contract law created by the Commercial Code of 1955, in conjunction with the Civil Code of 1977.

### **C. The Commercial Code of 1955: Overview and Scope of Application**

The Commercial Code of 1955 addresses several key aspects of contract law and was designed to apply to all commercial transactions as determined by the provisions of the Commercial Code. The Commercial Code has served as the primary source of commercial law since its adoption, and the Constitution provides that laws enacted prior to the Constitution remain in force unless explicitly repealed or superseded by a new law. It is not completely clear which parts of the Code have been superseded by new laws adopted since the 2004 Constitution. However, the new Corporations and Limited Liability Companies Law and the new Partnership Law both explicitly render void the portions of the Commercial Code that deal with corporations and partnerships.

Article 2 of the Commercial Code specifies that commercial disputes are to be resolved by reference to “the meaning and implication of existing commercial laws.” In other words, commercial law should be the first source that is used to determine the proper outcome of a dispute. “In the absence of a law, local and special customs” should be used, with preference given to local custom over general custom.

Application of the regulations of the Commercial Code is specifically limited to commercial transactions. Subchapter C of the Code enumerates specific qualifying transactions,

including the lease of movable and personal property (Articles 14 and 15) and the employment of workers (Article 16). Articles 18 and 19, reproduced below, provide helpful guidelines for what the court will consider to be a commercial transaction:

### **Commercial Code of 1955**

#### **Article 18**

The following transactions are commercial and business transactions:

- a. Agreement to provide any kind of movable property and accept any kind of activities and products.
- b. Establishment of a power plant or press; photography; printing; and selling of books.
- c. Establishment of theaters, movies, parks and public places, e.g., hotels, business compounds, restaurants and the like, employment offices, and auction.
- d. Transportation of passengers, animals, and goods via land, air and water.
- e. Distribution of water, gas, electricity and the establishment of telephone communication.

### **Commercial Code of 1955**

#### **Article 19**

The following transactions are commercial transactions regardless of the parties concerned:

- a. Working for commission.
- b. Brokerage.
- c. Bill and draft transactions (whether recorded in the name of a person or a bearer).
- d. Money exchange transactions.
- e. Transactions made by private and public (special and general) banks.
- f. Transactions relating to current accounts and agreements thereof.
- g. Transactions relating to mortgage documents and receipts existing against goods placed in commercial general storehouses.
- h. Establishment of commercial companies and buying and selling of shares.
- i. Contraction of any kind of insurance for all risks whether for fees or for reciprocal terms.

### **Commentary: The Afghan Civil Code and Its Treatment of the Contract Tradition**

In its totality, the Civil Code presents an underlying theme that contracts are instruments to be guarded against, rather than enforced according to their terms. More charitably, the Civil Code reflects Afghanistan's tradition of "apology and forgiveness" that can be found throughout its customary law.

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The tone and priorities of the Civil Code lean much more heavily to the side of parties that find themselves unable to meet their contractual obligations, rather than to the side of those who would seek to enforce those obligations through the formal court system. Ultimately, Afghanistan's contract law in its current form does exactly the opposite of what market-oriented law seeks to do: it institutionalizes a very high risk involved with entering into a contract.

*Source: USAID, Afghanistan's Agenda for Action: Developing the Trade & Business Environment 31 (2007).*

#### **D. The Civil Code of 1977: Overview and Scope of Application**

The Civil Code, which was adopted in 1977, suffers from some problems that make it an imperfect source of contract law today. The first issue with the Civil Code is its questionable validity due to the recent adoption of several new laws. As with the Commercial Code, the Constitution provides that laws enacted prior to the Constitution remain in force unless explicitly repealed or superseded by a new law. It is not completely clear which parts of the code have been superseded by new laws adopted since the 2004 Constitution. Another problem with the code is that it uses many Arabic legal terms that are not common in the Dari or Pashto languages and are not defined in the text of the code. Therefore, the interpretation of the code can be uncertain.

However, the Civil Code of 1977 is still a useful source of important contract concepts that seem to serve as one basis for current court decisions. As judges continue to consult the provisions of the Civil Code when rendering their decisions, it is important to have some working knowledge of its contents.

The Civil Code dictates many of the technical and procedural rules for resolving legal disputes, such as determining which state's law should be applied in the event of a dispute arising from a contractual obligation. Article 27 stipulates that the law that is applied to a contract can be determined by the jurisdiction of the place of residence of the parties, by agreement of the parties, or by the location where the contract was formed, depending on the specific circumstances.

Another important function of the Civil Code is its recognition of which entities can be deemed a legal person for the purposes of applying the law. Article 338 recognizes entities such as companies and other organizations as legal persons who are able to enter into a contract or bring a claim under contract law in court against another person just as a real person may. The

Civil Code sets forth the important legal connections between jurisdiction, entities, and property that allow for contract law to fulfill a wide variety of roles in society.

We will now explore some of the most common and central concepts of contract law in greater depth.

### **III. KEY CONCEPTS OF CONTRACT LAW**

Although Afghanistan is a civil law country, many of the contract law principles covered in this chapter have their origins in common law. The common law of contracts is a form that is used by many countries including the United Kingdom, Pakistan, India, and the United States. As discussed earlier, although the process by which laws are derived in common law differs from the civil law system used in Afghanistan, the common-law contract law concepts that we will deal with in this section also apply to contract law more generally.

#### **A. What Is a Contract?**

##### *The Definition of a Contract and the Purpose of Contract Law*

Every legal system makes distinctions between promises that are deemed to be legally enforceable and promises that are not. Recall the situation of Asad the baker. His offer to pay Abdul 500 Afghanis for each sack of flour delivered, and Abdul's acceptance of this offer, would likely be the kind of promise that the law will enforce. We call this kind of enforceable promise a "contract." However, if you promise to accompany your cousin to a restaurant, this is not a promise that the law will enforce.

The closest thing to a definition of a contract that existing Afghan law provides is found in Article 494 of the Civil Code, which states, "Legal transaction in contracts is completed with concurrence of the intention of the two contracting parties, and as a result obligation is incurred to one of the two parties." The Second Restatement of the Law of Contracts, a treatise on American contract law, defines a contract as "a promise, or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty."<sup>9</sup>

Therefore, the term "contract" only applies to acts that have "legal effect." Put more simply, a contract is an agreement between parties that has a legal means of enforcement. Contract law was the result of a need for a formal means for people to cooperate with each other in society for both business and personal purposes.

Generally, contracts are formed when parties exchange promises to take (or not take) certain actions. At the heart of a contract is the element of agreement between the parties. The necessary agreement is most easily visualized in terms of offer and acceptance. For example, you may offer to your friend, "I will buy your car for 200,000 Afghanis." If your friend accepts, then presumptively a contract has been created. Therefore, the first step to understanding and

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<sup>9</sup> RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981).

applying contract law is the recognition of when an offer and an acceptance of that offer have been made.

For example, Asad and Abdul agree that Abdul will bring two sacks of flour to Asad's shop at four o'clock in the afternoon every day. This is a term of the contract that they have entered. However, one day, Abdul's car breaks down, and he is unable to make the delivery by the time agreed upon in the contract. Under contract law, a party who does not fulfill their promise is said to have breached the contract. When a party breaches a contract, they are required to compensate the other party or parties to the contract for the damages caused by their breach. Normally, the breaching party is required to compensate the other parties with money, but sometimes a court may require the breaching party to perform some action to alleviate the damages to the other party or parties.

The ultimate goal of contract law is to provide the damaged party with the benefits they should have received had the promise been fulfilled. Therefore, when a court or other authority assesses damages, the damages are assessed with the intent of compensating the damaged party for the losses they have sustained as a result of the breach and are not intended to penalize the breaching party for wrongdoing. Unlike criminal law, there is less focus on wrongdoing and more focus on fulfillment of whatever promises were agreed to by the parties. Frequently, the parties will agree to an alternative arrangement when one party breaches a contract since actual enforcement of the contract could take time and might be expensive.

### Concept Review: The Contract Process

The enforcement of a contract is premised on a promise being made as part of a **bargained exchange**. This bargained exchange usually takes the form of an offer made by a person identified as the offeror, and an appropriate and timely acceptance being made by the offeree, the person to whom the offer was made.

An **offer** is a communication that shows an intent on the part of the offeror to be legally bound. A valid offer creates in the offeree the power to form a contract by manifesting an appropriate **acceptance**.

If either party fails to perform the contract as agreed, this is a **breach of contract**.

### B. How Is a Contract Formed?

#### Key Definitions: Four Elements of an Enforceable Contract

**Mutual consent:** The agreement between the offeror and the offeree to be bound by the terms of the contract as proposed by the offeror.

**Consideration:** The circumstances or factors that the offeror and the offeree considered when agreeing to the contract, and which motivated the contract.

**Capable parties:** The law only recognizes enforceable contracts between parties who have the capacity to understand the implications of their actions.

**Enforceable subject of the contract:** The law will not enforce a contract with an illegal purpose.

### *Elements that Render a Contract Legally Enforceable*

So now that we know what a contract is, we need to understand how to properly form one so that it is legally enforceable. It is clear to us that Asad wants to enter into a contract with Abdul, but is Asad's intention enough to form a contract that also binds Abdul?

The answer is no. As indicated above, in order for a promise to constitute a binding contract between parties, four elements are generally required: mutual consent of the parties, consideration, capable parties, and an enforceable subject of the contract.

**Mutual consent** of the parties means that one party offers to enter into an agreement, and the other party accepts the terms of the agreement that the offering party has proposed. When Asad approaches Abdul and offers to pay him 1000 Afghanis for two sacks of flour, and Abdul agrees, there is mutual consent. Often the accepting party will do so formally, either in writing or by saying "I accept." However, sometimes consent may be inferred through the actions of the parties.

For instance, if Asad makes the offer discussed above to Abdul, and the next day, at precisely four o'clock, he finds two sacks of flour at the door of his shop with a bill for 1000 Afghanis, it would seem that Abdul accepted Asad's offer even if he did not explicitly say so or do so in writing. However, in cases where the value of the agreement is high or the contract is for certain purposes, contract law may require that the parties make their agreement in writing. This decreases the likelihood that there will be a misunderstanding about what was intended by the parties.

Afghanistan law places greater emphasis on the acceptance of an offer than on the offer itself, with Articles 610 to 618 of the Commercial Code governing various aspects of acceptance, including: the period of time after the offer within which an acceptance must be made, what means of communication is sufficient to convey an acceptance, and when a contract takes effect. In the event that an acceptance's answer is not identical to the terms made in the offer, then the Commercial Code treats the acceptance as a counter-offer to which the original offeror must give acceptance in order to form a valid contract.

Second, contracts also require **consideration**. Consideration is an abstract concept that is best thought of as the underlying motive for the promise. The law seeks to enforce promises that result in mutual benefits, as these promises are more likely to generate wealth and increase welfare. Therefore, the law looks for consideration in determining whether an enforceable contract exists because it is proof of a bargained-for exchange, as opposed to a gratuitous promise.

Functionally, the requirement of consideration means that no party should enter into a binding agreement from which they will receive nothing. When one party gives something to another party without the expectation of receiving anything in return, then the law will view this act as giving a gift, not entering into a contract. Under most circumstances, one person's promise to give a gift to another person is not enforceable as a contract.

### Discussion Questions

1. Consider Asad and Abdul's agreement over the flour delivery. Is there consideration in this situation? What benefit would Asad derive from this transaction? What benefit would Abdul derive?
2. Why does the law view this transaction as wealth-enhancing?

Third, the law must find that Asad and Abdul both have **capacity**, or the legal power, to enter into an enforceable contract. In other words, the law will only find contracts to be enforceable if the parties involved are capable of understanding the implications of their actions. Because Asad and Abdul are both adults, the presumption is that they understand the consequences of the contract that they have entered into.

Generally, children are not deemed to have the capacity to enter into enforceable contracts because they do not have the maturity to understand all of the implications of their actions. Although adults are generally assumed to have capacity, evidence can be offered to refute this assumption. Some examples of instances where incapacity will be recognized include insanity or temporary incapacitation due to injury or medication. Often, contracts made with a party who lacks capacity are enforceable but may be canceled at the option of the party who lacks capacity or by their representative. Therefore, it is risky for a person with capacity to enter into a contract with someone who does not have such capacity. If the contract proves to be to the advantage of the capable person, the person without capacity can cancel it; if the contract is to the advantage of the person without capacity, they can choose to enforce the contract.

Similarly, the law will not recognize a contract as valid when consent from one of the parties is obtained by coercion or duress. For example, if Abdul threatened to use his powerful business connections in Herat to put Asad out of business unless Asad agreed to pay him 1000 Afghanis for each sack of flour, and Asad agreed out of fear, then this contract will not be enforceable because Asad's consent was improperly obtained.

Therefore, in order for a finding of duress to negate the consent of a contracting party, it must entail an improper threat of sufficient gravity to induce consent, and the consent must have in fact been induced by this threat. If someone enters into a contract due to threats made by the other party, then the contract is not enforceable.

The case for duress is most easily made when the threat by the coercing party is express. However, a threat may also be implied from the words or conduct of the coercing party, so long as an intention to cause harm or loss to the other party is communicated.

### Discussion Questions

1. Suppose that Abdul finds another buyer for his flour who is willing to pay a significantly higher price than Asad. What are some possible arguments for incapacity that Abdul may be able to argue in order to excuse himself from his contract with Asad?
2. Can you see how incapacity can operate as a defense against contract performance? How may a party that has changed his mind about a contract that he has entered into use such a defense to his benefit?
3. As a lawyer, how would you propose to limit the abuse of incapacity as a defense?

Finally, the law will examine the **subject matter** of a contract in determining its enforceability. A contract with an illegal purpose is unenforceable. This stems from the law's unwillingness to allow the judicial process to become involved with the enforcement of certain transactions which it perceives as being contrary to public welfare.

In these situations, the court is concerned with preventing the use of the courts as the enforcement agent of contracts that may be harmful to society, and not with protecting the parties from unfair bargains.

Therefore, contracts to engage in conduct that is illegal, or to engage in conduct that, while legal, is in contravention to public morals, are unenforceable. As a result, Asad cannot contract with a burglar to have him steal a car for him in return for some amount of money. No court would enforce such a contract, and Asad would be committing a crime by attempting to negotiate such an agreement. In short, a contract is only valid if its purpose is lawful.

#### *Commercial Code Requirements of Contract Formation and Acceptance*

The Commercial Code provides some important guidance as to how the Afghan courts will assess whether or not a contract has been formed. Below are the relevant excerpts from the Commercial Code that govern the requirements of contract formation and acceptance.

#### **Requirements of Contract Formation**

##### **Article 608**

In order for a commercial contract to take place, the consent of both parties is sufficient. Preparation of a contract or other ceremonies is not necessary.

##### **Article 609**

If it is required by the law that the contract be written on a special form, or if both parties delay the contract for certain ceremonies, the contract cannot take place without that form or before those ceremonies.

## **Requirements of Contract Acceptance**

### **Article 610**

If it has been necessary to specify a period for acceptance, acceptance cannot take place before the end of that period, even if both parties agree. If an agreement should be necessary, without specifying a period of acceptance, the validity of acceptance is conditional to the immediate acceptance and presence of the parties concerned. A contract made by communication means, such as telephone, is as if it had taken place in the presence of the parties concerned.

### **Article 611**

When the act of acceptance takes place in writing, if the period is not determined, the contract initiator cannot disregard the act of acceptance before the termination of the time necessary for thinking and positively answering by acceptor.

### **Article 612**

The acceptance answer should be sent during a specified period that should reach the contract initiator. If the answer comes after this period, the contract does not take place unless it is found that the acceptance answer has been given during the specified required period. The contract initiator must at once inform the other party about the delay in receiving the answer being responsible for the contract not taking place. Otherwise, the contract is valid.

### **Article 613**

Lack of response by the other party does not imply acceptance. In case two members have permanent commercial relations, or if one of them requests the other to execute certain transactions in his name, the decision made by the person referred to should at once be made known to the opposite party, or else the lack of response is considered as acceptance. The party rejecting the initiated proposition has to take special steps about the good sent to him when the proposition is made, as mentioned in Articles 762 and 763.

### **Article 614**

If the acceptance's answer is not in agreement with the proposition, the contract does not take place. In such case, the acceptance necessitates another proposition.

### **Article 615**

In order for a telegram concerning the proposition or the acceptance to be acceptable, it is necessary that it be proved that it contains the signature of the sender or has been sent with his consent.

### **Article 616**

In case the proposition is made in writing, the contract takes place from the date of arrival of the acceptant's answer to the proposal; but if the proposer should be informed before the arrival of the answer or during this time of the rejection by the acceptant, the proposition is without effect.

### **Article 617**

A contract taking place by communication is valid from the date the acceptance answer has been sent. Just as mentioned in Article 613, in case it is not necessary that acceptance be explicit, the contract is in effect from the date the proposition has reached the addressee.

### **Article 618**

The death or disqualification of the merchant does not necessitate the invalidity of his proposition in acceptance concerning his commercial transactions unless otherwise explicitly mentioned or understood from the nature of that transaction.

### *Exceptions to the Requirements of Contract Formation*

In certain specific circumstances, courts may determine that a contract exists even if all of the requirements listed above have not been satisfied. Imagine that Asad's bakery becomes wildly successful, and he becomes a very wealthy man. He learns that his nephew, Rajibullah, is about to get married, and he promises Rajibullah enough money to buy a house. In reliance on that promise, and with Asad's knowledge, Rajibullah enters into a contract to buy a house. Shortly thereafter, Asad and Rajibullah get into a disagreement and as a consequence, Asad informs his nephew that he no longer intends to give him the money. However, Rajibullah does not have the funds to pay for the house himself and he is now in danger of breaching the contract with the house seller. Although Rajibullah can concede that Asad's promise did not have the elements legally required of a valid contract (see discussion above) and is therefore not enforceable, he still feels that this outcome is unfair. Shouldn't contract law provide some remedy for his plight?

One of the circumstances where contract law will recognize an enforceable contract even in the absence of the required elements is called **detrimental reliance**. Detrimental reliance occurs when a person makes a promise and takes sufficient actions to fulfill the promise that the other party associated with the promise was justified in acting in reliance on that promise. If the other party relies on that promise to his detriment, the court will provide a remedy and find the promise to be an enforceable contract that must be carried out. Reliance upon a promise is a distinct basis for the creation of contract rights and duties, and so is not based on the existence of a bargain. Therefore, the usual requirements of mutual consent and consideration are not necessary for finding the existence of an enforceable contract. In the case of the wealthy uncle above, a court may find that Rajibullah justifiably relied on his promise and that the uncle therefore should be required to fulfill that promise.

A contract might also be implied in the event of a mistake where a person who was not originally a party to the contract benefits from the mistake. For example, an **implied contract** might exist if Abdul accidentally delivered flour to the restaurant next door to Asad's bakery, and the restaurant owner then used the flour for his own business. In this situation, fairness would dictate that the restaurant owner be required to compensate Abdul for the flour as if a contract between them had existed in the first place.

### Discussion Questions

1. Why might the law find an enforceable contract even if the promise lacks the four required elements?
2. What ends is the law trying to achieve by implying the existence of a contract in those circumstances?

### C. What Happens When a Contract Is Ambiguous or Incomplete?

#### *Common Problems Arising from Contract Ambiguity or Incompleteness*

Recall Asad's concern that a misunderstanding between him and Abdul may result in costly consequences to his business, and the benefit of having the terms of the agreement explicitly stipulated in the contract between them.

As was discussed earlier, the primary concern of contract law is the protection of the reasonable expectations of persons who have become parties to a contract. This concern is reflected in how the law chooses to recognize the formation of contracts, and is also reflected in how the terms of a contract are interpreted.

However, the problem is that it would be nearly impossible for contracts, other than those for a single, immediately completed transaction, to incorporate provisions for all possible scenarios that could arise during the life of the contract. For example, although Asad and Abdul came to an agreement that Asad would pay 500 Afghanis for a sack of flour, it may be that what Asad considers to be a sack differs from what Abdul considers to be a sack. However, if Abdul did not in fact intend that his statements be understood to communicate the meaning that Asad inferred from them, then they will have differing expectations as they enter the contract. So although Asad may feel that the terms of the contract may be very clear: "Asad will pay Abdul 500 Afghanis for one sack of flour," he may not realize that Abdul has a different understanding of how large one sack is, and this problem would not manifest itself until the contract had been signed and Abdul had begun performing on it.

Therefore, a common problem that plagues contracts is uncertainty over their terms. As you can imagine, this happens frequently as it is almost impossible for the parties to be in complete agreement over the meaning of every term of the contract, even if they think that they may be. If in offering to sell the flour Abdul makes statements that cause Asad as the buyer to believe that the flour is of a certain quality, then Asad will have expectations of receiving flour of that quality as a result of entering into a contract with Abdul. For example, Abdul may have promised that his flour was of "good" quality, which Asad may have understood to be better than what Abdul actually meant. If this difference in expectations becomes a source of dispute, then the interpretation of the contract is a question of law to be decided by the judge.

In addition, parties drafting a contract also have to confront numerous information uncertainty problems. Since the parties to the contract do not know what course future events will take, it is difficult to anticipate all the things that could occur that might influence the

parties' obligations under the contract. Therefore, their contract is likely to be silent about these uncertainties. As the duration of a contract increases, this information problem is likely to increase. Similarly, some contingencies may purposely be left out of a contract because the parties view the potential for that outcome as unlikely and discussion of such a contingency might have an adverse effect on negotiations.

*"Default Rules": The Basics of Contract Interpretation*

What guidelines does contract law provide in these cases? Should a court "fill in the gaps" of the contract after the fact with terms that the court deems fair given the circumstances that have occurred? Would such "gap filling" by the court undermine the voluntary consent of the parties that takes place during the formation of a contract?

Although courts do sometimes use their equitable powers to "fill in the gaps" of an incomplete contract after the fact, frequently these incomplete contracts are dealt with using default rules. **Default rules** are terms that are implied to be part of every contract unless a provision of the contract explicitly specifies that a different term will be used. For instance, if the default rule is that a contract remains in effect in perpetuity, the court will assume that the contract is perpetual unless a provision of the contract specifies a time when the contract will terminate.

Articles 619 to 623 of the Commercial Code and Articles 705 to 729 of the Civil Code are some of the default rules that the court must use in resolving contract interpretation disputes in Afghanistan.

The law in Afghanistan demonstrates a preference for enforcing the "real purpose" of the contract, which refers to what the parties subjectively intended. The **subjective intention** is the true intention that the people actually had in their heads but was unspoken. However, since the parties are engaged in a dispute, then it is more likely than not that their subjective intentions were in disagreement with each other. In the disagreement between Asad and Abdul, they both attached different meanings to the word "good."

If they decide to resolve the dispute under the Commercial Code, the Commercial Code would dictate that since they are unable to find a congruent "real purpose," then they should look first to the contents of other contracts that Abdul and Asad may have entered into, and then to custom or the transactions prevailing at the time of the contract, for clues as to how to interpret the ambiguity. If they have a previous course of dealing whereby Abdul has sold Asad products that Abdul has characterized as being in "good" condition and which Asad has accepted without protest, then Abdul would prevail on the grounds that Asad knew what Abdul meant by "good."

However, if no such previous relationship exists between them, then we look next to custom or prevailing norms for similar transactions. If there were no customs or traditions to inform us, then both the Commercial Code and the Civil Code call for the contract to be interpreted in favor of the offeree and against the offeror.

The law may also establish mandatory rules that create implied terms that cannot be negated by the parties because the rule is seen to serve positive social benefit. For instance, many jurisdictions in the United States include an implied covenant of good faith and fair dealing in all contracts. Parties may not opt out of the requirement that they deal with their counterparty fairly.

Below are some relevant excerpts from both the Commercial Code and the Civil Code that pertain to contract interpretation in the event of dispute over ambiguity.

### **Commercial Code of 1955**

#### **Contract Interpretation**

##### **Article 619**

If the meaning of the statement of a commercial contract should be explicit and logical, the apparent meaning is assumed. Otherwise the real purpose is honored. If the content of the statement is inconsistent with that of the contract, the interpretation of purpose is held applicable.

##### **Article 620**

In case a statement has [multiple] interpretation[s], the common purpose is determined from the contents of other contracts, [from] custom, or [from] the transactions and circumstances prevailing at the time of the preparation of the contract, or according to previous applications.

##### **Article 621**

In case the statement should have unusual and common meanings, it is interpreted as according to which meaning it is closer to.

##### **Article 622**

In case the statement of the contract should be interpreted with many meanings, and according to Article 620 the real purpose of both parties should not be determined, the contract is interpreted against the person promising and for person to whom the promise has been made.

##### **Article 623**

Recognition is given to commercial custom as well as to legal orders in commercial transaction unless otherwise explicitly agreed to by both parties.

### **Civil Code of 1977**

#### **Contract Interpretation**

##### **Article 706**

In contracts, abiding by the conspicuous will of the parties to the contract, credence shall be given to objectives and meaning rather than words and letters.

##### **Article 708**

Insinuation shall not be credible against clarity; in case the meanings of the two are contradictory, the clarity shall be given preference.

**Article 711**

Use of language is preferred to its neglect. So long as a meaning can be expressed by language, its neglect is impermissible except when its use is excused.

**Article 717**

Doubt shall be interpreted in the interest of debtor.

**The Place of Habit and Custom****Article 720**

What is common in tradition, is as if it were a condition.

**Article 721**

Habit, whether it is common or special, shall be considered by law.

**Article 722**

Habit is credible when it is universal or prevalent. Credence shall be given to the widespread prevalence, not restricted prevalence.

**Article 723**

What is customarily impossible is considered as actually impossible.

**Discussion Questions**

1. How would Article 622 of the Commercial Code and Article 717 of the Civil Code influence a judge's decision regarding our dispute over what is meant by the "good" condition of the car that I am selling you? Do you think that this rule is fair?
2. Why do you think that the law provides such a default rule? Can you think of a fairer rule?

**D. How Can the Rights and Duties That Flow from a Contract be Transferred from the Original Promisors to Another Party?**

Sometimes a party to a contract may wish to transfer the *rights*, or benefits, of the contract to another party because it no longer makes sense for him to remain in that contract. Suppose that Asad decides to retire and leaves the bakery to his son, Yasir, to run. It no longer makes sense for Asad to remain in the contract for flour delivery with Abdul, because Asad no longer has use for that flour. However, instead of having Yasir renegotiate a contract with Abdul, Asad may simply transfer his right to receive that flour to his son. Such a transfer is called an **assignment**. The law likes to recognize these types of assignments because they create efficiency. Generally, assignments are allowed as long as the contract does not explicitly forbid them.

### Assignment and Delegation

Once you have entered a contract, the rights and duties that flow from the contract can be considered to be property rights. Just as you are entitled to all the benefits, and are accountable for all the obligations, that come with ownership of real property such as a farm, the same applies when you are a party to an enforceable contract. And, as with all property, there are strong practical reasons why we want to make these rights transferable.

A party to a contract may also wish to transfer his or her *duties* under a contract. Although one can transfer rights, one cannot as easily transfer duties. Where duties are not personal in nature, they may be transferred through **delegation** as long as the recipient of the service approves of this delegation. For instance, the merchant that is required to deliver a ton of flour to me may wish to transfer that obligation to another merchant. If I agree to this change, the law allows for this obligation to be delegated because flour is **fungible**—that is, the nature of the good is such that it is freely interchangeable with another specimen of that same good. My approval of this delegation presumes that I consider the flour that I will receive from the other merchant to be equal to the flour that I was receiving from the original supplier.

Generally, delegation is not allowed if the contract obligates a party to perform personal services that are unique. A famous musician could not delegate his or her obligation to perform a concert to another musician. Additionally, even though a person delegates his or her obligation to another party, he or she remains liable in the event the obligation is not performed unless the non-delegating party explicitly releases him or her from the obligation. So although the merchant was able to delegate to his friend his duty to provide flour to me, if his friend fails to supply the flour as agreed upon, the merchant will be liable to me for damages because the duty was not properly performed.

#### **Concept Review: The Transfer of Contract Rights and Duties**

**Assignment:** When a right or a benefit conferred by a contract is transferred from the original party to the contract to another party.

**Delegation:** When a duty or obligation imposed by a contract is transferred from the original party to the contract to another party. Note that although the obligation may be delegated, the liability for non-performance remains with the original party. Delegation is not allowed in cases where the duties are personal in nature.

#### **Discussion Questions**

1. What is the difference between assignment and delegation?
2. How does the law's allowance for the transfer of contract obligations and duties create efficiency?

3. Recall the example where I transfer my rights to receive flour from the merchant to you once you purchase my bakery. Why is this transfer efficient for me? For you? For the merchant? Can you imagine the time and resources that could be saved if such a simple transfer were repeated on a much larger scale, such as in a nationwide economy?

## E. What Do We Do When a Contract Is Broken?

### *Breach of Contract and Its Remedies*

Now suppose that Asad's worst fear comes true, and Abdul fails to make the delivery of the flour as promised. Under contract law, when one of the parties to a contract fails to perform his or her obligations, we say that he or she has **breached** the contract.

Dealing with a breach a contract is one of the most important aspects of contract law, since without an effective means of enforcing the contract (or remedying the damage caused by the breach of that contract) the certainty that contract law is supposed to provide would be greatly diminished. Therefore, the law safeguards the value of the contract form by giving a **remedy**. Article 739 of the Civil Code makes the following provision for compensation in the event of a breach: "In case one of the two contracting parties, in contracts which impose obligations on both sides, does not fulfill his obligation, the other party can demand the cancellation of the contract, and when necessary, with compensation for losses."

After it has been established that a party to an enforceable contract has failed to perform according to its terms, a court must determine what remedy the other parties should receive to compensate them for the damages caused by the breach. In general, the presumptive form of relief for a breach of contract is **monetary relief**. However, in some cases a court might order the breaching party to take a specific action to compensate for the breach. This is referred to as **specific performance**. Finally, the parties sometimes specify what the damages will be in the case of a breach in advance as part of the agreement. These damages are called **liquidated damages**. We will now examine each type of remedy in turn.

### *Monetary Relief*

Money is most commonly the compensation that is awarded to the non-breaching party. Courts attempt to award a non-breaching party with an amount of money equal to what they would have expected to receive had the contract been fulfilled. In deciding to award monetary damages, the court must have some way to systematically calculate what amount is appropriate.

Because people enter contracts to create wealth-enhancing transactions, the formation of an enforceable contract creates an **expectation** in each party that the law will protect. The award of **expectation damages** is most easily understood as the court deciding to award the non-breaching party money damages to compensate them for the benefits that they *expected* to receive had the contract been properly performed but did not as a result of the breach. The right to the benefits that will be obtained from performance by the other party is a property right. When one party breaches, the aggrieved party is entitled to receive a judgment for that amount of money necessary to be placed, as nearly as possible, in the position that person would have

occupied had the contract been performed. Often, the extent of expectation damages is more attenuated than we may initially imagine. Deciding when to draw the line is one of the most challenging aspects of remedy law.

To illustrate, consider the example that Abdul is contractually obligated to deliver two sacks of flour to Asad's bakery every day. If Abdul fails to deliver the flour to Asad every day for one week, and the court decides to award Asad his expectation damages, what amount would he be entitled to?

The most obvious amount that Asad would be entitled to would be the money that Asad had paid for the deliveries that never occurred. If Asad had paid Abdul 5000 Afghanis in advance for a week's worth of deliveries, and Abdul had failed to deliver that week's flour, then Asad would be entitled to 5000 Afghanis.

However, in order to keep his business going, Asad had to find another merchant from whom to buy the flour on short notice. As a result, Asad had to pay a higher price—say, 600 Afghanis, for each sack of flour. Because the goal of expectation damages is to put the non-breacher, in this case, Asad, in the position that he would have been in had the contract been properly performed, this also includes whatever extra costs Asad had to reasonably incur as a result of the breach. Finally, the expectation damages also include any lost profits that Asad suffered that week as a result of not having the flour with which to bake the bread.

### *Specific Performance*

A court is most likely to order **specific performance** when the damage caused by the contract breach cannot be accurately or adequately compensated with money. The most common basis for finding monetary damages to be an insufficient remedy is if the subject of the contract is unique. If a contract is for the sale of a unique piece of property, money damages will not place the aggrieved party in the same position that he would have been in had the contract been performed because the money cannot be used to buy the same property elsewhere. For instance, if I contract to sell you an exceptional racehorse and then change my mind, the court is likely to order me to give you the horse because it is difficult to determine how money would accurately compensate you for the loss of the horse. In general, there is a greater presumption that real property is unique, and so specific performance will often be the remedy in situations where the breach of contract is over land transfer.

### *Liquidated Damages*

Article 731 of the Civil Code, reproduced below, expressly allows for **liquidated damages**, which gives the parties to a contract the power to stipulate specific damages to be paid in the event of breach. The use of liquidated damages provides several advantages to the contracting parties. First, it allows the parties to control their level of risk exposure by letting them set the payment for breach in advance. This is particularly useful when the damages are uncertain and difficult to calculate. Second, it allows the parties to know with greater certainty what the damages will be. As a result, parties can avoid the uncertainty, delay, and expense of using the judicial process to determine actual damages.

## Civil Code of 1977

### Liquidated Damages

#### Article 731

The parties can determine the amount of compensation which must be paid in case of non-fulfillment, or postponement of fulfillment of obligation while concluding the contract, or thereafter.

#### Article 732

In case the debtor proves that the prescribed surety is unjust, and is not proportional to the damage accruing from non-fulfillment, the creditor shall not be entitled to it.

### Court's Calculation of Damages

#### Article 734

The court can, in case the amount of surety is not agreed upon, or it is not specified in the law, fix its measure with due consideration to the losses incurred by the creditor and the fall in his income.

However, courts will sometimes invalidate liquidated damages provisions in a contract if the court determines the liquidated damages are being used as a means to *penalize* a breach rather than to accurately compensate the non-breaching party. If the court finds that the liquidated damages were set at a high figure simply to compel performance, the provision will be void. Therefore, a court will only honor a stipulated damage provision if it reflects an honest effort by the parties to anticipate the probable damage that would result from a breach.

The reason for this prohibition on liquidated damages penalties is that they encourage breaches of contract when the breaching party can more cheaply compensate the non-breaching party for the breach than it can perform its obligations under the contract. Some courts take the view that such breaches should be allowed as long as the damages awarded to the non-breaching party are sufficient to compensate them for the losses they have incurred.

How courts deal with breach of contract depends largely on how contract law deals with the policy tension inherent in many areas of commercial law that we introduced at the beginning of this chapter. The way that a court decides to award damages in a contract dispute must balance the need to protect a contracting party who is damaged with the somewhat conflicting need to provide incentives for all parties to enter into a contract in the first place.

Parties may want strong enforcement and large damages to create greater certainty that the contract will be fulfilled, but at the same time parties may be discouraged from entering some contracts if it is likely they may face excessively high damages in the event they must breach. This is especially true in some circumstances where the breach would be more economically efficient than performance but for the distortion caused by damage awards that exceed the true economic damage that has been done to the non-breaching party.

#### IV. REALITIES OF CONTRACT LAW IN AFGHANISTAN TODAY

Much of the new legal framework necessary to govern agreements between private parties and to encourage and protect private investment in Afghanistan is still being designed. Additionally, there are overlapping systems that govern disputes between parties (customary law as implemented by *shuras* and the formal legal system instituted under the 2004 Constitution), and these different systems have yet to be fully harmonized. A commercial court system is in the process of being established, but few commercial courts outside of major cities are functional today. International businesses do not use the commercial courts that are functioning due to the fact that outcomes from the court are likely to be uncertain since there is still no official contract law and the courts' decisions tend to be unpredictable. The commercial court still has relatively limited ability to deal with complex commercial disputes.

##### A. The Afghanistan Law on Contracts

However, many aspects of commercial law are improving, and in recognition of the particular importance of a stable contract law in creating an environment conducive to economic development and in transforming Afghanistan into a free-market economy with minimal barriers to entry for foreign investors, the new Law on Contracts is expected to be adopted.

Over the past several years, a committee of lawyers working under the auspices of the American Bar Association's initiative to support commercial law reform in Afghanistan has been cooperating with senior Afghan government officials to develop a new law of contracts that is aimed at promoting certainty in transactions and protecting the lawful rights and interests of contracting parties. The product, the new Law on Contracts, will eliminate the current piecemeal approach of having contract law provisions scattered across the Commercial Code and the Civil Code, and will replace it with a single self-contained statute.

The Afghanistan Law on Contracts recognizes, as fundamental principles, the concepts of freedom of contract, mutual consent, and good faith. The current draft statute addresses several key areas including: (i) contract formation and the essential elements of a contract, (ii) the validity and effect of a contract, (iii) contract performance, (iv) rules of interpretation, (v) rescission and termination, (vi) assignment, (vii) remedies for breach, and (viii) agent-principal relationships.

In facilitation of the market economy that the government hopes to see develop in Afghanistan, the statute also devotes an entire section to sales, and the special remedies that apply in sales transactions, and also contains chapters addressing barter transactions, contracts of carriage, and warehousing contracts.

The Law on Contracts was drafted with the status of Islamic law in contemporary Afghanistan in mind. Consequently, the new law draws extensively upon existing statutes in the United Arab Emirates, Kuwait, and Egypt, and incorporates principles of Islamic law and expressly recognizes the role of certain traditional Islamic law contractual relationships such as *mudaraba* and *murabaha*. At the same time, the law took inspiration from contract law in

industrialized and industrializing countries, ranging from the United States to China, for specific rules that do not conflict with Islamic law.<sup>10</sup>

## **A Preview of the Law on Contracts**

### **Book One: General Provisions**

Chapter 1.	Scope and Purpose
Chapter 2.	Essential Elements & Formation of Contracts
Chapter 3.	Validity and Effect of Contracts
Chapter 4.	Formalities; Conditions; Rights of Rescission
Chapter 5.	Performance of Contracts
Chapter 6.	Rules of Contract Interpretation
Chapter 7.	Modification & Assignment of Contracts
Chapter 8.	Contract Term; Discharge; Premature Termination
Chapter 9.	Breach of Contracts
Chapter 10.	Special Provisions

*Book One provides clear definitions of terms (Art. 2) and clearly states that men and women have equal capacity to enter into contract (Art. 9). It states that there are four elements essential to the formation of a valid contract—offer, acceptance, a lawful object, and a lawful cause—and clearly defines these elements (Arts. 11-15). Book One also lists the various terms that may be found in a contract, including quantity, quality, price and others, but unequivocally states that these elements are not essential for a contract to be enforced (Art. 11). Next, a thorough list of circumstances that may arise over the course of a contract relationship is covered, including conditions for voidability (Arts. 29-36); the meaning and impact of performance (Arts. 47-54); and general principles of interpretation (Art. 60). Book One defines and explains the consequences of breach of contract, including remedies, damages, specific performance, and liquidated damages (Art. 79-90).*

### **Book Two: Sales Contracts**

Chapter 1.	General Provisions
Chapter 2.	Warranties and Related Rights
Chapter 3.	Transfer of Ownership; Scope of Certain Sales
Chapter 4.	Risk of Loss
Chapter 5.	Performance, Breach & Remedies
Chapter 6.	Certain Types of Sales Contracts

*Book Two introduces the conventional treatment of sales of goods that is found in many of the world's free-market economies. Critical to this area is the issue of warranty, including implied guarantees that items sold are "merchantable," and the fact that Afghan traders under the new law will face new expectations that they may have avoided in the past (Arts. 104-110).*

<sup>10</sup> USAID, AFGHANISTAN'S AGENDA FOR ACTION: DEVELOPING THE TRADE & BUSINESS ENVIRONMENT 16 (2007), available at <http://www.bizclir.com/galleries/country-assessments/Afghanistan.pdf>.

*The new law gives buyers the right to inspect goods they have contracted for (Art. 104) and the right to reject defective goods, so long as they meet a clear list of criteria (Art. 107). In addition, the new law clearly allocates the risk of loss, stating that, unless otherwise provided, the risk of damage to, or loss of, the sold item is borne by the Seller prior to delivery and by the Buyer after delivery (Art. 118). Book Two also defines a number of sales contracts that may arise in the Afghan marketplace, including sales contracts requiring delivery in separate lots (Art. 134); installment purchases and repossession (Art. 135); sales between merchants (Art. 136); sale by trial (Art. 137); “Free Carrier” (FCA) sales contracts (Art. 138); and “Carriage and Insurance Paid” (CIP) contracts (Art. 139). Several of these concepts are “aspirational”—that is, the Afghan economy may not be sufficiently dynamic to support them now, but they may arise in the future.*

### **Book Three: Agency**

*Addressed in Chapter V*

### **Book Four: Certain Other Contracts**

Chapter 1.	Barter
Chapter 2.	Gifts
Chapter 3.	Carriage Contracts
Chapter 4.	Warehousing Contracts
Chapter 5.	Special Provisions

*Book Four describes certain situations in contracts that may come up in the Afghan marketplace. The inclusion of warehouse contracts—the type in which a warehouse stores the goods delivered by a depositor and the depositor pays the warehousing fee—is significant in its responsiveness to the agrarian nature of the Afghan economy as well as its reduction of risks for parties involved in such a relationship.*

### **Book Five: Miscellaneous Provisions**

*Book Five will include the critical details of the new law’s applicability, including its date of effect and implementation. It also clearly states that upon the effective date of the new contract law, all existing contract laws, decrees and regulations will be terminated and have no further effect.*

*Source: USAID, Afghanistan’s Agenda for Action: Developing the Trade & Business Environment 32-34 (2007)*

### **Commentary: Challenges Faced by the Integration of the Law on Contracts into the Afghan Marketplace**

As noted, the integration of the new contract law into the marketplace and legal arena will present enormous challenges in fundamentally dismantling, and then rebuilding, how people think about commercial agreements and obligations. The tortured language of the existing Civil Code represents a national consensus in favor of forgiveness over enforcement, a sentiment that is essentially rejected by the new contract law that presumes to hold people to their obligations. The initial users of the new law will likely be larger businesses that wish to grow according to free-market terms—that is, they will abide by written contracts and use the courts as a means of documenting their credit-worthiness. In the meantime, individuals and micro-businesses will likely continue to rely on local or tribal institutions—*jirga* and *shura*—that traditionally handle dispute settlement. Although these informal institutions work against a backdrop of high illiteracy and do not typically resolve cases according to written guidance, they will be part of Afghanistan’s legal framework for dispute resolution for the foreseeable future.

*Source: USAID, Afghanistan’s Agenda for Action: Developing the Trade & Business Environment 34 (2007)*

### **Discussion Questions**

1. Do you agree with the writer when he says that the integration of the new contract law will dismantle and then rebuild how people think about commercial agreements and obligations?
2. What impact do you think the new Law on Contracts will have on the current understanding of contracts in Afghanistan?

Once this law has been officially adopted and implemented, the outcomes of commercial disputes are likely to become more predictable, and the legal system is more likely to be utilized to resolve those disputes.

Given the condition of contract law in Afghanistan up until now, the legal system has not played a significant role to date in adjudicating commercial disputes. Most businesses tend to use informal mechanisms to resolve disputes and enforce property rights. For example, the Afghan Investment Support Agency (AISA) sometimes assists investors in mediating disputes. It is common for investment disputes to arise out of contracts, and the absence of a clear contract law has resulted in the near unenforceability of commercial agreements through formal means. The Private Investment Law does provide some mechanisms for dispute resolution under United Nations Commission on International Trade Law (UNCITRAL) rules or under any mechanism that the investor has specified in a contract with another investor. However, these provisions are untested, and disputes continue to be solved through customary means such as *shuras*.

There are also some mechanisms at the international level that can be used for settling disputes between Afghan and international parties. Afghanistan is a party to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States and the New

York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards. These international agreements provide a forum and framework for settlement of disputes with international parties. Generally, if a contract is entered into with international actors (whether business, non-profit, or the United Nations), then the parties typically choose to include an arbitration clause in their contract that stipulates another country's contract law.

Recently some progress has been made in the effort to create a system that facilitates the resolution of commercial disputes. Significantly, two new laws have recently been enacted to provide a means for commercial dispute resolution. The first law, the Commercial Mediation Law, provides a framework for parties to informally settle disputes in a more formalized way. Informal mediation has been a common means of commercial dispute resolution in Afghanistan, but this law seeks to make such informal mechanisms more effective. The law specifies how a mediator is appointed by the parties to the dispute and how the mediation will be conducted. It also provides guidance to courts about how a settlement through mediation should be viewed and enforced.

The second law, the Commercial Arbitration Law, allows parties to specify arbitration as the means to settle a commercial dispute. Arbitration can be specified to take place either domestically or internationally. In either case, courts in Afghanistan will not rule on the dispute and instead will refer it to the specified arbitration authority. Probably most significantly, arbitration agreements may specify that the law of any jurisdiction may be applied to the agreement. Therefore, although a Contracts Law has not been approved, parties can choose to apply the contract law of another country to their agreement. The adoption of these new laws is an important step for creating a solution that will make contracts in Afghanistan more easily enforceable.

## **V.     LAWYERING SKILLS APPLICATION: THE EMPLOYMENT CONTRACT**

So far in this chapter, we have used Asad's quest to find a supplier for flour to study the mechanics of a contract, and more specifically, the components of a contract for the sale of goods. We turn now to the other most common type of contract: a contract for employment.

### **Discussion Question**

Asad still needs to find someone to replace Rajibullah in operating the store, and wants to hire someone to do so. From our study of the elements of a contract for the sale of goods, can you think of some of the issues that an employment contract may address?

### **Legal Drafting Exercise**

In the legal profession, the job of contract drafting is highly precedent-driven. That is, often lawyers will use contracts from a previous, similar transaction and modify it to suit their needs for a specific instance. Because the content of a contract for the sale of goods tends to be fairly standard, the structure does not vary much from contract to contract. For example, every contract for a sale of goods will identify the good that is to be sold, and disclose all of the representations that the seller is making about the good. Price, method of delivery, and time of

payment are also common points that a contract for the sale of goods must cover. As a result, often only the specifics that are pertinent to the transaction at hand vary from contract to contract.

Below is an example of a real employment contract that was used by a company operating in Afghanistan. One of the most important skills that a lawyer must have is the ability to read contracts carefully and to identify all of the ambiguities that may be potential sources of dispute later on between the parties. The goal of a good lawyer in drafting a contract, then, is to eliminate ambiguity as much as possible.

Before reviewing the following contract, try to think of some terms that should be included. The key to writing a good contract is to anticipate all of the relevant information that the parties will need to consider when they are performing the contract. One good way to approach this task is to put yourself in the place of each party to the contract. If you were someone looking for a job, what kind of provisions would you want in your employment contract? What kind of protections would you want?

Similarly, if you were someone looking to hire a new employee for your business, what concerns would you have? What are the provisions that you would include that would help to alleviate those concerns?

### **Employment Contract**

This agreement is entered into between -----, hereinafter referred to as the “Employer” and **Mr/Mrs/Ms** ..... hereinafter referred to as the “Employee,” whose address is: .....

The terms and conditions of this agreement are based on Afghanistan’s labor law and regulations.

#### **I. TERMS OF REFERENCE**

A: **Trial period:** There is a one (1) month trial period for all staff. The trial period is defined as the first thirty (30) days of continuous employment with the Employer. During this time the employee will learn his/her responsibilities, learn about the Employer and project and about the job. Additionally, the introductory period gives the employee’s supervisor a reasonable period of time to evaluate his/her performance. The employee may be discharged at any time during this period if his/her supervisor concludes he/she is not progressing or performing satisfactorily.

B: **Employee’s Position/Title:** .....

C: **Modification of terms and conditions:** Subject to discussion and written agreement of both parties, these terms of reference, as well as the terms and conditions of this employment agreement, may be periodically modified as required by the project.

D: **Scope of work:** The employee will be assigned to a project as per the attached Scope-of-Work which forms an integral part of this agreement and must be signed on each page by the Employer and the Employee.

E. **Medical certificate.** To qualify for employment, the employee must present a medical certificate indicating that the employee is in good health.

## II. DURATION OF AGREEMENT

A: This Agreement is for the period between \_\_\_\_\_ and \_\_\_\_\_ and covers the project assigned to the Employer as per the attached “Scope of Work,” subject to the conditions set forth in Sections VI and IX of this Agreement.

B. This Agreement will become in effect upon its signing by Employer and Employee.

## III. SALARY

A. **Salary Payment.** The Employee’s gross monthly salary is the equivalent in Afghan local currency of \$..... US Dollars. The salary will be paid on a monthly basis.

## IV. BENEFITS/TAXES

A. **Income Tax or Employment Tax:** The Employer will withhold income tax from staff salaries as directed by the Government of Afghanistan.

## V. WORK HOURS, OVERTIME, LEAVE, and HOLIDAYS

A. **Work Hours:** The office working hours are from 8:00 a.m. to 4:30 p.m. with a half an hour lunch break.

B. **Work Week:** The office work days are Saturday through Thursday. Fridays are non-work days.

C. **Annual Leave:** The employee is eligible for XX work days annual leave per contract year. Annual leave may only be taken after three months of consecutive employment. Annual leave should be planned and approved XX days in advance. Prior written approval from the employee’s supervisor must be obtained to use annual leave with planning of activities during the employee’s leave. No entitlements of annual leave/sick leave are applied to assignments of six months or less. All annual leave must be taken within the period of the assignment and any unused annual leave days may not be carried over from the previous year to the new year.

D. **Sick Leave:** The employee is eligible for XX days sick leave per contract year. Sick leave is accumulated at 1 day per month worked. Sick leave may not be accumulated from one year to the next over the course of the employee’s employment. Any employee

who is sick for three consecutive days must bring a certified note from the attending physician. Failure to do so will result in the immediate termination of the Employee.

- E. **Maternity Leave:** Twenty (20) working days of maternity leave are provided to the mother around the time of birth. Maternity leave may not be commuted to cash upon termination. Employees may request up to three months of additional unpaid maternity leave. No entitlements of maternity leave are applied to assignments of six months or less.
- F. **Special Leave-without-Pay:** Special leave-without-pay must be requested from, and approved in writing by, the employee's supervisor. The request should include the exact dates and number of days for which unpaid leave is being requested.
- G. **Holidays:** Employees are eligible to XX holidays per calendar year. The holidays recognized by the Employer are attached to this Agreement.

#### **VI. AGREEMENT TERMINATION**

- A. Either party may terminate this agreement with XX days written notice. This agreement can also be terminated immediately if the Employer's project is terminated for any reason.

#### **VII. DISPUTE RESOLUTION**

- A. **Dispute Resolution:** All disputes arising from this contract shall be handled by friendly negotiations and through local and accepted mechanisms of mediation. Should negotiations and mediation not result in resolving the dispute, the issue shall be presented to a three panel arbitration counsel selected by the Employer. The prevailing law shall be the law of Afghanistan.
- B. **Language of the Agreement:** In the event of a dispute, the prevailing version of this employment agreement shall be the English version.

#### **VIII. CONFIDENTIALITY**

- A. The term "confidential information or material" means all information or material that is not in the public domain and that is disclosed or otherwise made available by the Employer to the Employee, or that comes to the attention of the Employee in the course of his/her employment or contract with the Employer, or in the course of his/her discussions with the Employer; and specifically includes, but is not limited to, information or material concerning;
  - 1. *The nature of discussions or other communications between he/she and the Employer with regard to an employment or contract arrangement; and*
  - 2. *The Employer's organization, finances, financial structure, and financial condition; assets and liabilities; directors, officers, and employees; and stockholders, investors,*

- financial backers, creditors, supporters, advisors, consultants, associates, contractors, agents, and representatives; and*
3. *The Employer's operations, interest, and plans (including, among other matters, information material concerning business practices and procedures, competitive position; trade secrets, product concepts, designs, blueprints, plots, and drawings; research and test results; practical and theoretical knowledge and techniques; production capacity and equipment; product development plans, technical, manufacturing, marketing, distribution, and pricing approaches; material sources and cost; land acquisition and development plans and cost, building acquisition and renovation plan and cost, and resale or other disposition plan and prices; financing plans, arrangements, activities; and customers and clients); and*
  4. *The Employer's ability to provide protection, or its efforts to provide protection, against unlawful activities directed against the Employer's assets or against its directors, officers, or employees.*
- B. In the event the Employee's contract is terminated, he/she must continue to abide by the confidentiality clauses of Section VIII. Employee shall not disclose any confidential or proprietary information concerning the Employer including information and material under Section VIII, A, 1, 2, 3.

**IX. BREACH**

- A. In the event that the Employee breaches any parts of the Agreement, he/she will be subject to immediate termination.
- B. In the event that the Employee's actions and breach of the agreement cause any harm to the Employer's business, in addition to the termination of the employee's contract, the Employer shall also be entitled to, (1) seek an injunctive relief from the appropriate court to stop the breach, (2) sue to recover the damages caused by the employee's breach, (3) recover from the employee any costs associated with lawyer's fees and court fees, and/or (4) any other action within the laws of Afghanistan that will provide relief to the Employer.

**X. GOOD FAITH EFFORT**

- A. Employee will maintain Good Faith towards the Employer during the course of his employment and after the termination of this contract.

This Agreement is hereby signed between:

Employer: \_\_\_\_\_ Employee: \_\_\_\_\_

Date: \_\_\_\_\_ Date: \_\_\_\_\_

## **VI. GOVERNMENT CONTRACTS AND THE LAW OF PROCUREMENT**

Afghanistan is currently undergoing a process of significant transition, involving major reconstruction and reform efforts. The urgent need for civil and physical infrastructure in the form of government ministries, schools, hospitals, and highways has created a need for a specific legal framework that will govern the various transactions that are involved.

While the new Law on Contracts will address agreements made in the private sector, there remains a large body of legal issues surrounding contract enforcement in the specific context of government procurement. These issues are addressed by the Law on Procurement, which was enacted in Afghanistan in October 2005.

Its purpose, as stated in Article 2, is to “establish an open, transparent, competitive procurement system, based on effective budgetary and expenditure controls and reporting requirements designed to achieve efficiency, economy, the prevention of abuses, and a fair opportunity for participation by all potential contractors, including private enterprises and other persons.”

The goals of public sector contract enforcement are straightforward: to create a competitive bidding process, deliver goods, and provide services with minimal risk of default.

The Law on Procurement faces the daunting challenge of bringing Afghanistan’s sprawling system of government contracts under control. At this time, the twenty-six line ministries are plagued by a lack of accounting controls, consistency of rules, and disclosure requirements. The introduction of controls to create greater transparency is especially important given the vast government funds that are continuously being expended to procure services and goods from various contractors. For example, although the Ministry of Economy operates a unit that oversees most high-value contracts (those valued over \$200,000 USD), the flow of lower-value contracts is virtually unregulated.

To stem the damage that could result from millions of dollars of unchecked government spending, Article 93 of the Law on Procurement established the Procurement Policy Unit (PPU) within the Ministry of Finance. The PPU was created for policy and professional development and as a performance-monitoring organ in the field of procurement. It is charged with two general tasks: drafting implementing regulations and training procurement officers throughout the line of ministries. In drafting the implementing regulations, the PPU is also expected to establish a mechanism for appealing contracting decisions, as well as to create standard bidding documents that will bring greater transparency and consistency to the government contracting process.

The importance of a robust government procurement system is that it sets a standard of contract performance that will benefit both the private sector contractors and the public sector agencies that hire them. Moreover, a smoothly functioning and consistently enforced government procurement system creates the expectation that government contracts will be subject to scrutiny and enforcement, which has positive effects on the government’s legitimacy and its abilities to meet its obligations to the people.

### Discussion Questions

1. Why do you think it is especially critical that government contracts be transparently enforced? Why is transparency in government spending important?
2. How might good government procurement practices have an impact on contract enforcement between private parties?

### Commentary: The Importance of Implementing and Supporting Institutions to the Vitality of Contract Law

The effectiveness of Contract Law turns on far more than the substance of the law itself: the commitment of implementing and supporting institutions is key. Even if the written rules governing Contract Law are sound, courts and other institutions must be willing and able to enforce the law and help prevailing parties secure their remedies. Specifically, courts and judges must be capable of accurately interpreting contracts, impartially judging the performance rendered, and reliably implementing the appropriate remedies. Other legal institutions, such as law schools and professional organizations, must be capable of training and overseeing lawyers who are competent at drafting contracts that satisfy legal requirements.

Thus, a reform program dedicated to improving the enforcement of contracts must necessarily assess and take steps to improve the organizational effectiveness of courts, the capacities of judges, the quality and effectiveness of lawyers, and the supporting institutions of the private sector, among other groups. Where implementing or supporting institutions prove hostile to change, careful effort must be placed into diagnosing interest structures and power relationships that are at the root of the recalcitrance. In many instances, resistance may be based in simple fear of being exposed—perhaps for the eminently forgivable failing of not understanding the new laws, or for the greater problems of incompetence or even corruption. Or the hostility may be directed at outsiders who presume to “reform” their system, however broken it may be. The process of unraveling webs of institutional intractability and engendering trust is slow and often painful, but also necessary to fully understand and act upon an impediment to reform.

*Source: USAID, Commercial Law & Microeconomic Reform: A Practical Guide to Program Implementation 26 (2007)*

## VII. CONCLUSION

Contract law is concerned with the enforcement of promises. Societies can advance and develop on the premise that when a person says that he will do something, it will in fact be done barring some unexpected problems. In the context of small communities, the dynamics of pressure and expectation from other members in the community provide the motivation to perform as promised. However, as the community grows larger to encompass a city, a province,

and even a country, such relationship-based dynamics will be insufficient to govern the performance of all of the promises made. Therefore, a legal system must necessarily:

- ❖ Define the rights and duties of the parties that have entered into a contract;
- ❖ Provide mechanisms for enforcement of the contract; and
- ❖ Prescribe the appropriate remedies for failure to perform.

The ability to create and enforce contracts under a clear, consistent legal framework is a critical component of economic growth. A clear legal framework will have a transformative effect on the marketplace because participants in the marketplace can expect that the law will require their business partners to do what they have said that they will do, be it pay money, deliver goods, or provide services. As a result, the risk of entering into transactions and doing business decreases, lowering the cost of doing business and elevating the potential for making a profit.

## Glossary

### ***Assignment***

The transfer of contractual rights or benefits by a party to the contract to a third party. This does not require the consent of the other party to the contract.

### ***Breach of Contract***

When one party fails to fulfill his obligation under a contract, this constitutes a breach of the contract, for which the law offers a remedy.

### ***Capacity***

The legal power for an individual to enter into an enforceable contract.

### ***Capable Parties***

The law only recognizes enforceable contracts between parties who have the capacity to understand the implications of their actions.

### ***Consideration***

The circumstances or factors that the offeror and the offeree considered when agreeing to the contract, and which motivated the contract.

### ***Gratuitous Promise***

A promise that is not an enforceable contract because it lacks consideration.

### ***Default Rules***

A set of rules that govern whenever a contract is silent about a certain provisions. If a party does not want a contract to be interpreted according to the default rules, they must specifically contract around it in their agreement.

### ***Delegation***

The transfer of contractual obligations or duties by a party to the contract to a third party. Unlike with an assignment, this does require the consent of the other party to the contract.

### ***Detrimental Reliance***

When one party makes a promise and takes sufficient steps to fulfill that performance so that the other party to the promise was justified in acting in reliance on that promise. The law provides a remedy for this, as a contract was created on the basis of this reasonable reliance.

### ***Expectation Damages***

This is the most common basis for calculating monetary relief. The goal of the court in awarding expectation damages is to put the victim of the breach in the position that he would have occupied had the contract been carried out as expected. Therefore, if the victim is being awarded his expectation damages, he is entitled to receive the amount of money necessary to place him, as nearly as possible, in the position that he would have occupied had the contract been performed.

### ***Fungible***

An item is fungible when it is freely interchangeable with another specimen of the same good. For example, a grain of sugar is fungible because it is indistinguishable from another grain of sugar, but a car would not be fungible because it is easily distinguished from another car.

### ***Implied Contract***

A contract that may not have all four requirements of a standard contract but which is inferred by the court for the sake of fairness.

### ***Liquidated Damages***

Because the damages that result from a breach of contract may sometimes be difficult to define, parties to a contract may choose to protect themselves from this uncertainty by including a liquidated damages provision in their contract. With a liquidated damages provision, the parties will agree beforehand as to the value of the remedy that will be paid in the event of breach. Courts will honor a liquidated damages provision as long as they see that the parties made a good-faith effort to base the amount of the liquidated damages on the actual damage that will result from the breach. The court will not enforce a liquidated damage that they view as purely punitive.

### ***Monetary Relief***

A type of remedy granted by the court to the victim of a breach of contract. The calculation of this remedy is based on the monetization of the damage that was incurred by the victim of the breach. This is the most common type of remedy that is granted.

### ***Mutual Consent***

The agreement between the offeror and the offeree to be bound by the terms of the contract as proposed by the offeror.

### ***Remedy***

A remedy is some form of redress offered by the law to compensate the victim of a contractual breach. The general goal of a remedy is to put the victim of the breach in the position that he would have been in had the contract been carried out as expected. Generally, the law offers two types of remedy: monetary relief and specific performance.

### ***Specific Performance***

Specific performance is a type of remedy under which the court will order the party in breach to perform on the contract as agreed upon. This is a rarer type of remedy and is only justified under circumstances where monetary relief would be insufficient to fully compensate the victim of the breach. In those cases, a court may choose to award specific performance as a remedy.

### ***Subjective Intention***

Subjective intention is what a party actually meant to do in a particular situation. This is the opposite of objective intention, where a party's intent is deemed to be what a reasonable person in the position of the other party would understand it to be.

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## CHAPTER 5: CORPORATIONS

### I. INTRODUCTION

Much of Afghanistan's economic activity occurs through the operation of business entities. Businesses are convenient legal entities that can enter into contracts, own property, and participate in the judicial process, usually with the goal of earning a profit for their owners.

Recall our story about Rajibullah from the beginning of the first chapter. Rajibullah wants to open his own brick factory. One of the first questions he faces is how to raise money. Since he does not have enough money himself to start the business, he needs to look to outside investors. Will Rajibullah be personally responsible for the debts and losses incurred by the business? If he is not the sole investor, how are profits and losses divided? Who will manage the day-to-day affairs of the company, deciding what materials to buy, what markets to enter and exit, and what employees to hire? If one of the investors becomes unsatisfied with the performance of the company, can she sell her ownership stake? What happens to the business if Rajibullah dies? Company law tries to answer these questions with many legal rules and standards of conduct, while at the same time trying to give individuals as much flexibility as possible to customize their contractual relationships. As you might imagine, people will answer these questions differently depending on their individual and business needs.

The basic objectives of company laws are (1) to give businesses maximum flexibility to customize their relationships with owners, creditors, suppliers, and customers, with the ultimate aim of promoting innovation and economic growth; and (2) to establish a system of corporate governance that ensures that the managers of the business run the business responsibly, in accordance with the law, and do not pursue their own interests at the expense of the owners. This second objective is important because often the people who have provided the capital and who own the firm are not the same as the people who run the firm's day-to-day operations. Thus, conflicts of interest naturally arise.

This chapter reviews the main statutes that govern business entities. It is important to remember, however, that the statutes are not the only laws that affect companies: companies are also influenced by other bodies of law, such as contract law, tax law, property law, tort law, criminal law, bankruptcy law, and civil procedure. The bulk of the chapter then focuses on the mechanics of how partnerships, corporations, and limited liability companies (LLCs) are created, governed, and dissolved. Since corporations and LLCs rely on non-owners to manage the firm, conflicts of interests between various participants in the firm are particularly problematic. Therefore, we first spend some time discussing agency law and later analyze the legal mechanisms that try to reduce these agency costs.

The company laws addressed in this chapter apply to business entities that are formed under the laws of Afghanistan. Businesses that are formed under the laws of other corporations (for example, a Canadian company that has offices or operations in Afghanistan) need not comply with Afghan legal requirements associated with corporate governance. In reality, many

of the largest companies in Afghanistan are actually incorporated or registered in other countries and are not subject to these laws. Why is this? The strength of corporate governance laws is one major factor that determines where a company will formally register. Afghanistan's new company laws are largely consistent with international best practices, so hopefully new companies doing business in Afghanistan increasingly will choose to incorporate under Afghan law rather than under another country's.

It is also worth noting that statutory provisions of company law only take us so far. The statutory framework cannot anticipate every business circumstance and situation. Gaps in the statutes will arise over time. These gaps are often filled by court-created judicial norms that have the force of law. But it is still early in this process for Afghanistan: most the gaps have yet to be discovered, and even fewer have been resolved by the courts. Then again, this is what makes the present such an exciting time to be a business-oriented lawyer in Afghanistan.

## II. SOURCES OF COMPANY LAW

Several laws govern the affairs of companies in Afghanistan. The key laws are described below.

### Commercial Code of 1955

The Commercial Code of 1955 ("Commercial Code" or "Code") has been the primary source of commercial law in Afghanistan since 1955. The 2004 Constitution provides that laws enacted prior to the Constitution remain in force unless they are explicitly repealed or superseded by a new law. Some parts of the Code have been explicitly superseded by various laws adopted since the 2004, although precisely which provisions have been superseded is not always clear.

The Commercial Code is an old law and must be updated to reflect recent changes in Afghanistan's society, economy, and government. Recognizing this need, the Ministry of Justice in August 2002 authorized an American Bar Association (ABA)-affiliated group to review and suggest revisions to the old company law contained within the Commercial Code. US lawyers working as unpaid volunteers prepared a draft company law to replace the Commercial Code. The new law essentially pulls the company law out of the Commercial Code and breaks it into two new freestanding statutes: a Partnership Law and a Corporations and Limited Liability Companies Law (together referred to as the "company law"). The two laws were signed into force by the legislative decree power of the President in January 2007 and sent to the National Economic Commission of the Wolesi Jirga in March 2007. The National Economic Commission may review the laws, but as of the publication of this textbook, the laws were being enforced as valid.

Although this chapter focuses largely on the new Partnership Law and Corporations and Limited Liability Companies Law, there are some provisions of the Commercial Code that remain valid and are worthy of discussion. Article 2 is a key provision that requires disputes to be resolved "in accordance with legally binding agreements and in their absence disputes are to be determined and settled by reference to the meaning and implication of existing commercial

laws.” In other words, if a legally binding agreement between two parties (a contract) does not resolve a dispute, commercial law should be the first source used to determine the proper outcome. In the event that no relevant commercial law exists, “local and special customs” should be used. The drafters of the Commercial Code noted that preference should be given to local and special custom over general custom because the custom of the locality develops from the history of business transactions in that locality. If a clear custom relating to a dispute in one particular locality does not exist, the custom of the nearest locality should be applied.

What is the scope of the Commercial Code? In other words, to what transactions, dealings, or interactions between people does the Commercial Code apply? The scope of the Commercial Code can be found in Articles 14-23. For example, Articles 18 and 19 provide a list of transactions that qualify as commercial transactions. Such transactions include: agreements to provide movable property; establishment of several types of businesses; transportation of goods and people; and the provision of services.

If for nothing other than historical value, you should familiarize yourself with the Commercial Code, particularly Articles 24-39 (business registration), Articles 40-54 (business title), and Articles 65-84 (commercial books). Articles 116-470 address partnerships, corporations, and limited liability companies (LLCs) and most have been superseded by the new Partnership Law and Corporations and Limited Liability Companies Law.

#### *Partnership Law and Corporations and Limited Liability Companies Law (2007)*

The Partnership Law and Corporations and Limited Liability Companies Law were signed into force in 2007 and now constitute the bulk of Afghanistan’s company law. The provisions of these statutes are discussed in detail in Sections V and VI.

#### *Investment Law (2005)*

The Law on Private Investment in Afghanistan (the Investment Law) was enacted based on Article 10 of the 2004 Constitution. Article 10 states that the legal system of Afghanistan should allow a free market economy to develop and should encourage and protect investments and private businesses. As stated in its text, the purpose of the Investment Law is to:

maximize the role of private investment, both domestic and foreign, in the economy, to create a legal regime and administrative structure that will encourage and protect foreign and domestic private Investment in the economy of Afghanistan in order to promote economic development, expand the labor market, increase production and export earnings, promote technology transfer, improve national prosperity and advance the people’s standard of living.

Thus, the central goal of the law is economic growth through private investment. In order to achieve this goal, the law establishes a system that will create favorable conditions for both foreign and domestic investments.

To do this, the Investment Law specifies the means by which investment may be

regulated. It outlines areas where investment may be prohibited or restricted, and sets out the way in which investment will be administered and monitored. The Investment Law provides that the High Commission on Investment (the Commission) is the government authority with responsibility for implementation of the Investment Law.

One of the key requirements of the law is that investors must register their businesses in order to operate in Afghanistan. This requirement is critical to the goals of the Investment Law since overly onerous or complicated registration requirements could deter the investment that the law seeks to attract (see Section VII for further discussion).

In order to register, an enterprise must be recognized by the government of Afghanistan in accordance with the Investment Law's provisions. Registered enterprises may be organized under the laws of Afghanistan or under the laws of another country, but the business must still be registered with the government of Afghanistan. This is beneficial to foreign businesses since they are not required to formally organize under Afghan law; they are only required to register. Registered enterprises in Afghanistan may be completely owned by investors or may be a joint venture between investors and the Government of Afghanistan. Therefore, the law allows investors to choose to operate independently or as a partner with the government, depending on which structure best serves their business interests.

A second key provision of the Investment Law is that registered businesses and foreign investors have important rights and responsibilities when they make an investment in Afghanistan. The responsibilities of investors include paying income tax and customs duties on any *capital* or profits associated with the investment. The rights of an investor include compensation for any government expropriation (by which the government assumes control and ownership of the business) of the investment. Investors also have the ability to specify in their contracts whether and where the business will be subject to arbitration or alternative dispute resolution. As noted in the contract law chapter, the contract may also specify that the laws of a jurisdiction other than Afghanistan may govern the contract and be used to resolve any disputes. These dispute resolution rights are particularly important to encourage investment since investors, particularly foreign investors, are able to choose the forum that will most likely protect their interests. There is thus less danger that they will be forced to resolve their disputes in a forum that is biased against their interests. With such protections, investors are likely to find Afghanistan to be a more attractive investment destination.

### **III. LAW OF AGENCY**

#### **A. Introduction to Agency Costs and Agency Law**

When a company becomes larger, perhaps operating several offices across the country or even around the world, owners cannot rely on family connections to manage their businesses. For example, Rajibullah decides to open two additional brick factories in Herat and Kandahar, but he does not have any relatives, friends, or other trustworthy contacts in those two cities that can run the factories and protect his investment. Thus, he needs to hire a local manager to run

each factory. In this scenario, Rajibullah is a **principal**, and the manager he hires to act on his behalf is an **agent**.

But what happens when the interests of the local manager and Rajibullah diverge? For example, what prevents the manager from employing his brother rather than another person who is more qualified and would be more valuable to the company? This divergence of interests can create costs for Rajibullah, which are called **agency costs**. More precisely, an agency cost is any cost—explicit or implicit—associated with an agent’s exercise of discretion over property owned by a principal.

Agency law is an important concept for social and business organizations. Agency law is designed to facilitate production and commerce by enabling some individuals (agents) to conduct transactions (enter contracts) with third parties on behalf of other individuals (principals). Agency law tries to minimize agency costs by defining the scope of an agent’s authorized activity and what the agent can and cannot do on behalf of the principal. Agency law also defines when a principal is required to take responsibility for the actions of his agent, which in turn makes third parties more willing to interact, contract, and conduct business with the agent.

The Commercial Code of 1955 includes a section on agency law, and the proposed Contracts Law is expected to include a new agency law. This subsection explores the basic concepts of agency law, specifically how agency law addresses the potential conflicts between principals, agents, and third parties. Much of this theory can be found in the Second and Third Restatements of Agency Law, published by the American Law Institute.

## **B. Agency Formation and Agent Duties**

The Third Restatement of Agency Law defines agency as “the fiduciary relationship that arises when one person (a “principal”) manifests assent to another person (an “agent”) that the agent shall act on the principal's behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.”<sup>11</sup> In other words, a principal and an agent both voluntarily agree that an agent will act on behalf of the principal, and the actions of an agent will bind the principal as long as the agent acted within the scope of his authority.

A **fiduciary** relationship is created when two people enter into an agency relationship. The agent is a fiduciary of the principal. A fiduciary is someone who must “act loyally for the principal’s benefit in all matters connected with the agency relationship” (Third Restatement of Agency Law § 8.01). This includes a duty to account for profits arising from the agent’s employment, a duty to deal fairly with the principal in all transactions, a duty not to act on behalf of an opposing party without the principal’s consent, and a duty not to compete with the principal on matters related to the agency. In addition to the fiduciary relationship, the agent owes the principal whatever other duties are specified in the agency agreement.

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<sup>11</sup> Restatement of the Law, Third, Agency. American Law Institute (2006) §1.01.

**Illustration:** Rajibullah has an employee in his brick factory who is responsible for buying the clay that is used to make the bricks. This employee is an agent for Rajibullah. The agent's brother happens to sell clay, but the price the brother charges is twice the price charged by other suppliers. Although the agent might be fulfilling the principal's need for cement by purchasing the clay from his own brother, the agent would not be acting in the interest of the principal, since he could have obtained the clay for a much lower price from another supplier. By putting his loyalty to his brother above his duty to act in the interest of Rajibullah, the agent is violating his fiduciary duty to his principal.

Note that all relationships where one person provides services to another person do not necessarily satisfy the definition of agency. In order to qualify as an agency relationship, three parties are actually involved: the principal, the agent, and a third party with whom the agent is to deal.<sup>12</sup> Therefore, agency involves the agent's authority to act on behalf of the principal *in dealing with other third parties*.

### C. Liability of the Principal to Third Parties

When is a principal responsible for his agent's conduct toward a third party? Under the Third Restatement of Agency Law, in voluntary (i.e. contractual) dealings, **liability** depends on whether the agent acted within the scope of his authority as an agent. If the agent acted within the scope of his authority, the principal will be liable for contracts (including the purchase or sale of goods) entered into by the agent. There are two types of authority to act on behalf of the principal: **actual authority** and **apparent authority**. Actual authority exists when the principal grants the agent the power to conduct a particular transaction. The principal is liable for the obligations created by the agent on his behalf because he has explicitly given the agent the power to act on his behalf. Apparent authority is created when the agent does not have explicit authority to conduct a transaction, but the actions of the *principal* lead the third party to the transaction to *reasonably* believe that the agent was authorized.

**Illustration:** Rajibullah provides his employee (the agent) with a uniform and a vehicle, and frequently allows him to enter into contracts to sell bricks to customers. One day, Rajibullah tells his employee that he is not to make any more contracts with a particular customer, Amir. However, the employee disobeys Rajibullah's instructions and enters a contract with Amir anyway (perhaps because he forgot Rajibullah's instructions or because he is friends with Amir). Since the employee was wearing the company uniform and driving the company's truck, and since Amir did not hear Rajibullah tell his employee not to enter into the contract, the employee acted with apparent authority to enter the contract with Amir, and Rajibullah would be responsible for fulfilling that contract.

However, just as you would be liable to the third party for the contract, your employee would be liable to you for breaching his **fiduciary duty** as your agent. If you lost money due to your agent's unauthorized contract, you could try to recover those losses from your agent. Apparent authority is an important and useful concept: by making third parties confident that a

<sup>12</sup> Floyd R. Mechem, A Treatise on the Law of Agency § 27 (2d ed. 1914).

principal will not simply walk out on a contract entered into by his agent, third parties are more likely to conduct business with those agents, which in the aggregate encourages more economic activity. It also creates incentives for principals to give clear guidance to their agents and to monitor their agents closely.

#### **Agency Under the Commercial Code of 1955**

Since the Commercial Code addresses agency, it remains the current legal authority until the new Agency Law is approved. The Code addresses agency law in Articles 85-97 and Articles 760-820, which you should read.

Agency law under the Commercial Code varies somewhat from the basic agency theory that has been described above. In general, the Commercial Code requires more formal steps be taken to establish agency relationships. For instance, in order to be considered an “explicit agent” under Article 88 of the Commercial Code (similar to the concept of actual authority described above), the agent relationship must be registered. If the agent relationship is not registered, it is considered an “undisclosed agent relationship.” In these cases, the rights of the agent with respect to his representation of the principal are unlimited and “includes all transactions that can be made during that specific business.”

#### **IV. OVERVIEW OF BUSINESS FORMS**

When an investor decides to start a new business, she must decide how the business will be owned. In other words, what legal form will the business take? In Afghanistan, investors can choose among different business forms depending on their business needs. Afghanistan law recognizes several different business forms, each with its own attributes. Investors can choose a business form whose attributes best facilitate their objectives and can customize that business form even further to accommodate unique needs. Most of the key attributes are discussed in this chapter.

Many businesses are owned by a single person. This type of business is called a **sole proprietorship**. The single owner receives all of the profits and is personally liable for all of the **debts** of the business. If the owner wants to sell or transfer their ownership interest but continue the business, they can sell the entire business to another party.

A business that is owned by two or more people can register as a **partnership**. There are two main types of partnerships. If the owners share the profits and each is responsible for all of the debts and losses of the business, the business is called a **general partnership**, and the owners are called general partners. If some of the partners have limited liability for debts and losses, the partnership is called a **special (or limited) partnership**. In special partnerships, the partnership is legally separate from the individual partners, which caps each partner’s responsibility for the partnership’s debt at an amount equal to their investment in the partnership. Generally, however, at least one partner in a partnership must be fully liable for the debts of the partnership. The partners that have limited liability are called special (or limited) partners and the partner that has

full liability is called a general partner. Section V of this chapter examines the partnership form in greater detail.

A **corporation** is a third form of business organization and like the partnership involves multiple owners. The Corporations and Limited Liability Companies Law of Afghanistan defines a corporation as a “business company whose capital is definite and divided into **shares**, with the share and responsibility of each **shareholder** limited to the proportion of his share.” Corporations are treated as separate legal entities from their owners. Multiple people may own a portion of the corporation. These portions of ownership in the corporation are usually called shares or stock. A corporation may sell its stock to investors, which allows the corporation to raise money to start the business or to invest in its operation or expansion. Individual owners of stock may also sell or transfer their stock if they choose. As with a limited partnership, owners of corporations have limited liability for the corporation’s debts. In the event the business fails, investors will only lose the value of the stock that they purchased. Corporations have a more rigid and centralized management structure that coordinates the company’s activities and is accountable to the owners, or stockholders. Section VI of this chapter examines the corporate form in greater detail.

A **limited liability company (LLC)** is similar to a corporation, but it also has some traits similar to a limited partnership. Like a corporation, the owners of LLCs have limited liability for the corporation’s debts. However, ownership interests are not divided into shares as in corporations, so the liability of each shareholder is instead capped at an amount agreed to by that shareholder. Limited liability is also the key difference between an LLC and a partnership. In contrast to a corporation, an LLC cannot have less than two or more than 50 owners, its shares cannot be traded on a public exchange, and shareholders are not authorized to sell, transfer or exchange the company. The LLC form is usually considered the best business form for small businesses with a small number of owners, which are the majority of businesses in Afghanistan.

The following chart summarizes the attributes of the four business forms just discussed.

Business Form	Individual liability?	Easy transfer of ownership?	Easy continuity of existence?	Centralized management structure?	Registration with government required?
Sole proprietorship	Yes	Yes	Yes	No	No
Partnership	Yes	No	No	No	Yes
Corporation	No	Yes	Yes	Yes	Yes
LLC	No	No	Yes	Yes	Yes

### Discussion Question

Summarize for yourself the differences between sole proprietorships, partnerships, corporations, and limited liability corporations. For each of these business forms, can you think of a business idea that would be a good fit?

## V. PARTNERSHIP LAW

Partnerships are governed by the Partnership Law of Afghanistan of 2007 (“Partnership Law”). A partnership is “an association of two or more persons to carry on business for profit as co-owners, as governed by the Partnership Agreement” (Article 2 of Partnership Law). This section reviews how partnerships are formed, discusses the rights and obligations of partners, and explains what happens when the partnership terminates.

### A. Partnership Formation

The partnership is the simplest form of a joint ownership. Why would two or more parties choose to form a partnership and therefore be forced to work together, inviting conflict over business policies and the division of profits? After all, these may be substantial costs. There are several reasons. One reason is to raise capital. One person may have an innovative and potentially lucrative idea for a business but may not have enough cash (or other necessary **assets**, such as property) to start the business. Or perhaps that individual has the capital but does not want to put all of his money at risk. This individual may bring in a partner that can provide the necessary capital to start the business. But why not simply borrow the money from a traditional lender and avoid the costs of joint ownership? Selling an ownership stake may be a cheaper way to raise capital than borrowing funds from a bank. In other words, the costs associated with the loan—such as increased risk of bankruptcy, high interest payments, and agency costs (the recipient of the loan would have an incentive to engage in risky activities since the recipient enjoys the gains from those risks but does not bear the losses from those risks)—may exceed the costs of joint ownership.

A second reason to form a partnership is to obtain an asset other than capital, such as a unique set of skills, services, processes, clients, or **goodwill** within the community. Although these assets can be difficult to value, they often can make a business more successful and profitable. For a simple example, we need not look further than the legal profession itself. Two individual lawyers may have different areas of legal expertise (for example commercial and criminal law), but together the two lawyers could offer a more comprehensive set of legal services and reach a larger client base than each lawyer could alone. See Article 7 for a complete list of capital that partners may contribute to a partnership.<sup>13</sup>

**Illustration:** Rajibullah has an acquaintance, Haroon, who has lots of money and is searching for a good investment opportunity. Rajibullah has another acquaintance, Khatera, who used to run a brick factory that was very well respected in the community. Rajibullah may try to bring one or both of these acquaintances into his brick business as partners, since one could provide money and the other could provide goodwill and customers.

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<sup>13</sup> Note that there are some restrictions on what types of capital special partners are permitted to contribute (Article 149).

But why not simply enter a contract with an individual that has one of these assets rather than giving them an ownership stake in the business? In some situations, it may be wiser to contract for the services. In other situations, however, the costs of contracting for the service may exceed the costs of joint ownership. For example, a person who is a joint owner may work harder than if he was merely subject to a fixed-fee contract, since as a joint owner he enjoys a percentage of all profits resulting from his efforts. Just as with capital, one should weigh the costs of joint ownership against the costs of contracting for the asset.

### **Discussion Question**

Review the list of “capital contributions” in Article 7 of the Partnership Law in your Document Supplement. Can you identify why an individual may want to pursue joint ownership with a partner that possesses each of the listed items?

The Partnership Law distinguishes between four types of partnerships: General Partnerships, Special Partnerships, Work Partnerships, and Credit Partnerships (Articles 21-24). The definition of each of these partnership types is excerpted below. Further, where important differences exist, they are noted in the following subsections.

#### **ARTICLE 21: General Partnership**

A “General Partnership” is one that is established for the purpose of carrying out economic or business transactions between two or among more persons with collective responsibility. If the capital of the General Partnership is not sufficient to pay the debts of the General Partnership each of the Partners is responsible to pay all the debts of the General Partnership and the Partner, or Partners, paying such debts shall be entitled to receive contributions from the other Partners.

#### **ARTICLE 22: Special Partnership**

A “Special Partnership is a Partnership established under a specified title in accordance with the provisions of this Law for the purpose of carrying out economic and business transactions, in which one or more Partners have unlimited liability (General Partners) and the rest of the Partners have limited liability with a definite capital (Special Partners). The capital of the Partners with limited liability can be divided into shares.

#### **ARTICLE 23: Work Partnership**

A “Work Partnership” is an association of two or more persons who perform work or fulfill an obligation for another person. The profits of the work of the Partnership shall be distributed between them as agreed by the Partners.

#### **ARTICLE 24: Credit Partnership**

A “Credit Partnership” is a company in which two or more persons agree to buy goods on credit to sell them and to share the profits and losses of the Credit Partnership. Each of the Partners shall be responsible for his specific part.

The document that governs a partnership is its Partnership Agreement. A Partnership Agreement can be written or oral according to Article 4 of the Partnership Law,<sup>14</sup> but a written agreement is required for general and special partnerships (see Article 61). A written Partnership Agreement must specify, among other things, the names of the partners, their capital contributions, and their shares of the profits and losses (Article 25). The Partnership Agreement, together with the Partnership Law, governs the partnership, relations among partners, and responsibilities to third parties. Note that many of the provisions in the Partnership Law are default rules that may be superseded by an agreement between the parties. In other words, default provisions (usually including a clause such as “unless otherwise specified”) govern when the Partnership Agreement is silent on the issue, but the parties are free to agree otherwise.

As described in Article 20, a partnership’s legal existence begins when it is recorded in the Central Business Registry at the Ministry of Commerce and Industry. However, if a partnership enters a transaction before registration is complete, it will still be held liable for any obligations, although it will be unable to enforce any rights against third parties. Thus, it is important to register before commencing any business activity! In addition, Article 63 requires any changes to the “title, business location, authorized signing Partners, withdrawal or inclusion of Partners, increase or decrease of Partnership capital, dissolution of the General Partnership before, or continuing beyond the specified period, or amalgamation with another company, must be put in a statement signed by all Partners” and must be registered.

Partnerships may exist for a definite term or an indefinite period. If duration is not specified in the Partnership Agreement, the partnership is considered to have an indefinite duration (Article 26).

## **B. Partnership Rights and Obligations**

In return for his or her contribution of capital, each partner becomes a partial owner of the business. Each partner’s interest in the business is called an ownership share. An ownership share carries certain rights and obligations.

### *Profits and Losses*

As joint owners, each partner is entitled to a share of the profits from the business. The capital that each partner contributes to the partnership is transferred to the partnership and is owned by the partnership (see Article 10). In Afghanistan, the default rule is that partners receive profits and bear losses in proportion to their capital contribution (see Article 15). Thus, if the partnership agreement values Rajibullah’s capital contribution to the partnership at 30 percent, Rajibullah will be entitled to 30 percent of the partnership’s profits, and must pay 30 percent of the partnership’s losses. Of course, this is a default rule, and the parties are free to assign different profit percentages to each partner or to stipulate that all partners will share equally in the profits. The same is true for losses sustained by the partnership. Note that the default rule in Afghanistan may be different from other jurisdictions. In the United States for example, the

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<sup>14</sup> Thus, even though two parties have not entered into a formal written agreement, a court may conclude that a partnership exists if it believes that oral representations or statements between the parties created a partnership.

default rule is that partners will share equally in profits and losses once capital contributions are repaid.

### Liability for Partnership Debts

The partnership is a legal entity and thus may own assets, enter contracts, and hold title to property. Partnerships are valuable because they provide a segregated pool of assets available to secure business debts. Making a separate pool of assets available encourages **creditors** to make loans to the partnership since they are more confident about repayment. These loans, in turn, allow the partnership to carry out its business activities. In the event the partnership defaults on a loan, the creditors can seek repayment from the segregated pool of assets owned by the partnership, as opposed to sharing the assets of the individual partners with other creditors of that individual. When it comes to the assets of the partnership, creditors of the partnership have priority over creditors of individual partners (Article 85).

But what happens when the partnership has insufficient assets to pay its debts? The rules are different for general and special partnerships (see Articles 22-24). In a general partnership, all of the partners are general partners, and each partner is individually liable for all debts of the partnership. This means that a general partner must pay off the debt with her own personal assets (see Articles 86 and 134).<sup>15</sup> However, the general partner that pays the partnership's debt can seek reimbursement from the other general partners. In a special partnership, the general partner(s) will likewise be individually liable for the entire debt of the partnership, but the liability of special partners will be limited to the amount specified in the Partnership Agreement. For all partnerships, if a partner is herself **insolvent** (bankrupt), her portion of the debts will be divided proportionately among the remaining partners (Article 48). The partners cannot enter an agreement that says they are not individually liable for the debts of the partnership (Article 47).

**Illustration:** Rajibullah, Haroon, and Khatera have formed a general partnership to operate a brick factory. The partnership borrows 1,000,000 Afghanis from a bank in the form of a loan. The loan must be repaid at the end of the year. This factory has a bad year, however, and does not make any profits. Regardless, the partnership must still pay back the debt. The company's only assets are the factory itself, which is worth 700,000 Afghanis. The partnership can sell the factory and use the money to pay back the loan, but it will still owe 300,000 Afghanis. Since the partnership's assets are insufficient, the bank could go after each of the general partner's personal assets. The bank could seize Rajibullah's house and cars, which are worth 300,000 Afghanis. Rajibullah could then seek contribution from Haroon and Khatera. If each partner's capital contribution was 33 percent, Rajibullah could seek 100,00 Afghanis each from Haroon and Khatera.

What happens when an individual partner has a *personal* debt that she is unable to satisfy with her personal assets? The creditor may demand the partner's proportion of the profits from the partnership. However, the partner's proportion of the profits is to be distinguished from the

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<sup>15</sup> Article 171 indicates that partnership creditors and individual creditors have equal rights to the assets of the individual partner.

partner's ownership interest in the partnership, which is immune from the individual creditor (Article 49).

Note, however, that if the partnership suffers a loss due to an individual partner's negligence, the negligent partner is solely responsible for that loss. Yet, this is only a default rule, and the partners can agree to jointly pay for the loss (Article 12).

### Decision-Making and Control

One problem that arises with partnerships is the potential for agency conflicts between partners as joint owners since each partner can enter contracts on behalf of the partnership and thus bind the other partners. Should the law place any limits on the power to enter contracts and incur liability on behalf of the partnership? How should decision-making power, or control, be allocated?

Article 40 requires that the partners designate at least one partner or other individual to "administer the affairs of the Partnership." This person is called a manager. Beyond this, however, the Partnership Law provides substantial freedom for the partners to allocate decision-making authority. For example, the Partnership Agreement can (but does not have to) require certain decisions to be approved by a majority of the partners. If the Partnership Agreement requires a majority vote, the Partnership Agreement may stipulate whether each partner has an equal vote or whether votes are based on each partner's share of the partnership (see Article 43). If the Partnership Agreement is silent on this point, each partner will have an equal vote. Finally, Article 44 even permits the Partnership Agreement to exclude partners from the management of the partnership.

In a general partnership, if the Partnership Agreement is silent on how decisions are to be made, Article 69 applies. Article 69 grants the manager(s) of the partnership with the power to make decisions concerning the day-to-day administration of the partnership. Unusual matters—such as the price of a product or service or the transfer of the partnership's assets—must be decided by a majority vote of the partners. The manager must make decisions with the same degree of care as they would their own business affairs. Similarly, any agent that acts on behalf of the partnership must act in "good faith and honesty" (Article 81). Recall our early discussion of agency law. Why would the law include these standards of care? It ensures that managers will not pursue their own interests at the expense of the firm.

In a special partnership, the special partners share in the profits of the partnership without incurring personal liability for business debts. In exchange for limited liability, special partners sacrifice control over the administrative affairs of the partnership. Exclusion from control can be thought of as the cost of limited liability. Special partners can, however, vote on unusual matters and review the partnership's financial records (see Articles 158 and 159). The general partner in a special partnership is treated like a general partner in a general partnership and thus faces unlimited liability for the actions of the partnership. The general partner also has control over the administrative affairs, or day-to-day operations, of the partnership and the power to represent the firm in dealings with third parties. However, under Article 167, the general partner has the option to delegate responsibilities for certain transactions to a special partner.

### Discussion Questions

How are partnerships managed? Does this management structure seem efficient? What problems do you foresee?

The prospect of being tied down by the decision of one's partners might make the partnership business form unattractive to many individuals. To compensate, partnership law makes it easy for partners to exit the partnership. Thus, if a partner disagrees with the direction, policies, or business decisions of the partnership, they can exit the business and receive compensation for their ownership interest. It is to this topic that we now turn.

#### C. Partnership Dissolution and Liquidation

The Partnership Law makes the dissolution of a partnership easy. This subsection describes the rules that apply generally to all types of partnerships (general, special, work, and credit) and highlights special rules that apply to general and special partnerships.

##### Dissolution

Article 50 of the Partnership Law lists eight situations that *may* trigger the dissolution of a partnership. Not all of them, however, *must* trigger a dissolution.

#### **ARTICLE 50: Dissolution of the Partnership**

A Partnership shall be dissolved in one of the following cases:

1. Expiration of the period set in the Partnership Agreement;
2. Realization of the objective for the achievement of which the Partnership has been established;
3. Elimination of the whole or most part of the capital of the Partnership as no profit is envisaged to continue with its activity;
4. The death of one of the Partners, or when a Partner is ordered by the Court to be dispossessed, or when a Partner is registered as bankrupt;
5. Withdrawal of one of the Partners from the Partnership when the period of the activity of the Partnership is unlimited, provided that the Partner declares such Partner's intention of withdrawal to other Partners three months in advance. Otherwise, such Partner's withdrawal would be deemed arising from dishonesty or it would be considered inappropriate, unless agreement is made to the contrary;
6. Agreement of the Partners to dissolve the Partnership;
7. Dissolution of the Partnership by Court order; [or]
8. An adjudication of the bankruptcy of the Partnership by the Court, or by agreement of the Partners and creditors of the Partnership to bankrupt the Partnership.

The fifth situation is particularly powerful. It applies only to partnerships of *unlimited* duration and gives any partner the right to withdraw from the partnership for *any* reason, even if

the other seven situations do not apply. In other words, as soon as a partnership of unlimited duration ceases to serve the interests of a partner, that partner may request dissolution. In general and special partnerships, the withdrawing partner must provide notice six months before the end of the fiscal year (see Article 93), and the remaining partners can choose to continue the partnership (see Articles 97 and 101). Unless otherwise provided for in the Partnership Agreement, the withdrawing partner in a general partnership will be paid out in cash for their interest in the partnership *when the firm dissolves*.

However, for partnerships of a fixed duration, partners do not enjoy the same freedom to force a dissolution. A partner cannot force a dissolution for *any* reason; if one of the other seven situations does not apply, a partner can force a dissolution only by obtaining a court order (see Article 53 for general rules and Articles 94 and 102 for rules governing general and special partnerships). Can you think of any reasons why the law should treat partnership of unlimited duration differently from partnership of fixed term?

### **Discussion Questions**

Why is the ability to exit a partnership so important? Do you think the law makes it easy enough? Too easy?

### Liquidation

Once a partnership has been dissolved, what happens to the partnership's assets? In general, the assets will be *liquidated* (sold) and the proceeds from the sale will be *distributed* to the partners according to the terms of the Partnership Agreement. Thus, the partners themselves can plan for liquidation and distribution and decide how any surplus money will be allocated. Articles 55-59 provide the general rules for liquidation and distribution, and Articles 114-146 provide the specific rules that govern general and special partnerships.

Liquidation and distribution generally proceeds as follows: First the partners or the court will appoint a party to sell all of the partnership assets. Second, the proceeds from the liquidation will be used to settle any partnership debts. Third, any surplus will be divided among the partners. If the Partnership Agreement has not specified how the surplus should be allocated among the partners, each partner will receive a share that is proportional to their ownership percentage. However, if the proceeds from the liquidation are insufficient to pay all partnership debts, the partners must cover the remainder, as discussed earlier.

The priorities that determine the order in which the partnership's assets are distributed are important because they inform the various participants of the company (for example, creditors and owners) where their claims on the company's assets rank relative to one another. They can therefore set their expectations and manage their risk accordingly, making them more willing to do business with the partnership in the first place.

### Discussion Questions

After dissolution of a partnership, an alternative to liquidating (selling) the assets and distributing the money is distributing the assets directly to the partners. This is called “distribution in kind.” For example, if the asset is real property (for example, the business’s office), each partner would receive a portion of the property rather than a portion of the money that was received through the sale of the property. What are the advantages and disadvantages of each rule? Consider which rule more accurately establishes the market value of the asset, which rule better protects creditors of the partnership, and whether dividing up real or personal property into parts reduces the total value of the property.

## VI. CORPORATION AND LLC LAW

The corporation is the most commonly used business form in the world, and the limited liability company (LLC) is probably the most common business form in Afghanistan. In Afghanistan, one law—the Corporations and Limited Liability Companies Law—governs both of these business forms. Two questions naturally arise:

1. How do these business forms differ from a partnership?
2. How does a corporation differ from an LLC?

As you may have understood from our earlier discussion, partnerships are advantageous because they are simple, inexpensive to establish, subject to fewer government regulations, and permit flexible management structures. But they also possess many drawbacks: the firm is unstable over the long term given that a partner’s death or departure can disrupt the operations of the firm and even force a dissolution; individuals that contribute capital are personally liable for the firm’s debts; investments cannot be easily withdrawn, making it difficult for investors to cash out their interests in the partnership short of dissolving the partnership; and direct involvement by the partners in the management of the firm can be complex and inefficient. As we will see in this section, the corporation and the LLC try to respond to each of these four drawbacks.

A few key differences distinguish a corporation and an LLC. The main differences are that LLCs cannot sell shares to the public, an LLC can have no more than 50 shareholders, and LLC shareholders do not have the power to sell the company should they so desire (see Article 3). Another difference is that a corporation’s capital is divided into shares, with each shareholder’s liability limited to the amount of her shares, whereas an LLC’s capital is not divided into shares, and each shareholder is liable for whatever amount she has agreed to. In practice, this means that the corporation is a preferred choice for a company that wants to raise large amounts of capital from the public.

This section reviews the four main elements that characterize corporations and LLCs. In so doing, it explains the laws associated with the creation and governance of a corporation and LLC. The section then goes on to explain how the law tries to reduce agency costs between shareholders and the managers of the company. The section concludes with a brief discussion of

how corporations and LLCs are dissolved. The term “corporation” as used in the remainder of this chapter refers to both corporations and LLCs, unless otherwise specified.

### **A. Elements of the Corporate Form**

What makes the corporate form the most popular business form in the world? For the most part, corporations around the world share several characteristics: (1) they are considered separate legal persons with an indefinite life; (2) investors enjoy limited liability; (3) shares or stock in the company are freely transferable between parties in most circumstances; and (4) the company is centrally managed by a board of directors elected by the shareholders. We will examine each of these characteristics in turn. These characteristics create several advantages over a partnership: ownership shares can be transferred without disrupting the business, making the business more stable over a long-term period; investors have limited liability for the company’s debts; it is easier for individual investors to cash out their investment; and management can be centralized, specialized, and more efficient.

#### *Separate Legal Entity*

A corporation or LLC is a separate legal person under the law with an indefinite life. This is a critical distinction that supports all of the characteristics of a corporation that we have discussed above. Consider the following excerpt.

#### **Advantages of a Separate Legal Entity**

*Source: William Allen & Reinier Kraakman, Commentaries and Cases on the Law of Business Organization (2003)*

Consider, for example, the simple act of acquiring a plot of ground. As a buyer, the corporation, acting through its authorized agents, may sign binding contracts, close sales, and so take title in its own name. Thereafter, it may deal with the acquired property as its board of directors deems expedient. Because its principal investors need not execute the transaction or even agree to it, the information and coordination costs of closing the transaction are minimal. Consider, too, the way in which a corporation’s ability to own assets as a legal entity enables it to enter into contracts, such as bank loans. Creditors need to know what stands behind a company’s promise to pay interest and principal. Enabling corporations to own assets—including businesses—delimits the pool of assets upon which corporate creditors can rely for repayment. If there were no separate corporate entity, a large creditor would be forced to investigate the asset holdings and creditworthiness of all the joint venturers—i.e., the company’s shareholders—on the loan. Thus, the doctrinal fiction of an artificial entity vastly reduces the costs of contracting for credit. In addition to economizing on the monitoring costs of creditors, the status of the corporation as a fictive legal entity allows it to have an indefinite “life.” This enhances the stability of the corporate form. Even without complex drafting, the death or departure of a principal need not disturb the operation of a corporation, as it would a partnership.

From a different perspective, it is also possible to view a corporation as merely a combination of many contracts. In other words, the corporation serves as “a single contracting

party that coordinates the activities of suppliers of inputs and of consumers of products and services.”<sup>16</sup> So this “fiction” that the corporation is a legal person facilitates and centralizes many complex contracts between investors, lenders, suppliers, customers, the government, and the public in general.

Just as the Partnership Agreement is the foundational document of a partnership, the Articles of Incorporation is the constitutional document of a corporation or LLC. A corporation’s legal existence begins when its Articles of Incorporation are signed by the founders of the company (the incorporators) and registered with the Central Business Registry. The Articles of Incorporation must include the name of the corporation, the name and address of each incorporator and initial director, the address of its registered office in Afghanistan, the number of shares the company is authorized to issue, and the duration of the corporation if it is anything other than indefinite (Article 21). The Articles of Incorporation can be amended, and the amendment process is discussed later.

### *Centralized Corporate Governance*

Beyond these minimal requirements, the Articles of Incorporation establish how the company will govern its affairs. The incorporators or the board of directors may also enact bylaws, which are additional rules for governing the company, as long as those bylaws do not conflict with the laws of Afghanistan or the company’s Articles of Incorporation (Article 25). Bylaws give companies substantial freedom to decide how the company will be governed. The delineation of the rights and responsibilities of the company’s various participants—including its boards, managers, shareholders, and other stakeholders—and the rules and procedures for making company decisions is called *corporate governance*. Corporate governance determines how companies will set and achieve objectives and how performance will be monitored. Good governance principles are also important because companies are more willing to take risks, invest in the Afghan economy, and interact with other companies if they believe those other companies have clear rules governing their conduct and third-party interactions.

### *Board of Directors*

One of the challenges that arises when you have multiple owners of a firm is how to structure decision-making and corporate governance in a way that minimizes agency costs and avoids inefficiencies that harm the organization. It would be inefficient and impractical to assemble the entire body of shareholders to vote on every decision—a large company may be faced with hundreds of such decisions each day. To improve efficiency, the law mandates that shareholders in corporations and LLCs elect a central body, called a “board of directors,” to “direct and regulate the affairs” of the company (Article 33). However, there is a tension between efficiency and placing too much authority in the hands of managers who may have different economic interests than the shareholders. Subsection B, below, addresses how the law tries to ensure that directors make decisions that are in the best interests of the shareholders.

Although partnerships must appoint a partner or other individual to perform a similar managerial role, corporations as a general rule concentrate more power in centralized

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<sup>16</sup> REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW* (2004).

management than do partnerships. To begin, let us review some basic rules concerning the board of directors. If you are ever in the position of creating a board of directors or advising someone on a board of directors, keep in mind the following items:

### **Checklist: Board of Directors**

**Selection process.** Directors must be elected by the shareholders.

**Number of directors.** The number may be set in the Articles of Incorporation or Bylaws, but the board must contain at least one director (Article 34).

**Eligibility.** Any person can serve as a director unless she is younger than 18 or has ever been deprived of her civil rights by a court.

**Term length.** The shareholders are free to determine the length of directorship terms, but they cannot exceed three years (Article 36).

**Removal.** Shareholders can remove a director by voting her out of office when she is up for reelection or by voting her out of office at a special shareholder meeting called for that purpose (Article 38). This right means that if enough shareholders are displeased with the performance of any single director, they retain the power, as principals, to remove that director from office. As we will discover later, this can be a powerful check on director misbehavior and agency costs. Directors may be removed with or without cause (i.e. with or without any reason relating to their performance), unless the Articles of Incorporation or Bylaws state otherwise. This means that a corporation is free to require that the shareholders show cause when dismissing a director.

**Vacant positions.** See Articles 36 and 40.

Once the board is created, it can take action on behalf of the company in one of two ways: (1) by holding a board meeting in which the action is approved by the requisite number of directors specified in the Articles of Incorporation or Bylaws, or (2) by the unanimous written consent of all of the directors (Articles 43 and 45). To take an action at a meeting, at least a majority of the directors must be present (Article 45). This minimum attendance level is called a “quorum.” The board can also form smaller committees of directors and delegate certain board responsibilities to those committees (Article 46). However, the board cannot delegate the following responsibilities: performing functions related to the shareholders, filling a vacancy on the board or a board committee, proposing an amendment to the Articles of Incorporation or Bylaws, or approving a merger or dissolution of the corporation. Why do you think the law requires that these responsibilities be fulfilled by the full board and not a committee of directors?

Although directors are responsible for “directing and regulating the affairs” of the company, the day-to-day operations of the company are usually managed by the officers of the company. These officers are appointed by the directors unless the Articles of Incorporation or Bylaws state otherwise (Article 57). Officers are often selected because they have special competence or expertise in the field. Note that an individual can serve as both a director and officer as long as he or she is not also a shareholder.

If the officers manage the day-to-day operations of the company, what role does that leave for the directors? In other words, what does “directing and regulating the affairs of the company” entail? Generally, the board of directors is responsible for *monitoring* the performance of the officers and for *approving* major decisions that will ultimately be *implemented* by the officers. The board of directors is thus formally distinct from the operational managers of the company. One example of a transaction that must be approved by the board is the issuance of *dividends* to the shareholders of the company (see Articles 91-94).

### **Corporate Shares and Dividends**

Companies can raise capital in two ways: taking a loan (debt) or selling equity (shares) in the company to investors (stockholders). When issuing shares, the board is free to determine their value and can accept as consideration for the shares cash or other property (Articles 30 and 31). If the company is issuing shares to the public, it must also follow any rules established by the Central Business Registry and other relevant agencies (Article 32).

As the company grows and accumulates profits, shareholders will want to receive some of those profits. One way for them to do this is to simply sell their shares, assuming the company’s growth has resulted in a higher stock price. However, shareholders may not want to sell their shares and terminate their investment in the company.

Dividends allow shareholders to enjoy the profits of a firm without selling their shares. A dividend is a distribution of any cash or property to some or all of the shareholders. For example, if a company receives a profit of 10,000 Afghanis during the year, the Board of Directors might conclude that it only needs 9,000 Afghanis to continue to operate the company. It thus will retain 1,000 Afghanis and distribute that amount to the shareholders through a dividend. If the company has issued 1,000 shares, each share will receive a dividend of 1 Afghani. In addition to cash, a dividend can take the form of additional shares in the company, tangible or intangible company assets, use of company property, or discounts on the goods produced by the company.

The board is also the actor responsible for maintaining the records of the company, such as the list of shareholders; the list of initial capital contributions; minutes of shareholder and board of director meetings; and company financial statements (see Article 56). However, there are some decisions that are so important to the existence of the company that they require approval by the shareholders themselves. These decisions include amending the Articles of Incorporation, unless the amendment concerns administrative details only (Article 95(3)); increasing the number of shares the company is authorized to issue (Article 96); and dissolving the company (Article 103).

### **Board of Supervisors**

In addition to a board of directors, corporations and LLCs in Afghanistan are required to have a “board of supervisors.” The board of supervisors sits “above” the board of directors and is primarily responsible for (1) reviewing the financial and operational records of the company and (2) supervising the conduct and implementation of actions by the board of directors (see Articles

64 and 66). For example, the supervisors must investigate the operations and the books of the company at least once every six months, inspect the corporate treasury at least once every three months, and help the directors prepare the company's financial statements to be presented to the shareholders. In this way, the supervisors, on behalf of the shareholders, actively monitor the financial wellbeing of the company and ensure the directors are behaving properly. Related to this, supervisors are responsible for investigating all complaints filed by shareholders against directors. These powers are guaranteed by statute and cannot be limited in the company's Articles of Incorporation or Bylaws (Article 65).

### **Checklist: Board of Supervisors**

**Selection process.** Supervisors must be elected by the shareholders at the annual shareholder meeting unless the Articles of Incorporation or Bylaws provide otherwise.

**Number of directors.** The board of supervisors must have at least two members.

**Eligibility.** A supervisor cannot also serve as director or officer of the company (Article 59) and cannot be related to any director (Article 63).

**Term length.** If the initial supervisors are appointed in the Articles of Incorporation, their term shall last one year. Otherwise, the company can set the length of the terms up to a maximum of three years (Article 59).

**Removal.** Just as with the directors, supervisors may be dismissed at any time by the shareholders (Article 60).

### **Discussion Questions**

If the directors already have a duty to act in the shareholders' best interests (more on this in the subsection on duties below), do you think a board of supervisors that monitors the directors is really necessary? What value does this extra layer of governance add? Consider the following: when shareholders are widely dispersed, it is difficult to rely on individual shareholders to identify director misbehavior, because the financial and logistical costs of such an investigation are not worth the benefit to each individual shareholder. This is called the **collective action problem** (discussed again in the subsection on shareholder voting below). Might a dedicated group of individuals that has a statutory responsibility to act as a watchdog for shareholders resolve this problem, and perhaps also serve as a deterrent against misbehavior by directors?

### *Limited Liability*

When an owner of a company has limited liability, her financial liability for the debts of the company is limited to a fixed amount, usually the amount the owner has invested in the company. For a corporation, this value is based on the value of the shares. For an LLC, this value is based on an agreement between the company and investor. In contrast, sole proprietors and

general partners are liable for the entire debt of their business.

For instance, imagine that you are the sole proprietor of a computer shop. You have taken out a loan to purchase inventory (computers that you intend to resell). Before you are able to sell the computers, someone breaks into your shop and steals the computers. The police attempt to find your computers but are unsuccessful. With no inventory to sell, your business has no way to repay the loan. As you are a sole proprietor, the person who made the loan to you has the right to ask a court to seize your personal assets (perhaps your car or your home if the debt is large enough) as payment. Had your business been a corporation or LLC you would not have lost your personal assets.

Limited liability has economic benefits. It encourages people to take risks and start businesses that could be very successful and socially valuable, but that also could fail. Since the person starting the business will not be personally liable for the debts of the company if it fails, he will be more willing to start the business. Society benefits because as more people are willing to take good risks and start businesses, the economy grows, new products and services are developed, and life improves.

Frank Easterbrook and Daniel Fischel, two leading scholars of corporate law, have further developed the arguments in favor of limited liability. In the following excerpt, which is rather complex, the basic arguments made for limited liability have been highlighted in bold text.

#### **Advanced Reading: “The Rationale of Limited Liability”**

*Source: Frank Easterbrook & Daniel Fischel, Limited Liability and the Corporation (1985)*

The publicly held corporation facilitates the division of labor. The distinct functions of managerial skills and the provision of capital (and the bearing of risk) may be separated and assigned to different people . . . .

Of course this separation of functions is not costless. The separation of investment and management requires firms to create devices by which these participants monitor each other and guarantee their own performance. Neither group will be perfectly trustworthy. Moreover, managers who do not obtain the full benefits of their own performance do not have the best incentives to work efficiently. The costs of the separation of investment and management (agency costs) may be substantial. Nonetheless, we know from the survival of large corporations that the costs generated by agency relations are outweighed by the gains from separation and specialization of function. **Limited liability reduces the costs of this separation and specialization.**

First, **limited liability decreases the need to monitor [managers]**. All investors risk losing wealth because of the actions of agents. They could monitor these agents more closely. The more risk they bear, the more they will monitor. But beyond a point more monitoring is not worth the cost. . . . Limited liability makes diversification and passivity a more rational strategy and so potentially reduces the cost of operating the corporation.

Of course, rational shareholders understand the risk that the managers' acts will cause them loss. They do not meekly accept it. The price they are willing to pay for shares will reflect the risk. Managers therefore find ways to offer assurances to investors without the need for direct monitoring; those who do this best will attract the most capital from investors. . . .

Second, **limited liability reduces the costs of monitoring other shareholders.** Under a rule exposing equity investors to additional liability, the greater the wealth of other shareholders, the lower the probability that any one shareholder's assets will be needed to pay a judgment. Thus existing shareholders would have incentives to engage in costly monitoring of other shareholders to ensure that they do not transfer assets to others or sell to others with less wealth. **Limited liability makes the identity of other shareholders irrelevant and thus avoids these costs.**

Third, **by promoting free transfer of shares, limited liability gives managers incentives to act efficiently.** We have emphasized that individual shareholders lack the expertise and incentive to monitor the actions of specialized agents. Investors individually respond to excessive agency costs by disinvesting. Of course, the price at which shareholders are able to sell reflects the value of the firm as affected by decisions of specialized agents. But the ability of individual investors to sell creates new opportunities for investors as a group and thus constrains agents' actions. So long as shares are tied to votes, poorly run firms will attract new investors who can assemble large blocs at a discount and install new managerial teams. This potential for displacement gives existing managers incentives to operate efficiently in order to keep share prices high.

Fourth, **limited liability makes it possible for market prices to impound additional information about the value of firms.** With unlimited liability, shares would not be homogeneous commodities, so they would no longer have one market price. Investors would therefore be required to expend greater resources analyzing the prospects of the firm in order to know whether "the price is right." When all can trade on the same terms, though, investors trade until the price of shares reflects the available information about a firm's prospects. Most investors need not expend resources on search; they can accept the market price as given and purchase at a "fair" price.

Fifth . . . **limited liability allows more efficient diversification.** Investors can minimize risk by owning a diversified portfolio of assets. Firms can raise capital at lower costs because investors need not bear the special risk associated with non-diversified holdings. This is true, though, only under a rule of limited liability or some good substitute. **Diversification would increase rather than reduce risk under a rule of unlimited liability. If any one firm went bankrupt, an investor could lose his entire wealth.** The rational strategy under unlimited liability, therefore, would be to minimize the number of securities held. As a result, investors would be forced to bear risk that could have been avoided by diversification, and the cost to firms of raising capital would rise.

Sixth, **limited liability facilitates optimal investment decisions.** When investors hold diversified portfolios, managers maximize investors' welfare by investing in any project with a positive net present value. They can accept high-variance ventures (such as the development of new products) without exposing the investors to ruin. Each investor can hedge against the failure of one project by holding stock in other firms. In a world of unlimited liability, though, managers

would behave differently. They would reject as “too risky” some projects with positive net present values. Investors would want them to do this because it would be the best way to reduce risks. . . .

On the other hand, consider the argument against limited liability: it creates too much incentive for risk and imposes costs on the rest of society. For example, when a business whose owners have limited liability fails to pay its debts, the bank that made the loan loses money since it cannot seek payment from the personal assets of the owners. To make up for this loss, the bank must charge a higher interest rate on loans to all businesses, even those that repay their debts. Successful businesses indirectly end up paying a price for the bad debts of failed businesses.

### **Discussion Question**

Given the arguments for and against limited liability, do you think limited liability is a positive or negative development in Afghanistan?

### *Free Transferability of Ownership*

Enabling owners to freely transfer their ownership interests without disrupting the company’s operation avoids the dissolution and reformation problems that we saw in partnerships. Free transfer of ownership has many benefits. First, the value of the company will be more stable. As was noted in the Easterbrook & Fischel excerpt above, free transferability of shares is closely tied to limited liability; if liability were unlimited, the assets of each shareholder would affect the value of the company, so each exchange of ownership would change the value of the firm.

Free transferability also allows owners to withdraw, or liquidate, their ownership stake easily. This, in turn, makes investment more attractive since individuals can spread their investments across multiple companies, thus diversifying their risk. Investors also do not need to worry about being tied to a company for an indefinite period of time. These factors, in turn, makes it easier for companies to raise capital.

Finally, free transferability of ownership deters self-serving behavior by managers, thereby reducing agency costs. If managers are misbehaving, investors can simply sell their shares. If enough investors sell their shares, the price of the stock will drop as the supply of shares increases and the demand decreases. This, in turn, will encourage the remaining shareholders to discipline or dismiss the misbehaving managers.

In Afghanistan, the default rule is that shares in a corporation may be transferred freely without the consent of the corporation. Since this is only a default rule, however, companies have the option to restrict share transferability in their Articles of Incorporation (Article 99).

## Discussion Questions

Given the benefits of free transferability just discussed, what impact would a restriction on a shareholder's right to transfer shares have on that shareholder's decision to invest in the company? Can you think of any reasons why a corporation might restrict transferability in spite of these benefits? Hint: think about companies with just a small number of shareholders. Is allowing corporations to restrict share transferability a good law?

### **B. How the Law Tries to Reduce Agency Costs**

So far, we have talked about how corporations and LLCs are structured and the roles that directors, supervisors, and officers play within those entities. Now we will examine how the law tries to ensure that directors, supervisors, and officers manage the firm in the best interests of the firm's owners: the shareholders.

Companies raise capital either through a bank loan (debt) or by selling equity (shares) to investors (stockholders). Selling shares can be advantageous because it allows companies to grow without having to put up collateral for a bank loan and without having to repay that loan. But shareholders will worry about their investment, particularly if they are not involved in the day-to-day management of the firm. In other words, shareholders are principals that have assigned day-to-day control of the company to directors, supervisors, and officers (their agents). What prevents the agents from making poor or wasteful decisions, or decisions that further their personal or collective interests at the expense of the company, and thus the shareholders? For example, a manager looking for an electrician to fix the lights in the company's office may hire his brother, who charges him far more than the market rate for electrician services and has a reputation for poor work. By paying extra, the company suffers a financial loss, which is borne by the shareholders. However, the agent himself does not experience any financial loss (assuming he receives a fixed salary) and in fact advances his family's financial interests.

This is the classic dilemma that arises in the context of principal-agent relationships. Recall that an agency cost is any cost—explicit or implicit—associated with an agent's exercise of discretion over property owned by a principal. Shareholders look to the law to protect their investment from director/supervisor/officer mismanagement and misbehavior.<sup>17</sup> Corporate governance rules—established by the Corporations and Limited Liability Companies Law in conjunction with each company's Articles of Incorporation—are intended to encourage efficient decisions that benefit the company's shareholders while discouraging insiders from using the company to further their own financial interests at the expense of shareholders. “[P]ractitioners generally agree that strengthening domestic investor confidence in a country's own companies and capital markets [through good corporate governance systems] may contribute to business competitiveness and to the overall growth of a national economy.”<sup>18</sup>

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<sup>17</sup> In fact, a study by Doidge, Karayi, and Stulz (2007) has found that the presence of legal and regulatory protections for investors explains up to 73% of the decision to invest. In contrast, company characteristics explain only between 4% and 22%. WORLD BANK, DOING BUSINESS 2009, COUNTRY PROFILE FOR AFGHANISTAN 28 (2009).

<sup>18</sup> BOOZ ALLEN HAMILTON, COMMERCIAL LAW AND MICROECONOMIC REFORM 6 (2007).

Afghan law has three primary mechanisms to deter such mismanagement and misbehavior: shareholder voting, fiduciary duties and shareholder lawsuits, and the market for corporate control. We will address each in turn.

### Shareholder Voting

Giving shareholders the right to vote on certain decisions is the first, and simplest, way to control agency costs. Shareholders are required to vote on the election of directors and supervisors (Articles 35 and 59); on proposed amendments to the Articles of Incorporation (unless the amendment concerns administrative details only); on any increase in the number of authorized shares of the company; and on the dissolution of the company. How does requiring a shareholder vote on these issues reduce agency costs? If a director or supervisor is performing inadequately, shareholders can vote him out of office. And in key decisions such as an amendment to the Articles of Incorporation or the dissolution of the company, director and shareholder interests are more likely to diverge, and a shareholder vote enables shareholders to protect themselves against opportunistic behavior by directors and supervisors.

The legal mechanics of voting are relatively straightforward. It is important to remember that some of the rules are default rules, which means companies may change them as they wish in their Articles of Incorporation. Shareholders can vote in one of three ways: at the annual meeting, at an extraordinary (special) meeting, or by written consent.

#### *Annual meetings and extraordinary meetings*

Corporations must hold an annual meeting once per year (Article 69). In addition, an extraordinary shareholder meeting may be called by the board of directors or any shareholder with at least 10 percent (or another amount set by the Articles of Incorporation) of the votes.

#### **Discussion Question**

Why are only shareholders with 10 percent or more of the votes allowed to call an extraordinary meeting? Consider that shareholder meetings can be expensive and time-consuming. The 10 percent threshold allows shareholders with substantial ownership interests in the company to raise and voice their concerns, but it prevents shareholders with only minor ownership interests from calling time-consuming and potentially wasteful shareholder meetings. This assumes that shareholders with greater ownership interests are less likely to call wasteful shareholder meetings since they will suffer a greater percentage of the financial loss that the wasteful meeting would inflict upon the company. In any case, this is a default rule, and the corporation can specify a different minimum percentage in its Articles of Incorporation.

#### **Checklist: Shareholder Meetings**

**Notification:** Shareholders entitled to vote at the meeting must be notified of the meeting at least 10 days before an annual meeting and five days before an extraordinary meeting (Article 74).

**Mode of participation:** If a shareholder is unable to attend a shareholder meeting in person, the Articles of Incorporation may permit participation via remote communication such as telephone (Articles 70 and 71(4)). Shareholders may also designate a “proxy”—a person to vote on their behalf at the meeting (Article 82).

**Number of votes:** As a default rule, each share is entitled to one vote (Article 81). However, since this is a default rule, companies can issue shares with more than one vote per share, no voting rights at all, or voting rights only on certain decisions. Shares with different rights are usually separated into different *classes*. Another important rule is that shares are not entitled to vote if they are owned by another corporation. Unlike the one-vote-per-share rule, this rule is mandatory.

**Quorum:** For a vote at a shareholder meeting to be valid, a minimum number of shareholders must be present. This minimum number is called a “quorum.” Each company may specify its quorum requirement in its Articles of Incorporation, although it cannot be less than 25 percent of the shares that are entitled to vote on the given matter (Article 84). If the Articles of Incorporation do not specify a quorum, the default rule is a majority of shares entitled to vote.

**Victory rule:** The Articles of Incorporation can also specify how many votes are necessary for a vote to pass. On some issues, such as the dissolution or sale of the company, a company may require a measure be approved by more than a simple majority (for example 75 percent) or that the measure be approved by a majority of each class of shares. However, if the Articles of Incorporation do not specify the percentage of the vote necessary to pass, a majority of the quorum will be required. The one exception is the election of directors, in which case only a plurality of votes is required.

### *Written action*

The third voting method is via written action in the absence of a shareholder meeting (Article 73). To pass, the written action must be signed by as many votes as would be required to pass the measure at a shareholder meeting. Thus, if the measure in question is an amendment to the Articles of Incorporation, and such an amendment would normally require a simple majority to pass at a shareholder meeting, the amendment could be approved by written action instead of a meeting if it is signed by a majority of the outstanding shares entitled to vote.

### *The collective action problem*

In principle, shareholder voting seems like a simple and effective check against agent misbehavior. In practice, however, most shareholders are unlikely to take their voting responsibilities seriously due to the *collection action problem*. Many shareholders, particularly individual shareholders with small ownership stakes, do not bother to vote. Either they do not think that their vote will affect the outcome or they believe the cost of participating in the voting process will outweigh any benefit they would receive as a small shareholder. Hence, these shareholders lack an *incentive* to vote.

One way to try to overcome this collective action problem is to allow shareholders to inspect the company's records (Article 87) and review the list of shareholders prior to a shareholder meeting (Article 80). Shareholders seeking to inspect the records must have a "proper purpose"—a purpose reasonably related to their interest as shareholders. The goal of the "proper purpose" requirement is to provide shareholders with a legitimate interest to access the company's records, and thereby facilitate shareholder monitoring of the company, but to prevent shareholders with an insignificant interest from demanding access to the company's records. We want to deter such inspections because they add little value to the company but are costly, distracting, and risk the disclosure of confidential information about the company. Deciding what information company shareholders should have access to raises important questions about the division of decision-making responsibility between shareholders and managers. By providing access to company records, it is easier for shareholders to monitor and challenge the behavior of the company's directors, supervisors, and officers. Any by providing access to the shareholder list, it is easier for shareholders to communicate with one another and to mobilize support should they discover wrongdoing and wish to bring the matter to a vote.

**Illustration:** Rajibullah decides to form a corporation for his brick company. The corporation sells shares to a wide range of investors. At its annual shareholder meeting, the company will vote on a proposed merger with a competing brick company (the shareholders must vote since the merger would require an amendment to the company's Articles of Incorporation). Amir owns a few shares in the company. He thinks the merger is a bad idea and calculates that his percentage of the losses from the merger would be 200 Afghanis. However, the costs of participating in the meeting will be 1,000 Afghanis (the cost of taking time off of work to read literature about the merger and to participate in the meeting). Thus, even though Amir stands to lose from the merger, he is unlikely to participate in the meeting and vote against the merger since he would lose more by doing so.

### Fiduciary Duties

#### *Basic duty*

At this point, you should review our earlier discussion of agency law. The goal of a fiduciary duty is to restrict an agent's freedom to conduct transactions on behalf of a principal and to bind that principal. It achieves this goal by imposing a standard of conduct that governs the agent's decision-making authority. Agency law can be challenging for lawyers: an agent's precise standard of conduct is only vaguely defined, and it is also unclear how courts should review whether an agent has complied with this standard.

Internationally, laws that prescribe the duty of corporate agents often offer only vague standards that can be difficult to apply consistently in practice. This may also turn out to be the case in Afghanistan, although time will tell how Afghan courts define the duty. Article 47(1) of the Corporations and Limited Liability Companies Law only states that the board of directors must "ensure the *best interest* of the Corporation and its Shareholders" and must discharge its duties with "*due diligence*." Similarly, Article 66(1) states that the board of supervisors must "exercise its duties in *good faith* and in the *best interests* of the Corporation and its Shareholders." With regard to complaints filed against a director, Article 67 states that

supervisors must “*properly* investigate . . . and take all *reasonable and appropriate* action.”

Although terms like “best interest,” “due diligence,” “good faith,” and “reasonable” sound simple, it is difficult to know what they mean in practice. To what practical standards should a director or supervisor adhere in order to avoid violating her duties? In crafting such a standard, it is important not to not discourage directors from all risk-taking. Clearly, a financial loss is not in the “best interests” of the company, but if directors are liable every time the company loses money, they will never take risks. Many value-maximizing investment decisions involve some degree of risk, and we do not want to discourage all risky decisions, as long as they are made in good faith. To illustrate this point, consider the following hypothetical. Rajibullah invests 10,000 Afghanis in a project. There is a 70 percent chance that the project will generate an extra 20,000 Afghanis in one year (a 20 percent gain) but also a 30 percent chance that it will lose 20,000 Afghanis in one year (a 20 percent loss). If, in one year, the project loses 20,000 Afghanis, should the directors be punished for making a decision that was not “in the “best interests” of the company? What if evidence shows that they acted in “good faith?”

Conventional wisdom is that the duty requires the agent to act with the level of care that would be exercised by an *ordinarily prudent person* in the *same position*. This means that directors should conduct an investigation that reasonably informs them about the risks and benefits of the decision—such as obtaining expert advice from company employees, outside legal counsel, or other professional advisors. We will later see that when a director also has a personal financial interest in a transaction, she must comply with additional formalities.

### Discussion Questions

Once we have defined the standard of conduct that agents must comply with, we must determine how courts should review whether an agent has in fact complied with that standard, thereby meeting her duty. Consider once again our hypothetical involving a project with a 70 percent chance of gain and a 30 percent of loss. Assume that the directors have conducted a reasonable investigation into the risks and benefits of the decision (thus satisfying their duty to conduct due diligence). Should the court defer to the business judgment of the directors regarding the “best interests” of the company—and only intervene if the decision is so offensive that no reasonable person acting in good faith could possibly have made it? Or, should the court place itself in the position of the directors, evaluate the available information, and decide for itself how the directors should have decided? Consider that the company’s directors, rather than the courts, possess business expertise, comprehend the complex dynamics of the company’s industry, and understand the unique needs of their company. What qualifies a judge to evaluate the merits of a highly technical investment and to compare it to other options available to the company? Which approach would you prefer if you were director or supervisor? Which would you prefer if you were a shareholder?

### *Enhanced duty when a director has a conflicting interest*

When a director has a personal financial interest in a transaction that his company enters into, that director is said to have a *conflicting interest* and must comply with additional procedures. According to Article 50, a director has a conflicting interest when the director or his

relative (spouse, parent, sibling, child, grandchild, or individual living in the director's house) is a party to the transaction or has a financial interest in the transaction. The law imposes additional duties because we suspect that the director's judgment will be compromised and that she will promote her or her relative's financial interests at the expense of the company. We therefore need to be particularly wary of agent misbehavior in these situations.

At the same time, it would be unwise to prohibit a transaction *solely* because a director has a conflicting interest. There are some transactions involving conflicting interests that are still valuable to the company. Thus, some mechanism is required for distinguishing between conflicted transactions that are good for the company and those that harm the company. The law achieves this by imposing upon the conflicted director a duty to *disclose* her conflict of interest to the entire board. This ensures that the board has complete information when deciding whether to proceed with the transaction.

After disclosure, if a majority of unconflicted directors still approve the transaction, the transaction will be valid (Article 52). A director is considered unconflicted if he does not have a conflicting interest in the transaction and if he does not have a familial, financial, professional, or employment relationship with the conflicted director. Similarly, if a majority of unconflicted shareholders approve the transaction, the transaction will be valid (Article 53). All shares are unconflicted except those owned by the conflicted director or a relative of that director.

Note that a conflicted transaction that has been approved by unconflicted directors can still be enjoined by a court or give rise to damages liability. But a conflicted transaction that has been approved by unconflicted shareholders, *and that is judged by the court to be fair to the corporation*, is immune from such sanctions (Article 51(2)). Therefore, a director who wants to ensure that a court upholds a conflicted transaction would be wise to obtain shareholder approval and ensure that the transaction could withstand an independent fairness assessment by a court!

**Illustration:** Rajibullah's brick company, Bricks Incorporated (BI), is searching for a shipping company to transport its brick to customers located across Afghanistan. One of BI's directors, Amir, happens to own the shipping company that would best meet BI's needs. Although Amir has a personal financial interest in hiring this shipping company, doing so may still be a good decision for BI. For example, the shipping company may be the only company that can deliver to all of BI's customers. If Amir discloses his interest in the shipping company to BI's board, and if either a majority of the other unconflicted directors or of the shareholders approve the transaction, Amir will not have violated his fiduciary duty.

#### *Enforcement of fiduciary duties: Shareholder lawsuits*

In order for fiduciary duties to be effective, there must be some mechanism to punish violators. Fear of punishment, in turn, is intended to deter directors and officers from committing violations. In principal, the mechanism for punishing violations and deterring agent misbehavior is the *shareholder lawsuit*.

A shareholder may file a suit on behalf of the company against a director or officer alleging a violation of fiduciary duty (Article 48). A director or officer who has harmed the

corporation has also harmed the owners of the corporation—the shareholders. Since a shareholder sues on behalf of the corporation rather than directly on his own behalf, this type of suit is called a *derivative lawsuit*: the harm to the shareholder *derives* from her ownership of the corporation. Therefore, to be eligible to sue, the shareholder must have been a shareholder at the time of the wrongdoing.

Before initiating a derivative lawsuit, shareholders are first required to ask the corporation to take suitable action against the wrongdoer. Such action can include taking internal corrective measures, or pursuing the lawsuit itself. The company must respond to the shareholder's request within 90 days. What purpose do you think this requirement serves? Because the company is the entity that has directly been harmed, it makes sense that it should have the opportunity to pursue a remedy on behalf of all shareholders. The requirement also encourages the corporation to take different corrective measures before pursuing a potentially costly and distracting lawsuit. And if the company decides that a lawsuit is the appropriate course of action, it is likely to have more resources with which to pursue the suit. But requiring shareholders to inform the corporation before initiating a lawsuit raises problems as well. Directors may be sympathetic toward or friendly with one another, and they may be reluctant to sue their friends and colleagues. If the company refuses the shareholder's request to take suitable action, the shareholder may proceed with the derivative lawsuit.

Finally, the law allows (and in some cases requires) companies to pay the litigation costs incurred by the agent being sued, as long as the agent is not found to have acted in bad faith (Article 58). Litigation costs can include attorneys' fees, damage awards, government fines, or settlements. The company's promise to pay such costs is called **indemnification**. The company also has the option to purchase *insurance* for litigation costs incurred by agents acting in their official capacities.

You might wonder why companies should be required to indemnify their agents, since indemnification absolves misbehaving agents of personal liability, and therefore weakens the effectiveness of fiduciary duties and shareholder lawsuits as a check on agency costs. Again, the indemnification requirement is explained by the fact that we do not want to deter directors and officers from making risky but valuable decisions. If directors face the prospect of personal liability for their decisions, they will avoid risk-taking—or, worse, refuse to serve as directors!

### **Discussion: Evaluating Fiduciary Duties and Shareholder Lawsuits**

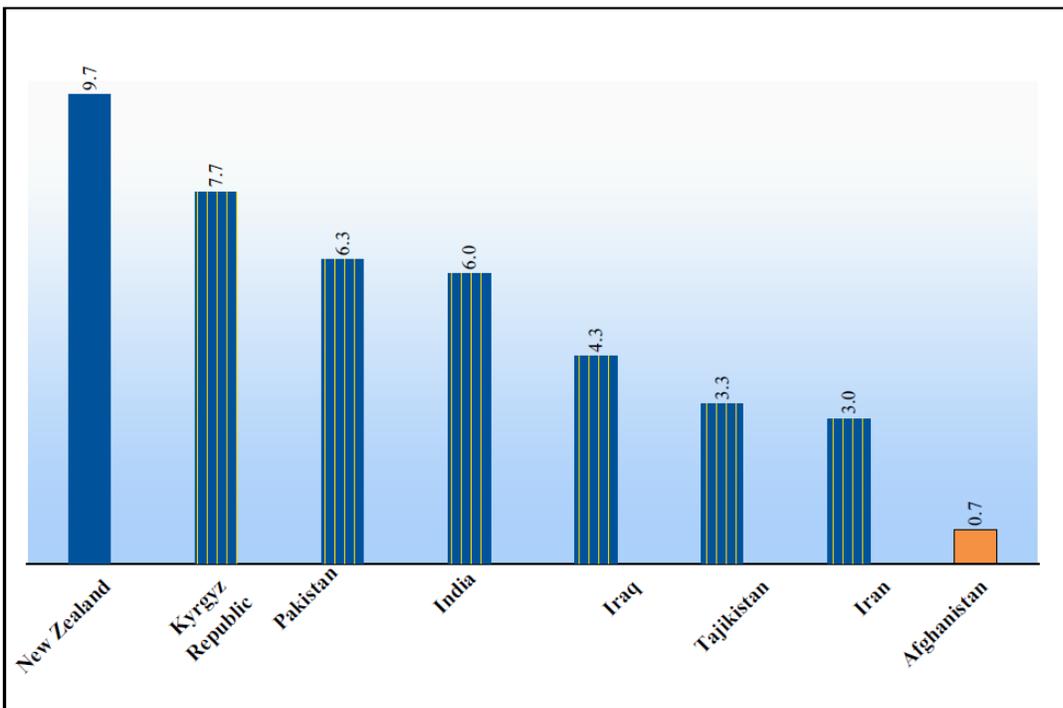
How effective is the shareholder lawsuit as a means of enforcing fiduciary duties and reducing agency costs? This is a subject of great debate. We have reviewed the intended benefits of shareholder lawsuits in the preceding subsection. Some arguments suggesting that shareholder lawsuits are minimally effective are outlined below.

First, individual shareholders may not have enough money to even bring a lawsuit. To bring suit, the shareholder's portion of the anticipated benefits from the lawsuit (whether they be monetary damages, the rescission of a contract, or the removal of the misbehaving agent) will have to outweigh litigation costs, which can be considerable.

Second, even if the shareholder does bring suit, the misbehaving director or officer can escape personal liability due to indemnification and insurance. The corporation, rather than the misbehaving agent, ends up paying any damages (as long as the agent has acted in good faith). The corporation may also have to pay for the agent's litigation costs. If directors and officers know they will not face any personal liability for violating a duty, the duty loses its deterrence effect. Further, costs paid by the corporation are ultimately losses borne by the shareholders. There is something odd and circular about shareholders paying the damages that they have been awarded for the misbehavior of the company's agents!

Despite these criticisms, shareholder lawsuits do offer some benefits. At the very least, they provide a formal process for identifying agent misconduct, which could lead to the removal of misbehaving agents from office. They also compensate shareholders for past harms (albeit imperfectly, since shareholders end up paying themselves), and they impose personal liability on agents that have acted in bad faith. Finally, they deter future misbehavior if for no other reason than that agents will want to avoid the time, energy, and reputation costs associated with a lawsuit.

Regardless of the theoretical debate regarding the merits of shareholder lawsuits, Afghanistan ranks poorly in its region with regard to investor protection. In a 2009 World Bank study that compiled an investor protection index—based on the extent of mandatory disclosure when a director has a conflicting interest, the extent to which directors are held personally liable for damages, the extent to which shareholders are able to rescind conflicted transactions, and the ease of bringing a shareholder suit—Afghanistan received a score of 0.7 out of 10 in 2007, 2008, and 2009. Afghanistan was ranked last of 181 economies surveyed.



Note: The higher the score, the greater the investor protection.

Source: World Bank, *Doing Business 2009, Country Profile for Afghanistan*

### Corporate Takeovers

So far in this subsection, we have considered two legal mechanisms for controlling misbehavior by the directors, supervisors, and officers who serve as agents of shareholders: shareholder voting and fiduciary duties. A final check on agency costs is corporate takeovers. In theory, when the directors and officers of a company misbehave, the value of the company declines. A third party could then acquire enough shares to control the company and replace the misbehaving managers. With “good” managers in place, the value of the company should increase, producing a profit for the acquirer and improving the welfare of other shareholders.

**Illustration:** The board of directors of Rajibullah’s brick company, Bricks Incorporated (BI), is known in the market for wasting the company’s resources and making poor management decisions. The management of BI is so bad that the company has lost money for three straight years, even though the demand for bricks in Afghanistan is growing. Shares in BI are currently worth 100 Afghanis. Another brick company, Afghanistan Brick Corporation (ABC) believes that the value of BI would be much higher under different management. ABC therefore offers to buy all of the outstanding shares in BI for 110 Afghanis per share. BI’s shareholders hold an extraordinary shareholder meeting to consider the offer. They vote to approve the merger and amend BI’s Articles of Incorporation accordingly. ABC, as the new owner, replaces BI’s board of directors with new agents. Within a year, the company is earning large profits, and the value of each share has increased to 200 Afghanis.

In practice, however, there are at least two problems that weaken the effectiveness of the corporate takeover. First, the logistical costs associated with a corporate takeover are substantial, and so the agent misbehavior must be particularly bad to make the takeover worthwhile. Thus, agent misbehavior that falls short of this threshold, but is still harmful to the company, will not be checked by corporate takeovers.

Second, takeovers can occur in two ways. If the incumbent directors support the takeover, it is considered “friendly.” If the incumbent directors object to the takeover, it is considered “hostile.” Not surprisingly, incumbent directors and officers may try to resist a “hostile” takeover. Even if the takeover requires shareholder approval, and does not give directors the final say, director resistance is still important because shareholders will often defer to the recommendations of their directors. Directors often have better information about the company, the industry, and how a takeover would affect the company’s value in the long-term. This is called *information asymmetry*.

Defensive actions taken by directors would be good for the shareholders if the directors’ goal is to obtain a higher price, protect uninformed shareholders, or protect the long-term value of the company. But directors sometimes abuse this trust in order to pursue their own interests—like preserving their jobs—at the expense of the shareholders. For example, directors may resist a takeover because they know that they will be replaced by the acquirer. To prevent the takeover, the directors may try to make the company less attractive to the potential acquirer. Sometimes, directors facing a takeover take on a lot of debt. Debt makes the company less attractive because it creates a greater risk that the company will default on its loans and go bankrupt. Or directors may find an alternate buyer that offers less value for the company but promises to retain the directors.

Of course, any such action on the part of the directors would be governed by fiduciary duties. In theory, these duties should prevent directors and officers from pursuing defenses that are not in the best interests of the shareholders. Yet in practice, as we discussed earlier, fiduciary duties can be difficult to enforce, and therefore they are not always an effective deterrent.

The field of “takeover defenses” is still undeveloped in Afghanistan. We have yet to see how tolerant courts will be of such defenses, particularly as more elaborate and complex tactics are developed.

### **Discussion Questions**

Given the goals and weaknesses associated with each of the three legal mechanisms we have just discussed—shareholder voting, fiduciary duties, and corporate takeovers—which do you think is most effective in protecting shareholder interests and reducing agency costs? Can you think of any ways to make each mechanism more effective?

### C. Dissolution

Although a corporation has an indefinite life upon creation, it can be dissolved voluntarily by the shareholders once it achieves the objectives for which it was created or once it ceases to serve the shareholders' interests. To dissolve a corporation, a majority of directors must approve the dissolution proposal, and then the shareholders must vote on the proposal (Article 103).

In addition to voluntary dissolution, a commercial court may dissolve a corporation in certain situations (see Article 107). The Ministry of Commerce and Industry may request dissolution if the company obtained its Articles of Incorporation fraudulently or if the corporation has exceeded its authority. A shareholder may request dissolution if the directors have acted illegally or fraudulently, if the shareholders are unable to elect directors at two or more consecutive annual shareholder meetings, or if there is a deadlock among the directors or shareholders and the company is suffering irreparable injury. Finally, a creditor of the corporation may seek dissolution if the corporation owes the creditor money and the corporation is insolvent.

## VII. CONCLUSION: ASSESSING THE COMPANY LAW

The Partnership Law and the Corporations and Limited Liability Companies Law (together referred to as the "company law") were written by foreign lawyers who did not spend much time in Afghanistan and who received little input from people and businesses inside Afghanistan. The law has been criticized by at least one foreign government agency as developed in haste without adequate domestic input. In addition, some provisions are unnecessarily complex. Many provisions reflect international best practices (which encourage foreign investment), but may not respond to Afghanistan's unique circumstances. Consider the following assessment and discussion questions.

### **Commentary: Advantages and Disadvantages of Afghanistan's New Company Law**

*Source: USAID, Afghanistan's Agenda for Action (2007)*

The corporations section of the new Company Law introduces U.S.-style corporate governance provisions as found in U.S. Delaware law and the ABA Model Business Corporation Act. These replace corporate governance provisions in the old Afghan company law that had covered much of the same ground but were simpler (and were themselves fairly strong). The new provisions include a requirement that conflict-of-interest dealings between a corporation and a director must receive prior approval of non-conflicted directors or shareholders or be "established to have been fair to the corporation" (Articles 66-69); that directors have duties of care and loyalty which are worded in U.S.-style language that has been extensively interpreted in U.S. courts, particularly Delaware courts (63); and that a corporation may indemnify a director, officer, employee, or agent (including for the person's legal fees) when the person is sued by shareholders for wrongdoing (74). The new provisions contain more detailed requirements than the old law for shareholder derivative suits, i.e., court lawsuits brought by shareholders in the name of the corporation against misbehaving directors (64). In addition, the new law states that directors of a

corporation can be held personally liable if their decision to pay shareholders dividends renders a corporation insolvent (65). The old law does not have such a provision.

At the same time, the new law contains provisions that are not generally harmonious with international corporate governance best practice and that may discourage new investment (particularly foreign and institutional investment). Some of these provisions . . . include: permitting a corporation to restrict free transfer of its shares (this is not appropriate in widely held companies); permitting a corporation to limit the votes which a shareholder may exercise at shareholder meetings (this is counter to the “one share one vote” principle); . . . permitting a corporation to require shareholders to show “cause” when replacing a director; and permitting a Board of Directors to delegate its powers to a committee.

### **Discussion Questions**

Having familiarized yourself with some of the key provisions of the Partnership Law and Corporations and Limited Liability Companies Law, do you agree with any of the above viewpoints? Consider any first-hand experience of your friends and family. If there is a conflict between an international best practice and a customary Afghan practice, which should prevail?

## **VIII. SKILLS APPLICATION: HOMEWORK ASSIGNMENTS**

### *1. Analytical assignment*

Find a friend or family member who owns a business. If you do not have a friend or family member who owns a business, try to find this information about any public company.

- Is the company registered properly?
- Does it have Articles of Incorporation?
- Does it have bylaws?
- Write a 1-2 page essay discussing the effectiveness of these governance provisions and any weaknesses or problems you can identify.

### *2. Drafting assignment*

Come up with any idea for a company.

- Which business form do you think would be best for your company? Why?
- Assume that your business will be a partnership. Draft a simple Partnership Agreement that includes all required provisions and any other provisions you think would be useful.
- Now assume that your business will be a corporation. Draft basic Articles of Incorporation, including all required provisions and any other provisions you think would be useful.
- Draft a few bylaws that you think would be useful. Try to have some fun thinking about how your fictional corporation should be governed.

### 3. Simulation

Five members of the class should be selected randomly as members of a corporate board of directors. The remaining members of the class will serve as shareholders in the company.

The company is a cement company. The board of directors is considering the following items and has placed them on the agenda for the next shareholder meeting:

- Whether the company should build a second plant in Herat.
- Whether the company should accept an offer from a competing cement company to merge.
- The election of new directors.

a. Which of these items require a shareholder vote?

b. The class should simulate a shareholder meeting:

- For the shareholders, what information would you like to know? What questions would you ask the board members about each of these items?
- For the board members, how would you respond to these questions? Feel free to make up facts as necessary.

b. At the end of the shareholder meeting, the shareholders should vote on each item that requires a shareholder vote. Which items have generated enough votes to pass, assuming the company uses default quorum and victory rules?

Have fun!

## Glossary

### ***Actual authority***

When the principal grants an agent the power to conduct a particular transaction.

### ***Agency cost***

Any cost associated with an agent's exercise of discretion over property owned by a principal.

### ***Agent***

A person that agrees to act on the behalf of a principal and subject to their control.

### ***Apparent authority***

When the agent does not have actual authority to conduct a transaction, but the actions of the principal lead a third party to the transaction to reasonably believe that the agent was authorized.

### ***Asset***

Anything of positive value owned by a person or company, such as buildings, equipment, inventory, technology, and cash.

### ***Capital***

Financial wealth used to start or maintain a business.

### ***Corporation***

A business entity whose capital is definite and divided into shares, with the responsibility of each shareholder limited to the proportion of his share ownership.

### ***Creditor***

Any entity that extends a loan to another entity.

### ***Debt***

An obligation to repay a loan or to otherwise pay a third party.

### ***Dividend***

A distribution of a portion of a company's earnings to a class of its shareholders.

### ***Fiduciary***

A person who must act loyally for the principal's benefit in all matters connected with the agency relationship.

### ***Fiduciary duty***

A legal relationship of confidence or trust between two or more parties. A fiduciary is expected to be loyal to the person to whom she owes the duty (the "principal"). She must not put her personal interests before the duty and must not profit from her position as a fiduciary, unless the principal consents.

***General partnership***

A business entity where multiple owners share the profits and each is responsible for all of the debts and losses of the business.

***Goodwill***

The value of a firm beyond its assets, such as the reputation the firm has with its clients.

***Insolvent***

When a company's debts (or liabilities) exceed its assets.

***Indemnification***

A guarantee to reimburse another party for a loss it might suffer.

***Liability***

1. Responsibility for a debt.
2. A debt or other obligation to make a payment to a third party.

***Limited Liability Company (LLC)***

A business entity whose owners (shareholders) have limited liability for the corporation's debts. The liability of each shareholder is capped at an amount agreed to by that shareholder and the company.

***Partnership***

See *General partnership* and *Special (or limited) partnership*.

***Principle***

A person that grants authority to an agent to act on her behalf, subject to her control.

***Share***

A unit of ownership in a company.

***Shareholder***

One that owns shares in a company and is thereby a partial owner of the company.

***Sole proprietorship***

A business entity owned by a single person.

***Special (or limited) partnership***

A business entity where some of the partners have limited liability for debts and losses. Each owner's responsibility for the partnership's debt is capped at the amount of their investment in the partnership.

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## CHAPTER 6: SECURED TRANSACTIONS

### I. INTRODUCTION

**Credit and lending** are vital components of a sophisticated economy. However, a functioning commercial lending sector would be impossible without clear rules that compel contractual compliance from those seeking the credit as well as those extending it. A commercial lending system can have significant economic benefits by allowing the inherent value of an **asset**, such as personal property or land, to be used as collateral to secure loans from lenders. Such a system allows businesses and individuals to use the value inherent in their assets as a means of reducing risk to the creditor, which in turn results in increased investment and economic stimulation. A legal system that supports and protects secured credit transactions is essential to reducing the perceived risks to creditors, thereby promoting the availability of credit for entrepreneurial activities.

The existence of a working legal system for enforcing a lender's rights to collateral should the borrower **default** is essential. We call such a framework—where a lender holds an interest in a debtor's movable property in order to secure a loan or a debt obligation—a system of “secured lending” or “secured transactions.”

The importance of an effective secured transactions law to Afghanistan's transition to a market economy cannot be understated. A legal system that is perceived to be efficient and effective at protecting creditors from undue risk will positively influence the general economic prosperity of the state by encouraging both domestic and foreign investment. In its 2009 *Doing Business Report*, the World Bank made the following recommendations for what an effectual secured transactions regime should accomplish:

1. Promote information sharing among private credit bureaus,
2. Clearly define the roles of, and cooperation between, public collateral registries and private credit bureaus, and
3. Build the institutional competence of the judiciary to enforce the rights of creditors.

Because the term “secured transaction” may initially seem daunting or unfamiliar, it may be helpful to consider the following situation:

Rajibullah always dreamed of owning his own brick factory. He finds out one day that the brick factory in his town is being sold, but, unfortunately, he does not have enough money on hand to buy it. He decides to approach the bank to ask for a loan so that he can put down an initial payment for the brick factory. The bank gives him the money he needs, but in exchange Rajibullah must give the bank an interest in something of value, which the bank will take if he fails to repay the loan. Luckily, Rajibullah is the owner of a brand new car, which he offers as security. He and the bank agree that should Rajibullah fail to repay his loan, broken down into more manageable monthly installments, within a set amount of time, the bank will take

possession of his car. The bank will then sell the car, and apply the proceeds from that sale towards the remaining balance of Rajibullah's loan.

The scenario discussed above is probably a situation that you have contemplated before, and represents a simple example of a secured transaction. Put simply, a secured transaction is a special type of contract between two consenting parties that allows for the transfer of an interest in personal property as security for an **obligation** created by the contract. In the example above, Rajibullah is the **debtor**, and the bank is the **creditor**. The terms of the relationship between the debtor and the creditor in a secured transaction is known as a **securing agreement**. Because he has borrowed money from the bank in this transaction, the obligation that is created is Rajibullah's repayment of that amount. Rajibullah's car represents the **collateral** in the transaction, so in the event that he fails to fulfill his obligation, the bank can collect on its interest in Rajibullah's car, which is known as the **securing charge**.

Now that you have been exposed to the basic concept of a secured transaction and been introduced to some of the vocabulary that is associated with it, we'll take a step back and spend the rest of this chapter reviewing its underpinnings slowly and methodically. We will begin with a general overview of Afghanistan's Law for Secured Transaction on Movable Property in Banking Transactions ("Secured Transaction Law").

Next, the chapter will address in detail each of the steps involved in a secured transaction, with a discussion of the legal concept behind each step, followed by a discussion of the corresponding governing provisions in Afghanistan's Secured Transaction Law. It is worth noting that secured transactions is a particularly difficult area of commercial law, but it is also extremely important that you master its basics, as secured transactions are at the core of almost every business transaction that takes place in a modern economy. However, keep in mind that secured transactions are simply a specific type of contract, and your mastery of contracts will serve you well as you tackle this chapter.

Finally, because the secured transaction regime in Afghanistan was only recently enacted in 2009, the chapter will end with a discussion of some of the key policy objectives for an effective and efficient secured transactions regime.

## **II. AN OVERVIEW OF AFGHANISTAN'S SECURED TRANSACTION LAW**

Afghanistan's Law for Secured Transaction on Movable Property in Banking Transactions (hereafter the "Secured Transaction Law") is an example of the Afghan government's commitment to developing a healthy private sector, which is critical not only to salvaging an economy that has been ravaged by years of conflict, but also to sustaining the nation's future economic growth. In recognition of the fundamental importance of a comprehensive secured transactions framework, the Afghanistan Bank's Legislative Drafting Unit developed the Secured Transaction Law to "regulate business and banking transactions that use Movable Property as security and specify the rights and obligations of the parties." (Art. I)

The Secured Transaction Law was approved in May 2009 and printed in Gazette 990 in August 2009. The Secured Transaction Law is available online in English at [http://www.centralbank.gov.af/pdf/Secured\\_Transaction\\_Law\\_English\\_06Jan10.pdf](http://www.centralbank.gov.af/pdf/Secured_Transaction_Law_English_06Jan10.pdf). Prior to the Secured Transaction Law, no comprehensive legal framework for secured lending existed, and this area of law was governed by provisions drawn from the Commercial Code of 1955 and the Law of Banking of Afghanistan. However, the treatment provided by this framework was incomplete and left many issues unresolved.

For example, the old laws did not establish priorities among competing security interests on the same property. Moreover, the old laws did not establish the infrastructure necessary to regulate and enforce collateral interests. While the laws referenced the recording of security interests in the official records, they did not create an independent collateral registry for security interests in personal property. It was therefore the province of the courts to handle such registrations—an expectation that was unrealistic and cumbersome. It was clear that piecing together the old provisions could not provide a sufficient framework for modern secured lending to develop in Afghanistan.

Those uncertainties are among the factors that made investing in Afghanistan risky and unattractive to investors. However, with the Secured Transaction Law now in effect, the protections that this law provides to both debtors and creditors should make Afghanistan a much more attractive place to do business.

### III. KEY TERMS AND DEFINITIONS FROM THE SECURED TRANSACTION LAW

We will officially begin our study of secured transaction law by looking over its vocabulary. The terminology used in secured transactions is precise and specific, and it is important that you obtain a working proficiency with it. Article 3 of the Secured Transaction Law provides the definitions that apply in the law. Excerpted below and grouped according to functions are the key definitions that you will find useful as you begin your study of secured transactions.

Keep in mind that this list of terms will likely be confusing to you as first, because you do not yet have a grasp of how the terms work together in a secured transaction. For now, read over the list so you have some exposure to the terms that you will encounter. As you continue through the chapter, turn back to it for reference as you come across terms that are **underlined and bolded**. By referring back to these definitions as you learn the mechanics of a secured transaction, you will become increasingly familiar and comfortable with these terms.

#### Article 3. Definitions

##### *The Basic Components of a Secured Transaction*

1-“**Debt**” means the amount of money that debtor (Chargor) owed on an Account or due to financing in accordance with a Securing agreement. Debt may include the cost of

Financing, penalties, damages, expenses and other related liabilities.

5- “**Securing agreement**” means the written agreement between Chargor and Chargeholder for one or more transactions.

8-“**Securing charge**” means a right in Movable Property, whether present or future. It secures one or more Debts that arise before or after the Securing agreement is signed.

9- “**Collateral**” means a real right in Movable Property charged to secure Debt. Collateral may be located within or outside Afghanistan and may include Proceeds collateral.

10-“**Proceeds collateral**” means money or a specific type of Movable Property that results directly or indirectly from the disposal of Collateral. The definition extends to later generation Proceeds from Collateral and to insurance payments for damaged or lost Collateral.

11-“**Property**” means possessions or things capable of ownership and includes Movable and Immovable Property.

12- “**Movable Property**” means Property that could be moved without decomposition and any change in substance or form and includes tangible things such as Goods and intangible things such as Documents of title, securities, accounts, copyrights, trademarks and patents.

13- “**Immovable Property**” means Property that could not be moved without decomposition and change in shape and substance. Land, homes and buildings are Immovable Property.

*Potential Functions of Participants in a Secured Transaction*

2-“**Debtor**” means a Person owing a Debt.

3-“**Lender**” means a Person who is engaged in banking affairs inside or outside the country and has due financial rights or enforceable obligations over another person.

6-“**Chargor**” means a Person who owns Collateral and, in most cases, owes the Debt subject to securing charge. When the owner of Collateral and Debtor are different Persons, the term Chargor means the owner of Collateral and Debtor means the one owing the Debt.

7- “**Chargeholder**” means a Person in whose favour a Securing charge is created.

21-“**Transferee**” means a Person to whom a Transferor assigns a Securing agreement or an Account.

22-“**Transferor**” means a Person who assigns money that others owed him under a

Securing agreement or an Account to a Transferee.

*Miscellaneous Secured Transactions Terms*

23-“**Notice**” means written information relating to a subject, that is sent to the address of the central office, or place of residence or activity of the Person in question and its receipt has been ensured.

24-“**Registry**” means an office that registers a secured transaction on Movable Property and its related documents and keeps the records.

25-“**Notice of Registration**” means a form that is drawn up in accordance with the the procedures for Registration of Securing Charge.

27- “**Default on Payment**” means failure to pay a Debt or its installment when due as stated in the Securing agreement.

28- “**Default on Performance**” means failure to perform an obligation when due as stated in the Securing agreement.

29- “**Documents of title**” means a written document prepared in accordance with the law that proves ownership or the right to possess Movable Property.

30-“**Security**” means a negotiable financial instrument.

#### IV. SECURED TRANSACTION BASICS

As you saw in the example involving Rajibullah and the bank, a secured transaction is an agreement by which the lender (someone who is owed money) obtains a securing charge in the collateral of the debtor. In general, every secured transaction has five elements in it:

1. **Debtor**
2. **Lender** (or secured creditor)
3. **Collateral**—The personal property of the debtor that is subject to the creditor’s securing charge.
4. **Securing Agreement**—This is the contract underlying the secured transaction, and creates duties, rights, and remedies for both the lender and the borrower.
5. **Securing Charge**—This is the creditor’s right to a debtor’s personal property. It exists to protect the creditor’s right to payment. If the debtor fails to satisfy his obligation to the creditor under the terms of the securing agreement, then the secured creditor has the right to take possession of the collateral in order to satisfy the debtor’s obligation.

*The Participants in a Secured Transaction*

The two most important parties in a secured transaction are the **lender** and the **debtor**. In most cases, the lender is also the **chargeholder**, who is the creditor who has or will have the

benefit of the security interest in personal property, if an obligation is secured. Similarly, in most cases the debtor is also the **chargor**, who is the person who has the ownership or other interest in the personal property in which the security interest is created.

This represents the most straightforward kind of transaction, and was illustrated by the example of Rajibullah securing his debt with his car. In that case, Rajibullah was the **debtor**, and because he was the owner of the car, he was also the **chargor**. As for the bank, it is both the **lender** and the **chargeholder** because it stands to directly benefit from the car if Rajibullah fails to repay his loan.

However, one can imagine a more complex transaction where this will not be the case. Consider the example where Rajibullah may be taking out a loan from the bank, but the car that he will use to secure this debt belongs to his father. In this case, Rajibullah would still be the **debtor**, but now his father would be the **chargor**.

### *The “Thing of Value” in a Secured Transaction: Collateral*

As you may remember from the introductory example to this chapter, Rajibullah’s car was the personal property in which a security interest was created (**collateral**). In Rajibullah’s case, the bank holds an interest (a **securing charge**) over the car as security for repayment of Rajibullah’s loan (**debt**).

Under Afghanistan’s Secured Transaction Law, any **movable property** can be used as the collateral to secure a debt. Movable property can further be broken down into two sub-categories: tangible items and intangible items. Tangible items include things such as cars, furniture, or electronics. Intangible items include documents of title, copyrights, trademarks and patents.

## V. COMPONENTS OF A SECURED TRANSACTION

### A. Creation of a Securing Charge

→ Key Point: A **securing charge** is created and can be enforced by the creditor against the debtor once the debtor acquires an interest in the collateral and the securing agreement is signed, whichever occurs later.

Under Article 7 of the Secured Transaction Law, a securing charge over collateral is “attached” and becomes enforceable against the chargor once the chargor and the chargeholder sign a written securing agreement. This means that until the securing charge has been created over the collateral, the debtor will not be required to give his personal property to the creditor in the case of default.

The securing agreement is an agreement through which the debtor transfers a securing charge in the collateral to the chargeholder. It is often more easily understood as the consensual creation of a property interest in the collateral. For the securing agreement to be valid, certain requirements must be fulfilled.

First, the agreement must describe the collateral that is to be used to secure the debt. The description of the collateral is important because it speaks to the substance of the transaction. It is not difficult to imagine the various ways in which people can benefit improperly if this were not a requirement. For example, in Rajibullah’s case, he may have offered a brand new Mercedes as the collateral for his debt. The bank would have assessed the value of the Mercedes and granted the loan to him accordingly. However, if in the securing agreement, Rajibullah simply writes “car” as the description of the collateral, then there is nothing to stop him from choosing not to repay his loan, and when the bank comes to take possession of the collateral, the “car” he gives them is a second-hand one that is worth far less than the collateral that the bank was expecting. However, despite the clear importance of an accurate description of the collateral at stake in the transaction, the Secured Transaction Law does not provide any formal or technical requirements. Instead, it simply requires that “the Collateral be described reasonably.” (Article 8(2))

The second requirement for the securing agreement to be valid is a description of the debt. Unlike the description of collateral, where the level of detail and specificity required is uncertain, Article 8(3) clearly states that “Debt amount and date of payment should be clearly identified at Securing agreement.”

Finally, the securing charge comes into effect once the chargor acquires ownership of the collateral and signs the securing agreement—whichever occurs later. Functionally speaking, once the securing charge is in effect, the creditor is protected against the default of the debtor; if the debtor defaults, the creditor has some recourse against the debtor. However, it is important to note that the securing charge does not always protect the creditor against the rights that other creditors may also have on the same property. This is a concept that we will explore in more detail in the following section.

**Illustration:** On January 1, Rajibullah borrowed 15000 Afghanis from Kabul Bank to purchase some machinery for his factory. He signed a securing agreement with the bank on January 1, which identified the machinery that he was going to purchase as the collateral for the loan. On January 20, Rajibullah bought the machinery. When did the securing charge come into effect?<sup>19</sup>

## **B. Completion of a Securing Charge**

→ Key Point: A completed securing charge has the effect of protecting a creditor from other creditors.

Completion is the second step in securing rights against the property of the debtor after the creation of the securing charge. As was mentioned previously, the creation of the securing charge in itself is not sufficient to protect the creditor against the claims on the collateral (personal property of the debtor) of other creditors. However, once the securing charge is

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<sup>19</sup> The securing charge came into effect on January 20, since that was when Rajibullah obtained rights in the collateral.

completed, it protects the creditor who holds the completed securing charge against the claims on the property by other creditors who do not hold a completed securing charge. Simply stated, completion is the process by which the creditor informs everyone else in the market who may be interested that he has a security interest in the property.

### **Discussion Question**

Can you think of some possible reasons why the law would be concerned with protecting a potential creditor's ability to find out whether a security charge existed on the collateral in question? (Hint: It may be helpful to consider why a potential creditor would be interested in this information in the first place.)

At core, completion is important because it permits other parties to discover the existence of securing charges over collateral without having to rely solely upon the assurances of debtor. If Rajibullah approached another lender and tried to use the same car that he promised the bank as collateral, the law wants to ensure that the second lender learns about the securing charge that the bank already has over Rajibullah's car.

This is because the Secured Transaction Law, like most other commercial laws, is structured with an eye towards protecting potential creditors—this is the best way to stimulate investment in an economy. If people with money did not feel that their interests or assets were protected, then they would not want to invest in the marketplace.

To understand why it is so important to protect a creditor, think about what would happen if the only way that the second lender could find out about existing securing charges on Rajibullah's collateral is to ask Rajibullah himself. If Rajibullah were a dishonest man, he would lie and say that there was no securing charge. If Rajibullah's brick factory performs poorly and he is unable to repay the loan to the bank, then under the terms of his securing agreement the bank has a right to take his car. As a result, the second lender would have no collateral to collect on when Rajibullah fails to repay his loan.

If this were how business transactions involving loans routinely ended—with the creditors not getting anything back for their loan, then creditors would have no incentive to make loans, which would in turn stunt entrepreneurship and development. This is precisely the scenario that the Secured Transaction Law wants to avoid.

### **Article 12. Completion of a Securing Charge**

(1) A securing charge is completed when it has attached to the collateral as provided in Article 7 of this Law and one of the following requirements is met:

- 1-The securing charge is registered as provided in this Law.
- 2-The chargeholder, or agent of the chargeholder who is not the chargor, has taken physical possession of the collateral pursuant to a securing agreement.
- 3-A provision of this Law states that the securing charge is completed.

Under Article 12 of the Secured Transaction Law, once the provisions of Article 7 have been fulfilled, a creditor may complete her securing charge through one of three prescribed methods.

**Method One: Registration.** The first method requires registration of the securing charge with the Central Charge Registry in accordance with Article 44 of the Secured Transaction Law. Under the old secured transaction system provided by the Commercial Code and the Civil Code, the lender in a secured transaction was required to take physical possession of the collateral. Otherwise, there was no way for the lender to be assured that his interest in the collateral could be honored. However, the new Secured Transaction Law, which provides for the establishment of an internet-based Central Registry where all secured transactions are recorded, should allow a debtor to retain possession of the physical asset to be used as collateral, thereby allowing the debtor to continue to use this asset to generate income.

#### **Article 44. Registration of Securing Charge**

- (1) The Registry Office shall be established by Da Afghanistan Bank.
- (2) The Registry Office shall provide electronic registration, notice of Securing Charges, liens, and searching of the notices. The existing registrations in the Registry Office are valid.

**Method Two: Possession of the Collateral.** By taking possession of the collateral property with the debtors' permission, the chargeholder may enact a simultaneous attachment and completion of the securing charge. The chargeholder is now the possession creditor, and any competing claims for the collateral must now necessarily go through him.

**Method Three: As provided by Statute.** The last method provides for any future statutory means of completion to be sufficient. Thus far no such provision exists in the Secured Transaction Law.

#### **Discussion Question**

Summarize for yourself the differences between a security charge that has been created and one that has been completed. As a creditor, what kind of protections do you have in the former case? In the latter case?

### **C. Determining Priority between Securing Charges**

Now we reach the most common difficulty that occurs in a secured transaction: the priority contest that arises when someone other than the debtor asserts a claim to the secured party's collateral.

Sometimes, as provided under Article 24 (reproduced below), a secured party may agree to subordinate its security interest.

#### **Article 24. Subordination Agreement**

A person with a securing charge that has priority under this Law may agree to modify or forego his priority in favour of other Chargeholders. This is referred to as a subordination agreement. A subordination agreement must be in writing and recorded in the Registry.

However, if there is no subordination agreement in effect, then the priority contest is resolved by application of priority rules. Priority rules determine which claimant's interest will first be satisfied out of the collateral's value. Once this claimant's interest is satisfied, then the remaining value of the collateral is available to the other claimants. Of course, if the only way for a secured party to satisfy the debtor's outstanding obligation is to take possession of the collateral, then it is in the secured party's interest to obtain first priority. First priority consists of the right to apply the collateral to secured obligations before holders of other security interests or liens, and to the exclusion of the debtor or any other parties with interests in the same collateral.

Because Article 15(1) allows for a chargor to grant more than one securing charge over the same collateral, the best way for a secured party to maximize his chances at obtaining first priority is to (1) thoroughly determine that there are no other competing interests in the collateral before obtaining the securing charge over it, and (2) to achieve "completion" (as provided in Article 12) of the securing charge as early as possible.

To determine who will win the priority contest, it makes sense to first establish whether the competing creditors are secured creditors or unsecured creditors. The priority rules for the two possible scenarios are set out below:

#### **Secured Creditors vs. Unsecured Creditors**

→ Key Point: The creditor with an attached securing charge (*secured creditor*) always prevails over a creditor without a securing charge (*unsecured creditor*).

As we covered in the section about creating a security charge, once the creditor has "attached" the securing charge over the collateral, the claim becomes enforceable against the debtor and the creditor becomes a secured creditor. Once the securing charge is properly attached to the collateral, the secured creditor has priority over the claims of all other unsecured creditors.

An unsecured creditor is a creditor whose securing charge has not yet attached to the collateral. Securing charges will most often fail to attach when the securing agreement is unsigned or during the period before the collateral comes into possession of the debtor. As you will recall from our coverage of Article 7, until the securing charge is attached to the collateral, it is not enforceable against the debtor. Therefore, the holder of an unenforceable securing charge (an unsecured creditor) has no priority over the holder of an enforceable securing charge (a secured creditor), and has no special rights above any other unsecured creditor to the collateral.

### *Secured Creditors vs. Other Secured Creditors*

→ Key Point: The secured creditor who completes his securing charge first is the prevailing creditor.

In the case where two or more creditors have enforceable securing charges over the same collateral, some mechanism is necessary to determine which secured creditor has the stronger rights to the collateral and will prevail in a priority contest.

The basic rule in these situations is known as the “first-in-time, first in right” rule. This rule provides that the first creditor to file or complete his securing charge has priority over all other creditors. Therefore, the rule discussed above regarding secured and unsecured creditors only applies when the competing securing charges have not yet been completed. Imagine a scenario where Party A attaches the collateral before Party B, but Party B files with the Central Charge Registry, or takes possession of the collateral, before Party A. Party B, although the “loser” in the race for attachment, is the winner in the race for completion. It is important to remember that a completed securing charge always prevails over an incomplete securing charge.

Article 15(2) of the Secured Transaction Law, reproduced below, provides the hierarchy that is to be followed in establishing priority between creditors.

#### **Article 15(2). Priority between Securing Charges**

- 1-** A completed securing charge has priority over an incomplete securing charge. Priority among incomplete securing charges is determined on the basis of the first securing charge to attach to the collateral.
- 2-** Priority between two or more completed securing charges is determined on the basis of the order in which the chargeholders registered their securing charges, took possession of the collateral, or the securing charges were otherwise completed.

**Review Question:** On January 1, Rajibullah borrowed 15000 Afghanis from First Kabul Bank to purchase some machinery for his factory. He signed a securing agreement with the bank on January 1, which identified his car as the collateral for the loan. However, First Kabul Bank does not file a registration of the charge with the Central Charge Registry until 10 days later. On January 8, Rajibullah signs a securing agreement for 15000 Afghanis from Second Kabul Bank, which he also secures with the same car. Second Kabul Bank files with the Central Charge Registry later that day. Two months later, Rajibullah defaults on both loans. Which creditor has priority to Rajibullah’s machinery?<sup>20</sup>

<sup>20</sup> Under the provisions of Article 15(2)1, although both First Kabul Bank and Second Kabul Bank have enforceable securing charges over the car (under Article 7), Second Kabul Bank has priority because it completed before First Kabul Bank.

## D. Collecting the Collateral: The Creditor's Right to Remedy upon Debtor's Default

### 1. *Default by the Debtor*

When the debtor fails to carry out his obligations under the securing agreement, we say that he is in default. Once a debtor defaults on his secured obligation, the secured party will be entitled to resort to the collateral for payment. To understand how a securing charge over property becomes transformed into value in order to satisfy a secured obligation, you must first understand the rights that are embodied in a securing charge.

A securing charge gives the secured creditor a contingent right to the private property. This right is contingent because the creditor cannot exercise the right until a contingency has been fulfilled—in the case of a secured transaction, the contingency that must be met is the debtor's default on the loan. Default is not stipulated by the Secured Transaction Law. Rather, the parties must agree between themselves what actions will constitute a default within the specifics of their particular transaction and include these agreed-upon terms in the securing agreement. If what the parties decide constitutes default (the "default clause") is absent from the securing agreement, it would be extremely difficult for the creditor to get the securing agreement enforced, and collect the collateral, against the debtor.

Below is a sample default clause from a real securing agreement. Note that the parties do not limit their definition of default as the failure to repay a stipulated amount by a stated date. In the default clause below, the loss of or damage to the securing collateral could be enough to trigger the creditor's right in the securing charge. Furthermore, under article (e) of the sample default clause, default has occurred if the debtor enters bankruptcy. This measure is intended to protect the creditor. If the debtor is bankrupt before the deadline for his loan repayment has passed, the creditor is not obligated to wait until that deadline before he can exercise claims in the debtor's collateral. This helps the creditor because the sooner he is able to make the claim, the higher his priority for the collateral will be in relation to other creditors.

**Events of Default.** Debtor shall be in default under this agreement upon the occurrence of any of the following events or conditions, namely:

- (a) default in the payment or performance of any of the Obligations or of any covenants or liabilities contained or referred to herein or in any of the Obligations;
- (b) any warranty, representation or statement made or furnished to Secured Party by or on behalf of Debtor proving to have been false in any material respect when made or furnished;
- (c) loss, theft, substantial damage, destruction, sale or encumbrance to any of the Collateral, or the making of any levy, seizure or attachment thereof or thereon;
- (d) dissolution, termination of existence, filing by Debtor or by any third party against Debtor of any petition under any Federal bankruptcy statute, insolvency, business failure, appointment of a receiver of any part of the property of, or assignment for the benefit of creditors by, Debtor; or
- (e) the occurrence of an event of default in any agreement between Debtor and/or Secured Party.

**Legal Drafting Exercise:** Using the template for a default clause above as a model, try to draft a default clause for Rajibullah's loan from First Kabul Bank. Try to draft it from the viewpoint of the creditor (the bank). What are some difficulties that you think a creditor faces when drafting a default clause?

## *2. The Creditor's Right to Remedy*

You will remember that one of the benefits of entering a secured transaction as a creditor is protection should the debtor fail to fulfill his obligation to you. When a debtor defaults under a secured transaction, as defined by the securing agreement, the creditor is entitled to certain rights and remedies. The creditor derives his protection from three sources:

1. Rights provided in the securing agreement between the debtor and the creditor;
2. Rights to any available judicial procedure (as provided under Article 42, discussed later); and
3. Rights as provided under Article 29 of the Secured Transaction Law:

### **Article 29. Measures on Default of Payment or Default on Performances**

- (1) Upon Default on Payment or performance, the Chargeholder may directly Enforce its rights against the Collateral as provided in the Securing agreement.
- (2) The Chargeholder may apply to the court for compulsory enforcement in the case of Default on Payment by Debtor.
- (3) All rights, duties and obligations arising from a Securing agreement, must be exercised and performed in a commercially reasonable manner.

Once the secured party has a right to proceed with collecting the collateral, it does not matter if the collateral now belongs to a third party that was not a party to the initial securing agreement with the creditor. Although we refer to a creditor enforcing the securing charge against the debtor for simplicity's sake, we must remember that the legal relationship we are concerned with is between the creditor/chargeholder and the owner of the collateral (chargor). Therefore, if the original debtor sells the collateral with which he secured his loan to someone else in order to avoid losing the collateral when he defaults, the collateral he sells is encumbered by the securing charge and is transferred to the next owner.

Although this may seem unfair to the subsequent owner, his recourse against the debtor lies in the debtor's representations to him when selling the collateral. For example, suppose that Rajibullah knows that he will not be able to repay his loan to the bank, and that once he is in default, the bank will have the right to possess the car that he used as collateral for the loan. If Rajibullah then tries to sell his Mercedes to Abdul in order to avoid losing the car to the bank, and makes representations that no other creditor has any claims over the car, then when the bank tries to enforce its securing charge over the car against Abdul, Abdul's may have recourse against Rajibullah for fraudulent misrepresentation.

However, Article 25(1) of the Secured Transaction Law tries to protect against this eventuality by requiring the transfer of responsibilities in a securing agreement (which occurs simultaneously with a transfer of the collateral) to be approved by the chargeholder. Both the bank and Abdul would therefore be on notice about their new relationship in the securing agreement. First Kabul Bank will now know to enforce its claim on the car against Abdul should Rajibullah default, and Abdul will know that the car comes encumbered with the possibility that it will be possessed by Rajibullah's creditor. Therefore, if Abdul were not willing to take on this significant liability, he would then withdraw his offer to buy the car from Rajibullah.

#### **Article 25. Transferring Responsibilities of Chargor and Debtor**

(1) Unless otherwise stated in this Law, the rights and responsibilities of a Chargor and Debtor in a Securing agreement and regarding a Debt can be transferred to another Person after consent of the Chargeholder.

Just as the duties and rights of a chargor may be transferred to a third person, so can a chargeholder transfer his right to collect the collateral from a secured loan to another person under Article 26. However, note that while the transfer of a chargor's responsibilities requires the consent of the chargeholder, the transfer of a chargeholder's right to collateral necessitates no such consent from the debtor—only notice to the debtor is required in order for the transfer to be enforceable. If the debtor does not feel comfortable with the possibility of having to owe a debt to a future, unspecified party, the debtor can request that the Chargeholder agree to forego transfer in the original securing agreement.

#### **Article 26. Rights of Transferring Responsibilities of a Chargeholder**

- (1) A Chargeholder may transfer his right to receive payments on a debt, along with related collateral, to a transferee without permission of the account debtor.
- (2) A transfer is enforceable upon written notice to the account debtor. Notice is not required for creation, attachment or completion of a securing charge on an account.

### ***3. Methods Available to the Creditor for Repossessing Collateral from the Debtor***

Practically speaking, in order for a creditor to execute his right to remedy, he must take control over the debtor's collateral. Article 29 outlines the measures that are available to the creditor to "repossess" the collateral upon the default of the debtor.

If the creditor is not already in possession of the collateral, he can require the debtor who has defaulted to assemble the collateral and make it available within 30 business days, unless the securing agreement specifies a longer or shorter time period for compliance. In cases where the debtor refuses to voluntarily surrender the collateral, the creditor has certain repossession options, such as the right to apply for "compulsory enforcement" from the court.

Finally, Article 29 requires that all the rights, duties and obligations that are created by the securing agreement must be exercised in a “commercially reasonable manner.” Although the law does not further elaborate on what behavior qualifies as “commercially reasonable,” we can turn to how the American common law system has defined “commercially reasonable” in this context for some guidance. Under American secured transaction law, all the rights, duties and obligations arising from a securing agreement must be executed in a “commercially reasonable manner.” In applying this requirement, the American courts have focused on the creditor’s conduct in their attempts to sell, or “dispose,” of the collateral once it has been repossessed (this concept is discussed in detail in the following section). That is, the courts will look to the effort made by a creditor to find a purchaser who will pay a reasonable price for the collateral. If the disposition of the collateral is through a public sale, the courts will look to the good-faith efforts made by the creditors to publicize the sales in places where likely bidders will learn of them. If the disposition of the collateral is through a private sale, then the courts will look to the efforts made by the creditors to find interested parties with whom to negotiate.

However, in some cases, the collateral in a secured transaction may not be a tangible item that can be repossessed, but rather, is in the form of an account, instrument or security. For example, the debtor in Secured Transaction A may himself be a creditor to other debtors in Secured Transaction B. In such a case, the debtor may use the future repayments that he anticipates receiving as the creditor in Secured Transaction B as collateral for the loan with the creditor in Secured Transaction A. Pursuant to Article 30, the creditor in Secured Transaction A could collect the payments directly from the debtors in Secured Transaction B. The secured party is permitted to add any costs of collection, including legal expenses incurred from dealing with any third parties, to the debt owed by the debtor.

#### **Article 29. Measures on Default of Payment or Default on Performance**

- (1) Upon default on payment or performance, the Chargeholder may directly enforce its rights against the collateral as provided in the securing agreement.
- (2) The Chargeholder may apply to the court for compulsory enforcement in the case of default on payment by debtor.
- (3) All rights, duties and obligations arising from a securing agreement, must be exercised and performed in a commercially reasonable manner.

#### **Article 30. Collection of an Account, Instrument and Security**

- (1) After a default and notice of default, the Chargeholder may inform any person owing money to the Chargor pursuant to an account, an instrument or a security to pay such money directly to the Chargeholder.
- (2) Any costs or expenses incurred while enforcing clause (1) of this article shall be paid from the funds recovered to the Chargeholder.

#### ***4. Disposition of the Repossessed Collateral by the Creditor***

Once a creditor has successfully repossessed the collateral, he is entitled to sell it in order to obtain the funds to satisfy the secured obligation. The Secured Transaction Law permits the sale, lease, license or other disposition of the collateral. The most common methods for disposition of the collateral include a public sale (auction) or a privately negotiated transaction (see Article 33). Note that the law requires the secured creditor to give proper notice of the proposed sale to the debtor, so that if the debtor chooses, he may “redeem” the collateral (i.e., pay the loan in full in order to free the collateral from the creditor’s securing charge) prior to its sale (see Articles 35 and 39).

Although redemption rights are important, they are infrequently exercised. If a debtor defaults, usually it means that he does not have the money available to make a scheduled installment payment to the creditor. If that is the case, it is unlikely that he will have the funds to pay off the entire loan in one lump sum in order to free the collateral. In some cases, the debtor may take on another loan in order to amass enough cash to redeem the collateral, but without other assets available as collateral, it would be difficult for the debtor to obtain such a loan.

Finally, recall from the previous section that all disposition of the collateral is subject to the “commercially reasonable” requirement imposed by Article 29.

#### **Article 33. Method of Disposal and its Effects**

- (1) Any or all of the collateral may be disposed of by:
  - (i) Public sale, private sale, lease or otherwise, subject to provision of this law, and may take place at any time or place and on any terms that are considered commercially reasonable; or
  - (ii) Purchase by the Chargeholder at a public sale for a purchase price considered at or near the commercial value of the collateral purchased.
- (2) Disposal of collateral in accordance with this law terminates the Chargeholder’s Securing charge, any subordinate securing charge and the Chargor’s interest in the collateral.
- (3) Any person that is liable to a Chargeholder under a guarantee, endorsement or similar agreement, and pays the debt, and receives a transfer of collateral from the Chargeholder, will succeed to the rights and duties of the Chargeholder. Such a transfer is not considered a disposal of collateral.

#### **Article 35. Notice of Disposal**

- (1) The Chargeholder shall give Notice of disposal not less than fifteen (15) days prior to disposal of the collateral to the Chargor and to any other Chargeholder registered in the Registry. Such notice shall include:

- (i) A description of the collateral;
- (ii) The unpaid amount of the debt secured under the securing agreement;
- (iii) The amount of costs and expenses or, where this amount has not been determined, a reasonable estimate;
- (iv) A statement that, on payment of the total unpaid amount in (ii) and (iii) above, a person entitled to receive notice may redeem the collateral;
- (v) A statement that, unless the collateral is redeemed by a person entitled to notice, it is subject to disposal and the debtor and/or Chargor may be liable for the total unpaid amount of the debt not recovered from the disposal; and
- (vi) The day, time and place of any sale by public auction, the place to which closed tenders may be delivered, and the day after which closed tenders will not be accepted, or the date of any other disposal of the collateral.

### **Article 36. Notice not Required**

Notice of disposal is not required when:

- (1) The Chargeholder has reason to believe that the collateral consists of perishable items or will decline substantially in value if not disposed of immediately;
- (2) The cost of care and storage of the collateral is disproportionately large in relation to its value; or
- (3) After default, each person entitled to receive notice consents in writing to disposal of the collateral.

### **Article 39. The Right of the Chargor to Redeem the Collateral**

- (1) At any time before the Chargeholder has disposed or contracted for disposal of the collateral, or before the Chargeholder is deemed to have irrevocably elected to retain the collateral, the Chargor or any other Chargeholder may redeem the collateral by paying all unpaid debt to the Chargeholder. If applicable, the Chargor or other Chargeholder must also pay the Chargeholder reasonable expenses for seizing, holding, repairing, and preparing the Collateral for disposal.
- (2) The Chargor may provide a written waiver of his right to redeem collateral after default on payment or default on performance.

## ***5. Priority of Distribution of the Proceeds from Disposal***

Once the collateral has been disposed of pursuant to the above requirements, the Secured Transaction Law mandates that the proceeds from the sale of the collateral must first be applied to reimburse the creditor for all reasonable expenses incurred in enforcing the securing agreement, and in repossessing and selling the collateral.

Only after these expenses have been recovered may the cash proceeds from the sale of the collateral be applied to the debt itself. Next, if there are any remaining funds, then the creditors that are subordinate in priority who have satisfactorily established their claims are entitled to be repaid in order of priority. Finally, the debtor is entitled to whatever surplus that may remain. Article 32 of the Secured Transaction Law outlines the hierarchy of priority in which the proceeds from the disposal of collateral must be applied:

#### **Article 32. Disposal of Collateral**

Upon default under a securing agreement, the Chargeholder may dispose of some or all of the collateral before or after any commercially reasonable repair, processing or preparation. Proceeds from such disposal shall be applied in the following order:

- (1) To pay reasonable expenses of the Chargeholder, including cost of insurance, payment of taxes and any costs incurred in taking, holding, repairing, processing or preparing the collateral for disposal. Other expenses may include those stated in the securing agreement;
- (2) To pay the debt covered by the securing agreement;
- (3) To pay any surplus funds to other Chargeholders in order of priority; and
- (4) To pay any remaining funds from clause (3) to the Chargor.

If the creditor sells the collateral to a good-faith purchaser, Article 40 provides protection to buyers of collateral by allowing that purchaser to take the property free of any claims from the chargor or from the debtor's subordinate chargeholders.

As it stands, Afghanistan's Secured Transaction Law makes no provision for what happens if the creditor sells the collateral to a good faith purchaser but the proceeds are insufficient to repay the debtor's original loan. Although Article 40 makes clear that the purchaser is not liable for the deficiency (the difference between the sale price of the collateral and the amount owed by the debtor), it does not expressly identify who the party liable for this deficiency is. Under American secured transaction law, the debtor is liable for any such deficiency, and the creditor is entitled to sue the debtor for this amount through a breach of contract claim. In those situations, courts will generally award a deficiency judgment for the difference between the debt amount and the sale price of the collateral to the creditor. As you can imagine, this is an important omission in the law because it exposes creditors to a significant risk of under-compensation. It remains to be seen whether, through the process of international and domestic consultation, the Secured Transaction Law will be amended to take this eventuality into consideration.

#### **E. The Role of the Courts in Enforcing a Secured Transaction**

A common theme throughout this textbook has been the interaction between well-written laws and the institutions necessary to support the implementation of these laws. In the realm of

secured transaction alone, we see two such institutional vacuums that need to be filled in order for the law on secured transactions to promote economic development. The first is the need for a modern Central Charge Registry, and the second is the need for an efficient judiciary that can respond in a timely and effective manner to creditors' requests for enforcement.

However, policy makers tasked with fashioning a secured transaction regime continue to debate the role that the courts should play in this process. Those who are in favor of more court intervention in the area of secured transactions feel that the courts are best positioned to objectively and definitively rule on issues of whether a securing agreement exists in the first place, what the terms of the securing agreement are, and how such an agreement should be enforced.

On the other hand, others argue that the involvement of the courts necessarily slows down the secured transaction system, thereby depriving the parties of the simple and efficient resolution that is integral to keeping secured lending profitable and attractive. The advocates for less court involvement argue instead that the Secured Transaction Law should vest more self-enforcement rights in the parties, allowing them to bypass a court system that currently lacks the capacity to be a strong institutional enforcer of an effective secured transaction regime.

#### **Discussion Question**

What do you think the role of the courts should be in Afghanistan's secured transaction framework? What alternative institutions would you create to fulfill the function of enforcement of secured transactions?

#### **Article 42. Request to the Court for Possession or Disposal**

(1) If the Chargeholder cannot or chooses not to take possession of the Collateral as provided in Article Thirty One, and elects to take possession of Collateral or dispose of such Collateral pursuant to Article Twenty Nine, clause (2), he may request in writing that the court order compulsory enforcement. The court may rule on the Chargeholder's request by the following manner, within 15 days:

- (i) Deliver Collateral to the Chargeholder, or his agent, for disposal;
- (ii) Dispose of the collateral;
- (iii) Require persons to pay fees and expenses as provided in the related procedures, or
- (iv) Seize the collateral.

(2) Neither the court nor the police officer as directed by the court is required to give prior notice to proceeding with clause (1) of this Article. Before disposing of the collateral, the court shall give the same notice as required by Article Thirty-Five.

(3) A third party who has rights to the collateral and is affected by seizure or disposal of the collateral may apply to the court to:

- (i) Stop proceedings on a basis in fact that a Default has not occurred;

- (ii) Temporarily or permanently suspend the court decree if the Chargeholder has not complied with this Law; or
- (iii) Amend the distribution of money from the disposal of Collateral, within 30 days after distribution.

(4) The court will rule on application referred to in clause (3) of this Article within 15 (fifteen) days from the date the application is filed with the court.

## VI. KEY GOALS OF AN EFFECTIVE SECURED TRANSACTIONS REGIME

The legislation process can be fascinating in how laws influence the behavior and incentives of the people to whom they apply. In this sense, commercial law is especially interesting because carefully drafted laws can have the effect of shaping and nurturing the kind of economy that the Afghans of today hope to create for the Afghans of tomorrow.

As we have discussed throughout this chapter, in order for a secured transactions framework to encourage lending and enhance investment, it must:

- ❖ Enable businesses and individuals to use the value already inherent in their property to obtain the maximum credit possible;
- ❖ Provide accessible public notice of security interests in property through a centralized, computerized registration system; and
- ❖ Offer clear and certain determination of priority among creditors in the event of the debtor's default.

We will devote the rest of this chapter to examining some of the policy objectives that should be considered as Afghanistan's Secured Transaction Law is implemented. For the most part, this section should strike you as a conceptual review of the mechanics that we have already covered in this chapter, but presented within the broader context of the interplay between law and development policy.<sup>21</sup>

### 1. *Promoting the availability of secured credit*

The increased availability of secured credit will enable individuals and the economy as a whole to obtain the economic benefits that flow from access to such credit.

### 2. *Allowing utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of credit transactions*

A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to use the full value inherent in their assets to obtain credit in a broad array of credit transactions. There are three main approaches to attaining this objective: (1) permitting a

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<sup>21</sup> This section is largely drawn from the United Nations Commission on International Trade Law (UNCITRAL) Draft Legislative Guide on Secured Transactions, 2007.

broad range of assets (including present and future assets) to serve as encumbered assets;(2) permitting the widest possible array of obligations (including future and conditional and monetary and non-monetary obligations) to be secured by security rights in encumbered assets; and (3) extending the benefits of the regime to the widest possible array of debtors, creditors and credit transactions.

3. Enabling parties to obtain security rights in a simple and efficient manner

The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, a good secured transaction regime must provide methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs.

These methods include eliminating unnecessary formalities; providing for a single method for creating security rights rather than multiple security devices for different kinds of encumbered assets; and permitting security rights in future assets and for future advances of credit without any additional documentation or actions by the parties.

4. Providing for equal treatment of diverse sources of credit

Because healthy competition among all potential creditors is an effective way of reducing the cost of credit, the secured transactions regime should apply equally to various creditors, including banks and other financial institutions, as well as domestic and non-domestic creditors.

5. Validating non-possessory security rights

Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, a secured transactions regime should provide for non-possessory security rights in a broad range of assets coupled with a mechanism in the form of a public registry system for publicizing the existence of such security rights.

6. Encouraging responsible behavior on the part of all parties by enhancing predictability and transparency

Because an effective secured transactions regime should also encourage responsible behavior by all parties to a credit transaction, it should promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting and addressing confidentiality concerns.

7. Establishing clear and predictable priority rules

A security right will have little or no value to a creditor unless the creditor is able to ascertain, at the time a transaction takes place, its priority in the property relative to other creditors. For this reason, a centralized and, ideally, computerized system for registering public

notices of securing charges is vital. Such a system will also provide clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

8. Facilitating enforcement of creditors' rights in a predictable and efficient manner

A security right will be of limited value to a creditor unless the creditor is able to enforce the security right in a predictable and efficient manner. Thus, the Guide proposes procedures that allow creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The Guide also recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate rules of insolvency law.

9. Balancing the interests of affected persons

Because secured transactions affect the interests of various parties, including the debtor, other grantors, competing creditors (such as secured, privileged and unsecured creditors), purchasers and other transferees, as well as the State, the rules in a secured transaction framework should take into account these parties' legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.

10. Recognition of party autonomy

Because an effective secured transactions regime should provide maximum flexibility and durability to encompass a broad array of credit transactions, and also accommodate new and evolving forms of credit transactions, the mandatory rules should be kept to a minimum so that parties may tailor their credit transactions to their specific needs. At the same time, the secured transaction regime must also recognize that other legislation may protect the legitimate interests of consumers or other persons, and should work in conjunction with, and not override, such legislation.

**Final Review – The Secured Transaction Process**

*Fill in the blank with the appropriate term from the definitions we have covered. Note that the same term may be used more than once.*

The process begins when a \_\_\_\_\_<sup>22</sup> requests a loan from a \_\_\_\_\_<sup>23</sup>. A lender will require \_\_\_\_\_<sup>24</sup> to secure a loan when a borrower's ability to repay the loan is uncertain. Collateral may take the form of a \_\_\_\_\_<sup>25</sup> on movable property.

<sup>22</sup> Borrower/debtor

<sup>23</sup> Lender/creditor

<sup>24</sup> Collateral

<sup>25</sup> Securing charge

The person who holds the securing charge over the collateral, who is also often the creditor, is known as the \_\_\_\_\_.<sup>26</sup>

A \_\_\_\_\_<sup>27</sup> is the contract underlying the secured transaction, and creates duties, rights and remedies for both the lender and the borrower.

If a \_\_\_\_\_<sup>28</sup> defaults on his loan, the \_\_\_\_\_<sup>29</sup> is entitled to certain remedies, including the sale of collateral without the Chargor's consent and without Court intervention.

In most situations, a securing charge must be recorded with the \_\_\_\_\_.<sup>30</sup> A prudent \_\_\_\_\_<sup>31</sup> will register his charge against the \_\_\_\_\_<sup>32</sup>'s collateral with the \_\_\_\_\_<sup>33</sup> to establish its priority and protect it from claims by other \_\_\_\_\_<sup>34</sup>.

## VII. CONCLUSION

As part of a thriving economy, all businesses, be they service providers, manufacturers, or end-use retailers, continuously require new capital in order to operate, innovate, and compete successfully in a burgeoning marketplace. In an economy such as Afghanistan's, which is just beginning its recovery after decades of conflict, it is even more vital that the inherent value in every asset be released and mobilized, so that credit can be obtained to fund the ideas and plans of those seeking to rebuild the Afghan economy.

As we have discussed in this chapter, a legal system supports secured transactions by reducing the perceived risk of credit transactions, thereby promoting the availability of credit and capital for growth. However, thus far the secured transaction regime that we have studied is a purely domestic one. As the Afghan economy flourishes and the country becomes a player in the international marketplace, the secured transaction regime must also be transformed to allow Afghanistan to participate in international trade and the movement of goods and services across national borders. As the future policymakers of Afghanistan, it will perhaps be incumbent upon you to devise a new secured transaction regime that will not only unlock the value of assets within the country, but which will also open the door for international cooperation in business ventures.

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<sup>26</sup> Chargeholder

<sup>27</sup> Securing agreement

<sup>28</sup> Borrower/debtor

<sup>29</sup> Lender/creditor/chargeholder

<sup>30</sup> Central Charge Registry

<sup>31</sup> Lender/creditor/chargeholder

<sup>32</sup> Borrower/debtor/chargor

<sup>33</sup> Central Charge Registry

<sup>34</sup> Lenders/creditors/chargeholders

## **Glossary**

### ***Asset***

Something valuable that an entity owns, benefits from, or has use of, in generating income. An asset can be (1) something physical, such as cash, machinery, inventory, land and building, (2) or something intangible, such as copyright, patent, trademark, or goodwill. Assets shown on their owner's balance sheet are usually classified according to the ease with which they can be converted into cash.

### ***Credit***

A contractual arrangement whereby a creditor exchanges goods, services, or money against a debtor's promise to pay later.

### ***Default***

A default occurs when a party to a contract fails to comply with the terms of a contract. Most contracts make provisions for handling defaults by including the conditions or procedures for dispute resolution and compensation (remedy).

\*Please note that this Glossary should be studied in conjunction with the list of definitions and terms from Afghanistan's Law for Secured Transaction, presented earlier in this chapter.

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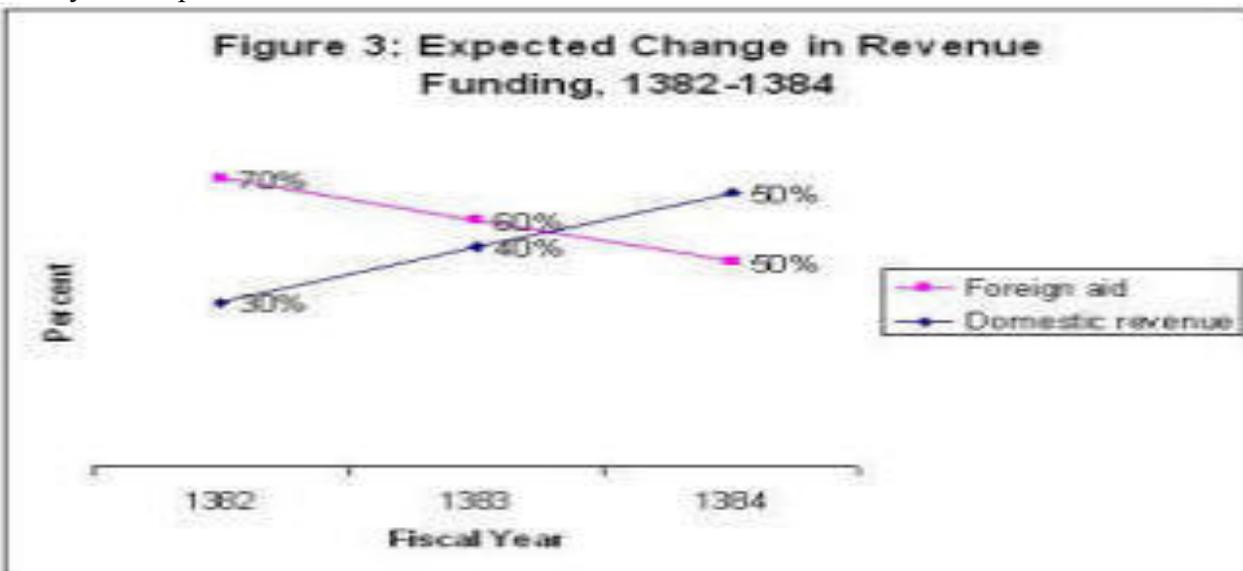
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## CHAPTER 7: TAX LAW

### I. INTRODUCTION

Governments are responsible for providing a variety of goods and services to their citizens and residents, such as police protection, sanitation services, and education, among many others. Governments can only provide these goods and services, however, to the extent they have the funds to pay for them. For many governments, the imposition of taxes is the primary method used to collect the funds necessary to provide goods and services. Thus, the primary purpose of a tax system is to raise revenue for the government. Although many people may object to the payment of taxes, the goods and services they expect their government to provide generally cannot be financed without taxes.

Afghanistan in particular desperately needs to boost its domestic tax revenue. Currently, a sizeable portion of the funds that are used to provide goods and services come not from domestic sources, but from foreign assistance. The figures below show the percentage of government revenue that comes from domestic and foreign sources respectively. However, this amount of foreign financial assistance will be unsustainable over time since foreign donors will expect Afghan citizens to take greater responsibility for their country's budget, particularly as the country develops.



Source: Afghanistan Ministry of Finance website (<http://mof.gov.af/en>)

Many elements must be considered when implementing or evaluating a tax system. First, taxpayers must be confident that their taxes are going to serve a legitimate purpose; even if they do not agree with the exact way in which the taxes will be spent, they should at least be confident that their taxes are not being taken by corrupt officials. But more than that, taxpayers want to receive services from their government in exchange for the taxes that they pay. Second, and most importantly, taxes should be “fair.” Tax fairness is a much debated issue, and reasonable people

will often disagree on how the tax burden should be distributed among society. Third, taxes should be efficiently collected. If the government spends anywhere near the amount of money on collecting taxes as the government actually raises in taxes, taxation is inefficient. There should also be clear and accessible rules that inform citizens as to when they must pay taxes and how much they must pay. Uncertainty about tax burdens can have a deterrent effect on investment since investors will be less willing to provide *capital* to a new business if they think their profits will be reduced by high taxes.

This chapter begins by examining basic tax theory and the types of taxes available to governments. In Afghanistan, the vast majority of government revenue raised domestically comes from just two taxes: the income tax and customs duties. The income tax is a tax levied on income earned by a taxpayer over the course of the year. Customs duties are taxes levied on goods transported into or out of the country. Afghanistan's current tax laws, the Income Tax Law of 2005 and the Customs Code of 2005, were passed only recently in 2005. The provisions and enforcement of these two laws are the focus of this chapter.

## **II. INCOME TAX IN AFGHANISTAN**

The first major source of revenue for the Afghan government comes from taxes on the income earned by taxpayers over the course of the year. The income tax must be calculated and paid at the end of each taxable year, based on the income received during that taxable year. The taxable year is the solar year, beginning on the first day of Hamal (21 March) and ending on the last day of Hoot (20 March). Income taxes are prevalent throughout the world; most developed countries and many developing countries have some form of income tax. If it is designed correctly, it can be a very fair tax. Taxpayers are only taxed on the amount of income they earned the previous year.

Because of the complexity of an income tax and the information required from taxpayers to assess compliance, however, income taxes can be very difficult to administer. Many countries have large and expensive bureaucracies to oversee their income tax systems (for example, the Internal Revenue Service in the United States and the Inland Revenue in the United Kingdom).

This section reviews the history of income tax laws in Afghanistan and examines the current income tax laws, tax collection procedures, and penalties for noncompliance. It concludes with an assessment of Afghanistan's system of income taxation.

### **A. History**

Before 2005, the income tax system was based on the 1965 income tax law, which was subsequently amended by 18 separate decrees. The current income tax system of Afghanistan took effect in 2005, with the Income Tax Law of 2005. The Income Tax Law was approved by the Council of Ministers and subsequently endorsed by the President on 14 November 2005. The current law contains some changes, but most provisions are reenactments of the 1965 income tax law. The Income Tax Law of 2005 was adopted in accordance with the Constitution of Afghanistan. Article 42 of the 2004 Constitution of Afghanistan states:

## CONSTITUTION OF AFGHANISTAN: ARTICLE 42

Every Afghan shall pay taxes and duties to the state in accordance with the provisions of the law. No taxes or duties shall be levied without legal representation. Tax rates and duties as well as the method of payment shall be determined, with due respect to social justice, by law. This provision shall also apply to foreign individuals and organizations. Every kind of tax, duty as well as paid incomes shall be deposited to a single state account.

The Ministry of Finance has also issued an Income Tax Manual under the authority granted to it by Article 113(2) of the Income Tax Law. The Income Tax Manual is an official source of guidance to the Afghanistan Revenue Department and others regarding the interpretation and application of the Income Tax Law.

### **B. Persons and Income Sources Subject to Tax**

There are two important principles that determine which people and what sources of income are subject to taxation. The first principle is the *type of person*. The law distinguishes between “natural” and “legal” persons and assesses them at different tax rates. **Legal persons** are corporations, LLCs, and other legal entities. **Natural persons** are individuals, sole proprietors, and the partners of a partnership. The income of general and special partnerships is taxed through the individual partners, each of whom must pay tax on his share of the partnership’s income (Article 33).

The second important principle is *residency*. A legal person (corporation or LLC) is considered a resident if the entity is either established in Afghanistan or has the “center of its administrative management in Afghanistan at any time during the fiscal year” (Article 2). A natural person is a **resident** if the person has his principal home in Afghanistan at any time during the fiscal year, the person is present in Afghanistan for at least 183 days in the year (i.e. more than one-half of the year), or the person is a government employee assigned abroad for any part of the fiscal year (e.g. an employee of the Ministry of Foreign Affairs).

Resident persons of Afghanistan are taxed on all of their taxable income, even if it comes from sources outside of Afghanistan. However, if the person pays income tax to a foreign government on its foreign income, that tax may be credited against the tax owed to the Government of Afghanistan on that same foreign income (Article 5).

Nonresidents, by contrast, are taxed only on income received from sources within Afghanistan. Their taxable income does not include income received from foreign sources (Articles 7 and 8). Furthermore, a nonresident will be completely exempt from income tax if the nonresident’s home country grants a similar exemption to residents of Afghanistan (Article 6). Thus, if Country X exempted nonresidents from income tax, nonresidents from Country X living in Afghanistan would similarly be exempted from Afghan income taxes.

The following chart summarizes the standard income tax rates in Afghanistan based on residency and type of person. The specific rates are discussed in further detail later.

	Resident	Nonresident
Legal person	20 percent of worldwide income	20 percent of income sourced in Afghanistan
Natural person	0-20 percent of worldwide income	0-20 percent of income sourced in Afghanistan

**Illustration:** Here are two examples that illustrate the differences between the tax treatment of residents and nonresidents and between domestic and foreign income:

1. A mining corporation is headquartered in Kabul and operates mines in Afghanistan and Pakistan. Since the company is headquartered in Afghanistan, it is considered a resident of Afghanistan. Therefore, it must pay tax on the income it receives from its mining operations in Afghanistan *and* Pakistan. However, if the company were not established as a legal entity or headquartered in Afghanistan, it would only have to pay tax on the income it receives from its mining operation in Afghanistan.

2. Hamid lives in Afghanistan for 200 days out of the year and lives in Iran for the remaining days. Thus, he is a resident of Afghanistan and must pay income tax on all of his wages received in Afghanistan *and* Iran. However, if Hamid pays the Government of Iran tax on the wages he earns in Iran, that tax will be credited against the tax he owes on those wages to the Government of Afghanistan. In contrast, if Hamid lives in Iran for 200 days and Afghanistan for only 165 days, is not an Afghan government employee, and does not have his principal home in Afghanistan, he will only be required to pay income tax on his wages received in Afghanistan.

Finally, entities that meet certain requirements, regardless of the above principles, are entirely exempt from income taxation (Article 10). The entity must be (1) established under the laws of Afghanistan and (2) organized and operated exclusively for educational, cultural, literary, scientific, or charitable purposes; and (3) contributors, shareholders, members, or employees cannot receive a benefit from the organization. This last requirement is rather vague (for example, does salary for employees count as a benefit?) but probably reflects a desire to limit such favorable tax treatment to entities exclusively dedicated to the public welfare.

### Discussion Questions

Why should entities “organized and operated exclusively for educational, cultural, literary, scientific, or charitable purposes” receive preferential tax treatment? Recall the principle that taxes can be used to encourage or discourage certain behavior. Why do you think the government has singled out these entities for favorable tax treatment?

### C. Taxable Income

Afghanistan’s income tax law distinguishes between different *types* of income (not to be confused with *sources* of income, which refers to the national origin of the income). Individuals, and especially companies, may receive money and other benefits from a variety of places. These

can include wages, interest or **dividends** earned on investments, commercial activities, rent, or commissions on sales (see Article 20 for a complete list). Income is not limited to only *money* that a taxpayer receives. If a taxpayer receives *property*, the value of that property is considered income. For example, if a taxpayer receives property with a value of 10,000 Afghanis, the Income Tax Law treats this transaction in the same way as it would 10,000 Afghanis in cash.

**Taxable income** is defined as the “the total of all receipts of an individual, corporation, limited liability company, or other legal person less those exemptions and deductions authorized” by the Income Tax Law (Article 12). Understanding what income may be exempted and what expenses may be deducted is essential to understanding how to calculate taxable income.

### *Covered and Exempted Types of Income*

#### *General provisions*

Certain types of income are exempt from taxable income and therefore not subject to tax. An individual may receive wages and health insurance from her employer, a scholarship from an international organization for part-time education, and dividends from shares she owns in a company. Which of these income types should be subject to taxation?

In Afghanistan, the following types of income are subject to taxation: salaries, wages, fees, and commissions; receipts derived from business and industry; receipts from the sale of movable and immovable property; interest, dividends, rents, royalties, awards, prizes, winnings, and bakhshish (gratuities, bonus payments); distributive shares of partnership **gross income**; and any other return from labor, capital, or economic activity (Article 13).

On the other hand, Article 14 lists types of income that are exempt from taxes. Examples include grants/awards/gifts from the Afghan government; certain grants from foreign governments or international organizations; educational grants; health, accident, and unemployment insurance benefits; life insurance benefits paid upon death; money received by a company from a loan or the issuance of shares to shareholders; and interest received on deposits by State banks.

What is the rationale for exempting certain types of income? Income is generally exempted when the government is trying to encourage the activity that produces that income. For example, in order to promote education, income tax laws generally exempt educational grants and scholarships.

#### *Capital gains*

Gains received from the sale or transfer of certain types of property are subject to income tax. In some countries, this is referred to as a “capital gains tax.” A gain is the difference between the price the taxpayer paid for the property and the price the taxpayer sold the property for. The provisions of the Income Tax Law that relate to the capital gains tax are Articles 21-30.

Gains from the sale or exchange of a **capital asset** or investment are taxable. A capital asset is an asset that is used to make more money (rather than being consumed) such as cash, stocks, and bonds. In addition, gains on the sale, exchange, or transfer of the following property are also taxable: businesses; factories (including equipment, machinery, buildings and land); equipment used in the business of transporting persons and property; shares of stock in corporations or limited liability companies; and the assets of a corporation or LLC when the company is liquidated (see Articles 23 and 44 for a complete list). The method of the sale, exchange or transfer will have no effect on the tax, unless the form of transfer is an inheritance, in which case the tax does not apply (Article 26). The value of the asset for tax purposes will be based on its market value at the time it was sold, exchanged, or transferred (Article 25).

We treat capital gains separately because some capital gains are subject to special tax rates instead of the standard tax rates listed in subsection D. The tax rate for the sale of immovable property (such as a building) is fixed at one percent, and the tax rate for the sale of movable property (such as a tractor or other vehicle) is fixed at two percent (Article 30). Assets that are held for at least 18 months before being sold or transferred and that meet the following conditions are also subject to a *special tax rate*: the transfer occurred in a form other than a sale or inheritance; the transfer occurred as part of a sale or liquidation of a business or the asset transferred was a capital asset. The process for calculating the special tax rate can be found in Article 29(3).

### Discussion Question

Think critically about why certain types of income are exempted while others are not. Do you agree that these types of income deserve to be exempted?

### Deductible Expenses

A company may receive 200 Afghanis from a customer for a certain product, but it may have paid 100 Afghanis to the person that supplied the materials for the product and 50 Afghanis to the employee that built the product. Should the company have to pay taxes on the entire 200 Afghanis or just on the profit of 50 Afghanis?

Afghanistan allows certain expenses to be deducted from taxable income. To deduct an expense is to subtract it from the taxable income. This lowers the amount of income subject to taxation, and thus lowers the tax owed. Generally, taxpayers can deduct expenses that were incurred during the production of the income.

#### *Ordinary and necessary business expenses*

The law allows the “[d]eduction of all ordinary and necessary expenses of the production, collection, and preservation of income of natural and legal persons” (Article 18). In other words, all legal and natural persons can deduct costs incurred as part of the production of income (as long as the expense was incurred during the tax year or one of the three previous tax years). These costs can include wages paid to employees, the cost of materials used to construct a product, interest paid on business loans, rent paid on property used for the business, dividends

paid in cash (as opposed to additional shares), taxes that are a necessary part of doing business (for example, the Business Receipts Tax), and even damage caused by a fire, earthquake or other disaster. See Article 18 for a complete list of deductible expenses.

**Illustration:** Returning to our example from the beginning of this subsection, the company would be permitted to deduct the 100 Afghanis it paid to the person that supplied the materials for the product and the 50 Afghanis it paid to the employee that built the product. Thus, it would only pay tax on the profit of 50 Afghanis. Similarly, if a truck driver earns 100 Afghanis delivering a shipment but spends 5 Afghanis on petrol while delivering the shipment, he should deduct the cost of the petrol from the amount he earns, so his actual taxable income is only 95 Afghanis. The petrol is an expense that the taxpayer incurred while “producing” the income.

Other types of expenses, however, are not deductible. Generally, these include expenses incurred for personal benefits, such as a taxpayer’s housing, food, or entertainment (see Article 19 for a full list). You could argue that some personal expenses arguably relate to employment and the production of income—such as the costs of commuting to and from work and the costs of health or life insurance—and thus should be deductible. However, these expenses currently are non-deductible. When a taxpayer spends money on himself, it is not considered money spent to produce income.

#### *Capital losses*

Recall that gains from the sale or exchange of certain assets (capital gains) are taxable. However, losses incurred in such sales may be deducted in calculating taxable income, as long as (1) the deduction is taken for the taxable year in which the sale occurred, and (2) had the sale or exchange resulted in a gain, it would have been taxable as a capital gain. Thus, if you buy a business for 100,000 Afghanis but sell it for 80,000 Afghanis, you could deduct the amount you lost (20,000 Afghanis). There is one exception to this rule however, which relates to stocks. Income from stocks is sequestered: stock losses can only be deducted from taxable stock gains as opposed to other types of income (Article 28). If you have more stock losses than gains during the taxable year, you can only deduct the losses up to the amount of the gains. You cannot “carryover” stock losses to other types of income.

#### *Operating losses of corporations and LLCs*

A corporation or LLC that incurs a net **operating loss** in a taxable year is entitled to deduct this loss from its taxable income for the three succeeding years, deducting up to one-third of the loss in each of the three years (Article 42). This is called “loss carryover” and it allows companies to “recover” some of their losses by effectively lowering their tax burden in future years. This provides an incentive for companies to undertake risky but socially valuable projects.

#### *Method of Calculation*

The method of accounting is important for tax purposes because it determines when income is recognized for tax purposes. Income may be owed to the taxpayer on a certain date, but there may be a delay before it is actually received by the taxpayer. While accounting

methods are beyond the scope of this chapter, it is worth noting that corporations and LLCs are treated differently from other persons. Corporations and LLCs must calculate their taxable income using the *accrual method*, which recognizes income and expenses on the date they are owed, even if the income and expenses are not paid on that date (Article 37). All other persons must use the *cash method*, which recognizes income and expenses only when they are actually paid (Article 38).

Another important concept is that all transactions must be valued for tax purposes as if they occurred between “unconnected” parties. This is often referred to as an arms-length transaction. For example, suppose that one company owned by Ahmed sells a product to another company owned by Ahmed (thereby making the two parties to the transaction “connected”) at a discounted rate of 100 Afghanis. Had no discount been offered, the price of the product would have been 200 Afghanis (i.e. the “market price”). Under Article 102, the company that sold the product must use the 200 Afghanis price when calculating its taxable income.

#### **D. Taxes and Rates**

The Income Tax Law contains several taxes, each with a different rate. You were exposed to one such tax and tax rate in the discussion of capital gains above. The goal of setting a tax rate is to strike a balance between raising revenues for government services and deterring valuable economic activities. Reasonable people will disagree on what this balance should be because they disagree about the amount of revenue a government needs to raise (which turns on a disagreement about the services government should or should not be providing). Tax rates can be a contentious economic, political, and social issue.

#### *What is a “Fair” Tax?*

Whether a tax is fair has to do with how the burden of taxation will be distributed among the citizens and residents of the jurisdiction in question. Whether taxes are imposed in accordance with taxpayers’ “ability to pay” is widely considered one of the primary measures of fairness with respect to taxes, but the precise meaning of this phrase is more complex than it might appear at first glance. For example, the “ability to pay” concept may be further divided into two principles: **horizontal equity** and **vertical equity**. Horizontal equity requires that similarly situated taxpayers be treated similarly under the tax laws (e.g., that taxpayers with similar incomes should pay similar amounts of tax), whereas vertical equity requires the tax laws to make appropriate distinctions between taxpayers that are differently situated (e.g., X, Y, and Z in the foregoing example would pay different amounts of tax that fairly reflect their different income levels). Think about whether the principles of horizontal and vertical equity are satisfied in each of the following tax regimes.

The simplest approach is a *head tax*, which is a tax of an equal amount on every person (or perhaps on every adult that is capable of working). Many people would consider such an approach unfair, for taxpayers in different financial circumstances would end up paying the exact same amount of tax. Thus, taxpayers with less income or wealth would bear a greater burden (in relative terms) than taxpayers with more income or wealth.

**Illustration:** Suppose that Country A has three citizens: X, a farmer who earns 1,000 Afghanis per year; Y, a university professor who earns 10,000 Afghanis per year; and Z, an owner of a large oil company, who earns 100,000 Afghanis per year. If Country A were to impose a head tax of 200 Afghanis, then each of X, Y, and Z would pay the same amount in taxes, even though Y is wealthier than X, and even though Z is considerably wealthier than Y or X. In other words, the head tax strikes many people as unfair because it treats all taxpayers the same way regardless of their “ability to pay” the tax. Taxpayer X’s tax burden would equal 20 percent of his income (200 Afghanis divided by 1,000 Afghanis), whereas Z’s tax burden would equal only 0.2 percent of his income (200 Afghanis divided by 100,000 Afghanis).

A second approach is a *progressive tax* in which tax rates increase as taxable income increases. Thus, under a progressive income tax, a taxpayer with greater income not only pays more in taxes than a person with lesser income, but also pays a greater proportion of his or her income in tax.

**Illustration and exercise:** Country A applies three tax rates to the income of individual taxpayers: zero percent for annual taxable income up to 5,000 Afghanis; 20 percent for annual taxable income up to 35,000 Afghanis; and 40 percent for annual taxable income above 35,000 Afghanis. How much tax would a person with an income of 1,000 Afghanis owe (Taxpayer X)? 10,000 Afghanis (Taxpayer Y)? 100,000 Afghanis (Taxpayer Z)? Taxpayer X would not be subject to any tax—his “effective tax rate” (the rate that reflects the amount of tax that X actually pays divided by X’s total income) would be zero percent. Taxpayer Y would not be subject to tax on the first 5,000 Afghanis of income, but would be subject to tax at a 20 percent rate for the remaining 5,000 Afghanis. He would pay 1,000 Afghanis in taxes ( $0.2 \times 5,000$ ) and would have an effective tax rate of 10 percent (1,000 Afghanis paid in taxes divided by an income of 10,000 Afghanis). Finally, Taxpayer Z would not be subject to tax on the first 5,000 Afghanis of income, would be subject to the 20 percent tax rate for the next 35,000 of income, and would be subject to tax at the 40 percent rate for the final 60,000 Afghanis of income. He would thus pay 31,000 Afghanis in taxes ( $0.2 \times 35,000 + 0.4 \times 60,000$ ) and have an effective tax rate of 31 percent (31,000 Afghanis paid in taxes divided by an income of 100,000 Afghanis).

Since Afghanistan uses a progressive income tax for natural persons, it is worth taking a minute to lay out the arguments for and against progressive taxation. Scholars and policymakers debate the fairness of the progressive tax. Advocates of the progressive tax argue that the tax is fair because the payment of additional taxes requires less sacrifice (in terms of subjective wellbeing) by wealthy taxpayers than poorer taxpayers. They also argue that the wealthy benefit disproportionately from government goods and services—particularly through the enforcement of laws that protect private property and from the provision of goods and services that facilitate the production and accumulation of income and wealth—and thus should pay a disproportionate share of their income in taxes. Finally, a progressive tax structure may serve as a vehicle for reducing economic inequality by redistributing income and wealth across society.

Opponents of the progressive tax argue that the mere fact that wealthier taxpayers can afford to pay a greater portion of their income in taxes does not mean that, as a matter of fairness, such taxpayers should be *required* to do so. Others challenge whether it is accurate to

assume that wealthy taxpayers sacrifice less by paying more taxes or that wealthy taxpayers benefit disproportionately from government services. Other critics contend that individuals are morally entitled to keep the “fruits of their labor” (i.e., their earnings and other income), and that the government’s redistribution of income or wealth from one person to another is itself unfair. Finally, some would argue that any tax system that imposes higher taxes on one person than another is fundamentally unfair, and that only a system in which each person (or at least each wage earner) pays the same amount of tax is fair.

Two other tax approaches bear mentioning. The first is the *flat income tax*, which taxes the income of all taxpayers at a single rate. A person with higher income would pay a greater *amount* of tax but would not pay a greater *proportion* of his or her income as tax. Thus, if the flat income tax rate were 20 percent, Taxpayer X would pay 200 Afghanis in tax, and Taxpayer Z would pay 20,000 Afghanis in tax. Supporters would argue that the flat income tax satisfies the principle of vertical equity, for it clearly requires differently situated taxpayers to pay very different amounts of tax. Yet, this approach also is arguably flawed, for taxpayers with different amounts of income are not equally (or even similarly) capable of paying the same rate of tax (e.g., a 20 percent tax rate will be much harder for X or Y to bear than for taxpayer Z). More generally, it is not clear why all taxpayers should pay the same rate of tax regardless of income level. Afghanistan uses a flat income tax for legal persons.

A *consumption tax* is another alternative. This is a tax on spending rather than on income. Consumption taxes have been described as “fairer” than income taxes because they tax people who spend more heavily than those who save. Suppose, for example, that Taxpayers W and Y both earn 10,000 Afghanis per year, and that Country A has the progressive income tax system described above; consequently, Taxpayers W and Y would both be subject to 1,000 Afghanis of income tax. Taxpayer W then chooses to spend 500 Afghanis on a vacation, while Taxpayer Y chooses to place 500 Afghanis of his income in an interest-bearing savings account. Since interest income is taxable, Taxpayer Y will be taxed on his interest, whereas Taxpayer W will not be taxed on his vacation. Unlike the consumption tax, this violates the principle of horizontal equity, for it treats people with the same income differently depending on whether they defer spending or spend immediately. Under a consumption tax, the money placed in the savings account may or may not be taxed depending on whether it is considered “spending” by the tax system.

Yet, a consumption tax may create more problems than it solves. For one thing, a person who has derived income from savings and investments clearly has experienced an increase in wealth (along with an increased ability to pay tax), and thus is not in the same financial position as someone who has not experienced such an increase. Thus, a consumption tax may not be horizontally equitable. Further, the burden of a consumption tax falls more heavily on people with lower income, for two reasons: (1) they must spend a greater proportion of their income than wealthy people on goods and services in order to satisfy their basic needs; and (2) people with greater income are more likely to have savings and to derive investment income than people with less income. If you find these arguments persuasive, it seems difficult to contend that a consumption tax is any “fairer” than a progressive income tax.

In sum, the question whether a particular tax system is “fair” or “unfair” is subject to considerable debate.

### Discussion Questions

Which tax systems sound the most sensible and fair to you? This section has presented the different tax systems in non-country specific context. Which system do you think makes the most sense for Afghanistan, given its unique circumstances and current stage of development? Let's find out if the Government of Afghanistan agrees with you!

### Afghanistan's Tax Rates

#### *Standard income tax*

The taxable income of legal persons (corporations, LLCs, and other legal entities) is taxed at a fixed rate of 20 percent (Article 4). Corporate tax is thus a “flat income tax.” In contrast, the taxable income of natural persons is taxed at the following rates, which vary based on the size of a person's income. This is a “progressive income tax.”

Taxable Income	Tax Rate
0-150,000 Afs	Exempt from taxation
150,000-1,200,000 Afs	10 percent of amount over 150,000
1,200,000 Afs and up	105,000 plus 20 percent of amount over 1,200,000

Recall that sole proprietors (individuals who own and operate their own businesses) and members of a partnership are taxed as natural rather than legal persons. This makes sense since sole proprietorships and partnerships do not qualify as corporations or LLCs. These individuals enjoy a tax benefit since the personal income tax rate can be lower than the 20 percent corporate tax rate. And although any sole proprietorship or partnership with a taxable income that exceeds 1,200,000 Afghanis will be subject to a personal income tax rate of 20 percent (the same rate as corporations and LLCs), the first 1,200,000 Afghanis will be subject to the lower natural person tax rates.

#### *Business Receipts Tax*

The provisions for the Business Receipts Tax (BRT) are located in Chapter 10 (Articles 64-67) of the Income Tax Law. The rates of the BRT depend on the type of services offered. In general, the BRT is:

- Two percent of the **gross receipts** (before any deductions) from the sale of products, goods, assets, and other services; the provision of materials, equipment, services, transportation, and construction of buildings under a contract; the receipt of insurance premiums; and the sale of admissions to public entertainment, AND
- Five percent of gross receipts from rent (excluding any rent withheld under Article 59), royalties, commissions, fees, interest, dividends, and similar income.

The BRT applies to legal persons and *only* those natural persons operating as sole proprietors.

However, income derived from four sectors—international passenger airline services, telecommunications/internet services, hotel services, and restaurant services—is taxed at 10 percent if the income is at least 100,000 Afghanis per month (Articles 64(2), 65(1)(6) and 65(2)). If the income from these services is less than 100,000 Afghanis per month, it will be taxed at the general two percent rate mentioned above. The BRT for these four service sectors applies to *all* legal and natural persons.

**Illustration:** Ahmad, who is a sole proprietor, runs a restaurant in Kabul. Monthly gross sales of the restaurant for Mizan, Aqrab, and Qaus are 90,000 Afghanis, 104,000 Afghanis, and 80,000 Afghanis, respectively. As the sales in Mizan and Qaus are less than 100,000 Afghanis, the business (a sole proprietor) does not have a BRT liability for those months. The business only has a BRT liability for Aqrab. The tax rate used in this case is 10 percent, which is applied to the full 104,000 Afghanis. Therefore, the BRT owed is 10,400 Afghanis.<sup>35</sup>

Unlike the standard income tax, the BRT is assessed on gross income, which means that ordinary and necessary business expenses, capital losses, and operating losses from previous years cannot be deducted. With the standard tax, losses incurred in a previous year could potentially offset a taxpayer's entire tax liability in future years. The BRT, however, must be paid every year, regardless of whether the taxpayer has experienced a profit or loss. Tax payments are due quarterly within 15 days of the end of the quarter (Article 93(5)).

Note that the BRT is very controversial because you pay it regardless of whether you make a profit!

### *Fixed taxes*

The Income Tax Law subjects certain commercial activities to a fixed annual tax rather than the standard income tax (Article 68-81). Examples of commercial activities subject to fixed taxes include importation and exportation (two to three percent of the cost of goods), transportation of passengers or goods (ranging from 2,600 Afghanis to more than 18,500 Afghanis depending on the type of vehicle), government contracting without a business license (seven percent), grain milling (10 percent of gross income), and physicians (6,000 to 15,000 Afghanis depending on experience). Shopkeepers and other small businesses are also taxed at a fixed rate, although the rate is determined based on nine criteria, including the type of goods or services offered, the estimated volume of business, the rent paid, the demand for the goods or services, the estimated costs of goods, and the estimated **net income**. However, if the business has not kept adequate records, the fixed tax will be two to six percent. Finally, persons with no fixed place of business, such as brokers and commission agents, are subject to a fixed tax determined by the Ministry of Finance.

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<sup>35</sup> Ministry of Finance, Afghanistan Revenue Department, Guide 03: Business Receipts Tax on Services (2006).

Why do you think these activities have been singled out for fixed taxation? Do they have anything in common? Consider the following explanations: These fixed taxes are lower than the 20 percent standard income tax rate for legal persons, and many are even lower than the 10 percent standard income tax rate for natural persons. These businesses generally involve high-volume, low-profit transactions, and a tax rate of 10 or 20 percent might make them economically unviable. Yet, these are valuable activities that we do not want to discourage. Further, due to the difficulty of recordkeeping, it would be costly to maintain the documentation necessary to calculate the standard taxable income at the end of the year.

### **Discussion Questions**

Tax rates, particularly when compared to one another, raise lots of questions. Do you think the above tax rates are appropriate—do they strike the correct balance between raising revenue on one hand and deterring valuable social activity on the other hand? Should corporations and LLCs (legal persons) be taxed at a higher rate (20 percent) than most individuals (zero to 10 percent)? Why or why not? How much more should corporations and LLCs be taxed? Is a 20 percent tax rate for corporations and LLCs (legal persons) too high, too low, or just right? Should their tax rate be “flat” or should it vary progressively depending on one’s income, just like the rates for natural persons? Should individuals earning more than 1,200,000 Afghanis pay a higher tax rate (20 percent) than individuals earning between 150,000 and 1,200,000 Afghanis (10 percent), even though they are already paying more total tax? Should anyone be exempt from income tax (i.e. those earning less than 150,000 Afghanis)?

### **E. Tax Collection**

Effective and efficient administration of tax laws generally requires the citizens of a country to voluntarily comply with the tax laws. It would be very difficult and very expensive for a government itself to determine the amount of tax owed by each taxpayer and to collect that amount from each taxpayer. The costs of such a system might add up to a substantial portion of the amount of tax collected. Instead, most tax systems rely on the taxpayers to submit information to the government and voluntarily make payments. The cooperation of taxpayers with the government is essential for a tax system to function. However, in virtually every tax system there is a “tax gap” between the amount that taxpayers should pay (i.e. the amount they owe) and the amount that the government actually receives.

In order for a tax system to raise the revenue it is intended to raise and for these taxes to be fairly distributed across all of the citizens of a country, the government should be able to effectively collect the tax that it has imposed under the tax law. If taxes cannot be collected effectively, or can only be collected from some taxpayers but not from others, the tax law may not produce sufficient revenue for the government or may burden some taxpayers more than others. A good system of tax administration is one that efficiently increases the number of taxpayers who comply with the tax laws.

There are many reasons why taxpayers might not comply with the tax law. One reason is because the tax law is too complicated or requires complex calculations to determine the amount of taxes owed. Taxpayers may not know that they owe taxes to the government or may not

understand the tax law. Voluntary compliance is improved when the tax laws and other administrative documents are clear and simple. If there is an obligation to file documents when paying the tax, these documents should be simple in order to reduce the amount of time required to comply with the law. Simple tax laws also make the tax system easier for the government to manage.

Some taxpayers, however, may not comply with the tax law simply because they do not want to pay taxes. Intentional noncompliance is called tax evasion. Generally, a tax system provides for penalties when a taxpayer does not pay the taxes he owes to the government. (These penalties might be civil penalties or criminal penalties.) However, if the government cannot effectively enforce these penalties, they lose their deterrent effect. One aspect of tax administration, therefore, must be monitoring which taxpayers are complying with the law.

One additional factor that influences whether taxpayers comply with tax laws may be their perception of the legitimacy of the tax system, the legitimacy of the government imposing the taxes, and the legitimacy of how the tax revenues are spent. For example, if taxpayers think that many of their fellow taxpayers do not pay their taxes (or that wealthy or influential people do not pay taxes) and are not punished, they may become more reluctant to comply with the tax laws. If the tax laws seem unfair or arbitrary or are enforced in a way that is unfair or arbitrary, taxpayers may be less willing to voluntarily cooperate. Finally, if taxpayers think that the government came to power illegally or that taxes are being abused by corrupt government officials, they will be reluctant to pay.

To effectively enforce penalties, an important aspect of tax administration is the collection of information. First, the government must know who the taxpayers are before it can determine if taxpayers are complying with the tax law. Many countries establish a system to register their taxpayers. In many countries, taxpayers are required to submit documentation, called a “tax return” to the government when they pay their taxes. This information allows the government to check the calculations that the taxpayer has made and to determine whether the taxpayer has paid his tax in full. If the government doubts that a taxpayer has provided accurate information, it may “audit” the taxpayer. In an audit, the taxpayer must prove that the information he provided to the government was accurate and the amount of tax he calculated was correct. In some tax systems, other parties also have a responsibility to provide information to the government. These third parties may be required to file an “information return” detailing transactions with other taxpayers. For example, if a business makes a payment of 100 Afghanis to an employee, the business might be required to inform the government that it has paid the employee. A tax administrator can then cross-reference this information with information provided by the employee to see if the employee has correctly reported the payment.

### Organization

The Afghanistan Revenue Department is the agency charged with administering the tax law, determining tax obligations, and collecting taxes. The Revenue Department sits under the Ministry of Finance. Domestic taxes are collected in provincial *Mustofiats* and district offices and are then supposed to be sent to the central government. The General Presidency of Revenue in Kabul serves as the national headquarters and coordinates provincial collection operations.

## Collection Procedures

### *Taxes collected during the year*

Afghanistan, like many other countries, relies on employers to *withhold* the standard income tax that would be owed by their employees. More specifically, all natural persons employing two or more individuals as well as all legal persons must subtract taxes from an employee's pay that the employee will owe on those wages or salary (see Article 17, 46, and 58). Within 10 days of the end of each month, the employer must submit a report containing information about wages and the amount of tax withheld, and the employer must transfer any withheld tax to the Ministry of Finance. By the last day of Hamal (one month following the close of the taxable year), the employer must submit a wage and withheld tax report for each employee to the employee and the Ministry of Finance (Articles 46 and 61).

**Illustration:** A withholding tax requires the employer to withhold taxes from any money owed to the taxpayer and to transfer those taxes to the government. For example, if an employee earns 10,000 Afghanis working for a company, and that income is taxed at a rate of 10 percent, the company may be required to withhold 1,000 Afghanis from the employee's paycheck and transmit this amount to the government. The employee thus receives only 9,000 Afghanis. However, the employee will not owe any more tax, since his tax liability has already been paid.

In addition to taxes withheld by employers, other taxes are also paid periodically during the year. Article 93(5)-(8) and (10) provide a complete listing. For example, the BRT tax is paid quarterly, due within 15 days of the end of each quarter. Some fixed taxes are due quarterly or even monthly. Some rental income, addressed in the following box, is also due monthly.

### **Special Case: Landlord Rental Income**

Rent on certain types of property is subject to special tax assessment and collection procedures (Article 59). The rental property must be used by a legal or natural person for *business purposes* and the rent must exceed 15,000 Afghanis. If these conditions are satisfied, the landlord owes a 20 percent tax on the rent. However, the *tenant* must deduct this tax from the rent payment and transfer it to the government. Thus, the landlord will actually receive the amount of rent minus the 20 percent tax. At the end of the tax year, the tax withheld and paid by the tenant will be credited against the landlord's total tax liability.

Most taxes that are collected during the year are paid by businesses (wage withholding, BRT, and fixed taxes). Collecting these taxes at intervals throughout the year achieves at least two purposes. First, it provides a steady stream of tax revenue to the government during the course of the year, which the government can use to pay for goods and services as its bills come due. Second, it helps ensure compliance with the tax laws. Companies and institutions, with their reputation and right to operate at stake, are more likely to comply with the tax laws than

individuals, and they are more efficient to monitor. Withholding taxes from employees' wages also makes it easier for individual taxpayers to comply with the tax laws since the amount of tax owed to the government has been determined by their employer. Employees do not need to understand or calculate the taxes themselves.

### *Taxes collected at year-end*

At the end of the tax year, every taxpayer that has income from salaries or wages from more than one employer or has income from sources other than salaries or wages must file an income tax return. This is a document that reports the taxpayer's income, deductions, tax withheld by an employer, tax due, and other necessary information. People whose income consists only of salary or wages from one employer and whose taxes have been withheld by that employer need not submit a return; to complete their tax obligations, these individuals need only submit a salary and tax statement certified by their employer (Articles 62 and 92(2)). Each person that owes tax (whether it is withheld by their employer or not) must apply for a Taxpayer Identification Number (TIN) from the Ministry of Finance (Articles 91 and 110). The deadline for the submission of tax returns is 1.5 months following the close of the taxable year (Article 62). Note, however, that the law appears inconsistent on this issue: Article 93(1) states that the tax return must be submitted by the end of the month of *Jawza* (the third month) of the following year.

If the tax return indicates that a taxpayer owes tax, the tax must be paid when the tax return is submitted. Procedurally, the tax is treated as an official **assessment** (i.e. amount owed), and the tax return is treated as a "notice" of that assessment (Article 92). If the Ministry of Finance finds that the taxpayer has paid more tax than he owes, it will apply the overpayment against any other taxes or custom duties owed by the taxpayer and then refund the surplus (Article 95). Conversely, if the Ministry of Finance finds that the amount of tax paid is incorrect, it may recalculate and amend the tax return (Article 92(4)). In addition, if a taxpayer that is required to submit a return fails to do so, the Ministry of Finance may calculate the tax itself and issue a notice stating the amount owed (Article 92(5)). However, there is a time limit on the Ministry of Finance's ability to issue or amend a notice of assessment for previous tax years: the Ministry can only issue or amend a notice of assessment within five years (although this time limit does not apply if the taxpayer failed to submit a tax return or submitted an incorrect tax return with the *intent* of tax evasion). The taxpayer has the right to dispute an assessment or amended assessment. The dispute resolution process begins in the Ministry of Finance but can ultimately end in the courts. The complete appeals process is outlined in Article 94.

Finally, all natural and legal persons must keep records of all transactions, movable and immovable property, and income, and they must make those records available to the Ministry of Finance upon request (Articles 36 and 96). The Ministry of Finance might inspect such records to verify a tax filing or to estimate a taxpayer's taxable income. The Ministry of Finance must keep all such records, as well as information contained in tax returns, confidential.

Why are the procedures for submitting tax returns and paying taxes so formal? Procedural requirements are important to ensure that taxpayers are treated fairly and to prevent abuse by the government—particularly since noncompliant taxpayers could face severe penalties

(discussed below). Taxpayers know what the process is, and as long as they comply with that process, they can be confident that they will not be arbitrarily punished by the government.

### **Special Assistance for Large Taxpayers**

Not all taxpayers pay an equal amount of taxes. Some taxpayers—particularly large companies—owe more tax and thus are more critical to the flow of revenue to the government. To facilitate the collection of taxes from these large taxpayers, the government has created the Large Taxpayer Office (LTO) located in the Ministry of Finance in Kabul. Taxpayers are selected for their inclusion in the program based on the amount of annual tax they owe and the risk nonpayment poses to government revenues. The LTO manages the tax responsibilities of the taxpayers, providing personalized service and training and devoting a larger number of tax personnel than would otherwise be available to the taxpayer.

### *Enforcement Procedures and Penalties*

Given the importance of income tax to the ability of the government to provide basic services for its people, the Income Tax Law gives the Revenue Department a wide range of tools to collect taxes from noncompliant taxpayers. The purpose of these procedures is to preserve the country's tax base. Note that the procedures may apply to failure to submit returns, failure to pay taxes, or failure to withhold taxes. They include:

- *Assessments:* As discussed in the previous subsection, the Ministry of Finance can issue or amend an assessment if the taxpayer fails to submit a tax return or submits an inaccurate tax return. Further, if the Ministry of Finance believes a person is about to depart the country, cease business, or transfer property, it does not need to wait until the end of the year and can issue the assessment at any time (Article 92(7)).
- *Collecting from third parties:* The Ministry of Finance may collect unpaid taxes from people that owe the taxpayer money (including salary and wages) or are holding money for the taxpayer (Article 97).
- *Collecting from directors and shareholders:* Where a *company* has failed to pay its taxes, the Ministry of Finance may collect from directors that failed to exercise care in ensuring the company met its tax liability, shareholders with at least a 10 percent ownership interest to the extent that the shareholder received dividends from the company, or anyone that has obtained assets from the company for less than market value during the past three years (Article 98).
- *Preventing departure from the country:* Where a taxpayer owes more than 20,000 Afghanis in unpaid taxes, the Ministry of Finance may issue orders to the relevant authorities to prevent the taxpayer from leaving the country (Article 99).
- *Closing businesses:* Where a taxpayer has failed to submit a tax return, pay tax on time, or withhold and pay tax as an employer, the Ministry of Finance may order the closure of the taxpayer's business, upon providing written notice of seven days (Article 100).
- *Property actions:* Where a taxpayer has failed to submit a tax return, pay tax on time, or withhold and pay tax as an employer, the Ministry of Finance may request a court order placing restrictions on the taxpayer's movable and immovable property until he

- pays the tax (Article 101). If the tax is not paid within 30 days of the court order, the Ministry of Finance may ask the court to order the sale of the property. Any proceeds from the sale that exceed the tax debt must be returned to the taxpayer.
- *Preventing the renewal of licenses:* Where a taxpayer has failed to pay its taxes, the Ministry of Finance may inform government agencies that are authorized to issue licenses to not renew the licenses of that taxpayer (Article 114).

In addition to the above-mentioned procedures employed to collect unpaid taxes, the Income Tax Law gives the Revenue Department authority to impose penalties upon taxpayers who fail to comply with the tax laws (see Articles 103-112). Penalties include:

- Additional taxes if a person fails to pay taxes on time (0.1 percent of tax due per day)
- Additional taxes if a person is negligent, grossly negligent, or deliberately fails to pay taxes at all, fails to maintain or provide access to records of business transactions without reasonable cause, fails to submit a tax return, fails to withhold tax as an employer should, or fails to obtain a Taxpayer Identification Number (TIN).
- Additional taxes and business closure if a person enters a transaction or arrangement whose specific objective or effect is to evade taxes.
- Fines up to 250,000 Afghanis and/or imprisonment up to two years if the taxpayer—*intending to evade taxes*—fails to pay taxes at all, fails to maintain or provide access to records of business transactions without reasonable cause, fails to submit a tax return, or fails to withhold tax as an employer should.

The law is most concerned with taxpayer conduct that represents an *intentional effort to evade taxes*, as evidenced by the imposition of additional taxes, fines, and/or imprisonment.

Finally, the Income Tax Law seeks to deter corruption on the part of tax officials by imposing hefty fines (up to 225,000 Afghanis) and/or imprisonment (up to three years) if tax officials disclose confidential taxpayer information for personal benefit or otherwise misuse their position for personal benefit (Article 111).

### Discussion Questions

Do you think the penalties associated with Afghanistan's income tax laws are appropriate, too harsh, or too lenient? Which ones are too severe or too lenient? Do you agree that intentional evasion of taxes should be subject to imprisonment? Why or why not?

#### F. Assessment and Conclusion

One commentator has identified the following problems with the pre-2005 tax system<sup>36</sup>:

<sup>36</sup> Thierry Kalfon, Structural Reforms: Revitalizing Fiscal Institutions *in* INTERNATIONAL MONETARY FUND, RECONSTRUCTING AFGHANISTAN (2005).

- Afghan citizens everywhere in the world were subject to taxes, which meant that any Afghan citizen living abroad that intended to return to Afghanistan would have had to pay a potentially large tax bill on all of their income earned abroad.
- The highest tax rate for personal income was 60 percent, which is high by any standard and had the practical effect of encouraging noncompliance with tax laws.
- There were 32 different tax rates, which was difficult for the government to administer.
- The BRT was under-inclusive in that it did not cover services provided to Afghans living abroad and other high-income earners.

### Discussion Question

How does the Income Tax Law of 2005 respond to each of these problems?

Afghanistan’s post-2005 income tax regime is simpler, making it easier to administer and comply with. There are clear rules about who owes taxes, what income is taxable and exempt, what expenses may be deducted, and the methods by which income should be accounted and calculated for tax purposes. The government receives some taxes consistently throughout the year, so it does not have to wait until the end of the year to collect the revenue necessary to fund its budget. The government has a variety of tools available to enforce compliance and punish violators. Compared to the 1965 income tax law, there are fewer tax rates, lower tax rates, and distinctions between resident and nonresident Afghan citizens.

A tax regime also has a major impact on the attractiveness of a country as a destination for investment (domestic and foreign), and recent reforms have made Afghanistan more attractive in this regard. For example, foreign businesses need not pay taxes on income received from sources outside of Afghanistan; branches and subsidiaries of foreign companies are taxed at the same rate; transactions between connected entities are valued for tax purposes at the unconnected market rate; and tax evaders are subject to harsh penalties.<sup>37</sup> Just having a proper set of laws and a government committed to enforcing these laws sends a positive signal about the rule of law in Afghanistan and increases investor confidence.

Yet, more can be done to simplify the tax laws and to eliminate inefficient and “extra-legal” taxes. According to Afghan businesses, the Income Tax Law does not begin to catalogue the many taxes and fees levied by various arms of the government on businesses. Often, the legitimacy of these taxes and fees is questionable. The result is a system in which neither the taxpayer nor the collector actually knows whether the tax or fee sought is properly authorized. These not only represent additional direct costs to business but indirect costs in the form of uncertainty. It is difficult to project how much goods will cost to produce if one of the key costs—taxes and government fees—is unpredictable.<sup>38</sup>

<sup>37</sup> See Ministry of Finance, Afghanistan Revenue Department, Guide 04: Tax Overview for Business Investors & Individuals (2006).

<sup>38</sup> See USAID, AFGHANISTAN’S AGENDA FOR ACTION 102 (2007).

Collection of domestic income taxes also remains a major obstacle. Collection is subject to uncertain provincial influences that affect the amount received by the central government and the timing of those receipts. According to the Ministry of Finance, the provincial *Mustofiats* and district offices have limited physical infrastructure, with little office equipment and damaged buildings. Some even lack electricity. Human capacity has been severely weakened by years of conflict, and skill levels are low. Average wage levels are around U.S. \$35 per month, and systemic corruption among tax officials is a serious threat to tax collection. Methods, systems, and work practices to administer taxes are inefficient and do not reflect modern tax administration practices. There is little voluntary compliance with tax laws. Enforcement of tax laws depends upon provincial and state police who are not accountable to the central government. The level of coordination and cooperation between the General Presidency of Revenue and other ministries is low. These forces will continue to obstruct tax collection and efforts at reform.

### III. CUSTOMS DUTIES IN AFGHANISTAN

Customs duties are taxes levied on goods that are produced abroad and brought into Afghanistan. Such goods are called **imports**. Goods produced in Afghanistan, however, generally are not taxed when they are transported out of Afghanistan for sale in foreign countries (**exports**). Customs duties are a direct tax on cross-border trade and an indirect tax on domestic consumption and income. Customs duties are very important in Afghanistan because they are the largest source of government revenue. From March to June 2005, for example, customs duties accounted for \$41.45 million, or 53 percent, of the government's \$71.16 million total revenue.<sup>39</sup>

This section reviews some of the history of, and challenges associated with, customs duties in Afghanistan. It then addresses the current organization of the customs administration and walks through the process of "clearing customs." It also examines how customs duties are calculated, the penalties for violating customs laws, and the process of appealing decisions made by the customs administration. Most of the law regarding customs duties relates to procedures and other clear-cut rules. Unlike the law in areas such as contracts and corporations, there is much less ambiguity and room for interpretation.

#### A. History and Challenges

Despite the importance of customs revenue to the government, customs collection has been problematic. First, customs are collected at the provincial level, so customs laws are not always applied consistently across Afghanistan. Second, the customs administration suffers from poorly trained staff, inexperienced managers, and inadequate facilities and equipment. Third, customs procedures are largely manual and cumbersome, resulting in extra costs and delays. Fourth, corruption is a problem among customs officials. To summarize, traders face unclear procedures and poorly trained personnel at the borders, as well as unauthorized "extra-legal" payments and bureaucratic obstacles.

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<sup>39</sup> USAID, AFGHANISTAN'S AGENDA FOR ACTION 111 (2007).

Improving national standardization and professionalism within the customs administration is critical to economic development. The Government of Afghanistan has recognized this and has made customs reform a priority. In 2003, the government adopted a five-year plan to improve the customs department, train customs officials, reform procedures, and centralize customs revenues collected by the provinces. The government also introduced the Single Administrative Document for customs clearance, based on the European Union customs regime, in five key provinces. In March 2005, the country started to implement the U.N.'s Automated System for Customs Data (ASYCUDA). This is a computerized system for customs collection that increases transparency, reduces opportunities for customs officials to arbitrarily hold shipments and solicit unofficial payments (i.e. bribers), and standardizes collection procedures. The Afghan government also has implemented a licensing program to build a network of legitimate customs brokers that can represent importers in the customs clearance process.

The government's biggest step forward in the formalization and standardization of the customs regime came in 2005, with the adoption of the Afghanistan Customs Code. The Customs Code was enacted pursuant to Article 42 of the Constitution in order to allow for the collection of state revenues by the national customs authorities. It also provides for the organization of a customs service, defines the scope of authority of customs officials, provides for the supervision and the control of the movement of goods in and out of Afghanistan, and seeks to deter violations of the customs laws. Since the Customs Code reflects the most current law, it will be the focus of the remainder of this section. Even though customs procedures have improved in recent years, they can still be complex, inconsistent, inefficient, and prone to corruption.

## **B. Organization and Customs Procedures**

Customs duties are easy to implement when goods are transported by air or by water. Usually ports and airports can construct centralized facilities to collect such taxes. This is harder to do for goods transported by land from neighboring states, but checkpoints can also be set up at common border crossings. Countries will generally form a separate agency—a “customs department”—not only to collect customs duties but also to ensure the legality of the items being brought into and taken out of a country.

Article 2 of the Customs Code gives the Ministry of Finance responsibility for collecting customs revenues and for enforcing the Customs Code and any other customs laws. Article 4 states that customs laws are to be implemented uniformly throughout Afghanistan. That means that individuals should encounter the same customs laws regardless of the province. Thus, there should be no legal advantage or disadvantage if a trader transports goods into the country from Herat or Kandahar.

Within the Ministry of Finance, the Afghanistan Customs Department (ACD) is the principal border control agency. The ACD is headquartered in Kabul, supervises 14 official border crossings, and has 18 provincial customs houses where goods are inspected and customs duties are paid. The ACD has approximately 1,600 personnel. Chapter 2 of the Customs Code

describes the organization and responsibilities of the customs administration. The ACD has enacted several procedures and regulations to supplement and further explain the provisions of the Customs Code. These procedures and regulations are available at [http://www.customs.gov.af/customs\\_codes.php](http://www.customs.gov.af/customs_codes.php).

All importers that bring goods into Afghanistan from another country must clear customs when they enter the country. At designated customs areas at the border, customs controls are performed and customs duties are collected. Customs areas are located where transporters are most likely to enter the country: border crossing points, international airports, **duty free zones**, and customs warehouses. These designated customs areas are the *only* places goods may enter the country legally (Article 10). Article 14, however, allows customs controls to be performed at an importer's warehouse in certain circumstances.

Article 11 lists the responsibilities of the customs administration:

#### ARTICLE 11

1. Determining the value of goods and collecting the related customs debt;
2. Supervising, detecting, reporting and preventing smuggling;
3. Detecting and evaluating violations of this law;
4. Participating in, preparing, and signing international agreements and conventions in customs matters, in accordance with customs legislation;
5. Preparing, collecting and, upon agreement of the Minister of Finance, distributing foreign trade statistical data to the Ministry of Commerce and other public institutions;
6. Supervising customs goods, throughout the entire customs territory of the state;
7. Exercising customs control over customs areas;
8. Maintaining customs records;
9. Carrying out all other activities determined in customs legislation.

More specifically, when a commercial transport (like an airplane or truck) enters a customs area, Article 34 requires the driver to submit a manifest with information about the nationality, flag, and crew of the transport, as well as all information necessary to identify the cargo.<sup>40</sup> At this point, the goods are surrendered to the control and supervision of the customs officials for the remainder of their stay in the customs area (Article 34). When the goods first arrive in the customs area, customs officials have the authority to collect a sample of the product for purposes of verification, although the importer is entitled to witness the removal of the sample (see Articles 47 and 58). The importer bears the cost of transferring the sample to the examination site, unpacking, weighing, and repacking the sample, and any other operations involved in the sampling and examination process.

Article 53 also grants customs broad authority to adopt prohibitions or restrictions on goods for reasons of “public morality, public security, protection of environment, health and life of humans, animals or plants, protection of national treasures possessing artistic, historic or

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<sup>40</sup> The ACD regulation that provides further explanation and a manifest template is available at [http://www.customs.gov.af/customs\\_codes.php](http://www.customs.gov.af/customs_codes.php).

archaeological value or the protection of industrial and commercial property and other state policies.” If a good is prohibited or restricted under Article 53(2), or believed to be smuggled, customs has the authority to sell or take other authorized action with respect to that good, after a final decision by a responsible authority. Customs, upon the request of the holder of a trademark, patent, or other proprietary right, may also prohibit the release of goods believed to be counterfeited or pirated.

The transporter’s second obligation is to submit a complete customs declaration. If the transporter is unable to complete the customs declaration within one hour of presenting the goods to customs, he may alternatively submit a summary declaration, requiring only a general description of the goods and a total volume and value (Article 48).<sup>41</sup> A complete customs declaration must then be submitted within five days of the summary declaration. Within 48 hours of receipt of the complete customs declaration, customs officials must calculate the tax debt owed (Article 151).

Since different categories of goods are taxed at different rates, customs must identify each category of good present in a shipment and the number of goods in each category in order to accurately calculate the tax debt. The process of sorting through an entire shipment and determining which tax rate applies to each good, however, can be very time-consuming. Mindful of the potentially detrimental impact delays (even of 24-48 hours) could have on commerce and trade, Article 67 allows customs, with the agreement of the transporter, to apply the highest tax rate in the shipment to all of the goods in the shipment. This avoids having to determine the precise number of goods subject to each tax rate, since all goods will be taxed at the same rate. The importer would agree to this if the cost of the higher tax rate is lower than the cost of the delay to his business.

The customs process concludes with the payment of the customs tax debt and the release of the cargo. After release, the goods are considered Afghan goods rather than foreign goods (Article 65). As an alternative to immediate payment of the customs tax debt, customs can allow transporters to post a security deposit guaranteeing future payment, pursuant to Articles 137-144 and 154-158. Customs is authorized to collect a charge (*haq ul zamat*) of 0.01 percent (or such other amount determined by the Ministry of Finance) during the period tax payment is postponed (Article 156).

Separate from the process described above, the ACD is authorized to establish “mobile customs verification teams” to stop transports along the roads within Afghanistan in order to verify that the goods in the transport match the accompanying customs documents. Even though the law specifically forbids custom officials from using their positions to enrich themselves or from undertaking any business activity that conflicts with the performance of their duties (Article 9), spot checks on the roads are particularly ripe opportunities for customs officials to engage in corrupt activities.

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<sup>41</sup> The ACD regulation that provides further explanation and a summary declaration template is available at [http://www.customs.gov.af/customs\\_codes.php](http://www.customs.gov.af/customs_codes.php).

## Advanced Reading: Afghanistan and the World Trade Organization (WTO)

*Source: USAID, Afghanistan's Agenda for Action (2007)*

To join the WTO, acceding countries must enact compliant Customs laws based upon the various GATT [General Agreement on Tariffs and Trade] agreements pertinent to Customs administrations. Many countries have used the precise GATT language to draft their statutes. The Customs Law of Afghanistan is not GATT-compliant. For example, the basis for valuation of goods for the members of the WTO is transaction value. The WTO Valuation Agreement establishes a Customs valuation system that primarily bases the Customs value on the transaction value of the imported goods, which is the price actually paid or payable for the goods when sold for export to the country of importation, plus certain adjustments. Because of the risks of undervaluation and the resulting potential revenue loss, Afghanistan uses lists of acceptable values or other means such as catalog costs and world commodity indexes. In addition, other legislative and regulatory changes for GATT compliance must be made that will include rules of origin, harmonized tariffs, intellectual property rights and trade agreements.

Enactment of a GATT-compliant statute and the issuing of the defining and implementing decrees are important steps in WTO accession that remain to be accomplished. Changing processes, enforcing the new rules and educating Customs staff and the Afghanistan trade community are challenges that ACD will face as implementation phases are undertaken and completed. Because of modernization efforts already completed or in process, Afghanistan has already begun to take steps that will ease the accession burden. This is especially true since Afghan tariff rates are already low and are rationally intended to protect nascent national industries. However, it will be impossible to achieve a fast accession without first changing the Customs law, adopting careful monitoring, evaluation, and planning systems, and conforming with the broader WTO standards.

### C. Calculating the Duty

With an understanding of the process by which customs duties are collected, we will now consider how the customs duty (tax) is actually calculated. Article 23 of the Customs Code provides that the Ministry of Finance, upon the recommendation of the ACD, will publish the customs **tariff**—a document setting the customs duties for each category of goods. The rates for each category may be found online at the ACD's website: [http://www.customs.gov.af/download\\_tariff.php](http://www.customs.gov.af/download_tariff.php). The customs tariff is organized in 22 sections, ranging from live animals to minerals to textiles to metals to transport equipment to arms to artwork. Article 27 lists the goods that are exempt from customs duties (for example, goods to be used by foreigners working in Afghanistan and products received by Afghan officials traveling abroad on state business).

Customs duties are different from other forms of taxation in that they are based on the value of the good rather than on a characteristic of the taxpayer, and are levied on the importer/exporter of the good. The purchaser/consumer of the good will indirectly pay for the tax, since the importer/exporter will increase the purchase price to account for such tax.

Customs duties are flat taxes: each category of goods is taxed at the same rate. The difference in tax is based solely on the characteristics of the good, not on the characteristics of the taxpayer. Since each good is taxed the same (i.e. one brand of cigarettes is taxed the same as another brand) such a tax seems inherently “fair.” However, like a sales tax, customs taxes will impact people with lower incomes more severely than those with higher incomes. For example, if an excise tax increase causes the price of cigarettes to increase by 2 Afghanis per packet, a person making 100 Afghanis per week may not buy the same number of cigarette packets, but a person making 3,000 Afghanis a week most likely will not buy fewer cigarette packets.

Customs duties in Afghanistan range from zero to 25 percent. Note that this is a change from the past, when the highest tax rates reached 150 percent. There are benefits and costs of such high tax rates. Customs taxes are a prime example of how taxes can be used to influence behavior. A higher customs duty on imported items (cars, for example) will make these items more expensive and may encourage consumers to buy domestic goods instead of foreign goods. In effect, high tax rates present a barrier to cross-border trade. These tariff-based trade barriers may be beneficial to a country when its government is trying to protect a key or burgeoning domestic industry that might not be able to withstand competition from foreign products produced more cheaply. Customs duties are common around the world, although the importance of customs duties in many countries has declined as a result of negotiations on free trade and the influence of the World Trade Organization. As more and more countries join the World Trade Organization (WTO) and as the WTO lowers tariffs, we have fewer trade barriers and freer flow of goods across international borders. Still, countries will continue to protect key industries from foreign competition through high tariffs.

**Exercise and concept check:** If you have access to the Internet, take a few minutes to browse the various sections of the tariff from [http://www.customs.gov.af/download\\_tariff.php](http://www.customs.gov.af/download_tariff.php). Do the tax rates for various products intuitively make sense? Think about why certain products may be taxed at a high or low rate. Might it have to do with which products are considered luxuries for more wealthy individuals? For example, plastics are taxed at 5 percent, most live animals at 2.5 percent, and most fresh vegetables at 2.5 percent. However, flowers and plants are taxed at 16 percent, motor cars at 16-25 percent, certain prepared foodstuffs (such as chocolate, pastries, ice cream, beverages, and tobacco) at 10-20 percent, artwork at 16 percent, and weapons at 16 percent. Which products do you think are taxed too highly? For which are taxes too low?

### **Duty Free Zones and Shops**

Afghanistan has created zones in which foreign goods are exempt from import duties. Article 124 states, “Duty free zones, free warehouses and duty free shops shall be a separate part of the customs territory of the State, in which non-Afghan goods are considered, for purposes of import duty and commercial policy measures, as not being on Afghan customs territory.” In other words, foreign goods in these zones are not charged the customs duties that they would normally be charged. However these zones are still subject to ACD supervision and control (to ensure their benefits are not abused or misused). Customs can still inspect goods, people, and transports (Articles 126 and 127).

The Ministry of Finance is responsible for designating duty free zones and duty free shops (the latter are commonly found in places like airports). The purpose of these duty free zones, often called special economic zones, is to encourage foreign investment and economic activity. Companies can carry out industrial, commercial, and service activity in the duty free zones without incurring the costs of customs duties.

We now know that the government sets different tax rates for different categories of goods entering Afghanistan (and we can make inferences about how the government and people of Afghanistan view different industries and types of goods based on those tax rates). We also know where to find those tax rates. Now we must understand how customs officials will value the goods. These values, when multiplied by the appropriate tax rate, provide the tax due. The Customs Code requires that customs officials use the market exchange rate, updated monthly, to value goods priced in foreign currency (Article 25). The use of the market exchange rate is an improvement over the past, when Afghanistan used artificially low exchange rates.

#### **D. Penalties for Violations**

The Customs Code established a Customs Police and grants it responsibility for detecting and preventing violations of the Code. Yet the law immediately limited the effectiveness of the Customs Police by placing it under the Ministry of Interior, while placing the ACD under the Ministry of Finance (see Article 164). The ACD and Customs Police are supposed to work together, and locating them in different ministries creates coordination challenges and turf battles.

How do you think violations of the Afghan customs laws should be punished? Customs violations can be divided into two categories: administrative violations and smuggling. Administrative violations are further divided into three classes, which are listed in Article 166. The penalties for administrative violations are fines, and the amount of the fine increases with the severity of the violation (as measured by its class). You should read Articles 166 and 167, which describe administrative violations and their penalties. Here is a brief overview:

- Class 1 administrative violations include delays in meeting deadlines for paperwork (e.g. summary declaration or complete customs declarations) or misrepresentations about the quantity or value of cargo, which has the effect of lowering the customs tax debt. Violators are liable to pay a fine equal to some percentage of the misreported value, in addition to the customs duty that would normally be owed on that value. However, an error made in good faith may be waived by customs.
- Class 2 administrative violations include outright failures (as opposed to delays) to present goods to customs or to provide declarations. The penalty for Class 2 violations is a fine of 10 to 50 percent of the value of the entire shipment.
- Class 3 administrative violations include *intentional* misrepresentation of information submitted to customs with the purpose of evading or obtaining a lower customs duty. The penalty for Class 3 violations is a fine of 50 to 100 percent of the value of the entire shipment.

The second category of customs violations is smuggling, as defined in Article 172(1):

### **ARTICLE 172(1)**

Carrying out the following activities is deemed to be smuggling and the offender shall be punished in accordance with this law and any other customs legislation:

- Bringing goods into or taking goods out of the country, in violation of the provisions of this Law and other customs legislation, with the intent of avoiding customs control or supervision;
- Carrying prohibited goods for the purpose of import, export, or storing without permission of the relevant authorities;
- Selling or purchasing of goods in a transit process without paying customs duties.

The penalty for smuggling is (1) confiscation of the smuggled goods; (2) a fine of two to five times the customs duty that would have been owed on the goods; and (3) imprisonment in certain circumstances. Imprisonment depends upon the value of the smuggled goods and whether the goods are banned or allowed under Afghan law (see Article 179 for details). Further, the length of the prison sentence increases if multiple people are involved, armed resistance is used, or a customs official is killed by the smuggler. These are called “aggravating circumstances” and are described in Article 180. The prison sentence also increases if a government official is involved in the smuggling (Article 181). Thus, the most severe punishment, depriving an individual of their freedom, is reserved for only the most offensive customs violations. Note that the drivers of vehicles involved in smuggling are subject to a separate set of penalties that depend on their awareness of the crime and the frequency of their offense (see Article 175 for further detail).

However, Article 168 allows smuggling to be treated as a Category 3 violation when the value of the smuggled goods is less than 10,000 Afghanis and no aggravating circumstances are present. If the value exceeds 10,000 Afghanis, customs may settle the case administratively, without referral to the justice authorities, if: (1) no aggravating circumstances are present, (2) a judicial prosecution has not started, (3) the customs duty owed on the goods is less than 20,000 Afghanis, (4) the violator pays the customs duty and fines, and (5) the violator waives his right of appeal.

Customs violations are cumulative, so a person that commits multiple violations will be punished separately for each offense (Article 173(3)). For all customs violations, customs must file a written report describing the violation, immediately notify the suspected violators, and hold a hearing on the violation within 72 hours of notification (Article 184). Violators have the right to appeal any fines by availing themselves of the process described in Article 18, which is discussed in the next subsection.

### **Discussion Questions**

Do you think the penalties and punishments associated with Afghanistan’s customs laws are appropriate, too harsh, or too lenient? Which ones are too severe or too lenient? Do you agree that smuggling should be treated as a criminal offense? Why or why not?

### **Procedure for Seizing Smuggled Goods**

Granting the government the authority to seize goods suspected of being smuggled might be an invitation for unscrupulous customs officials to use the seizure as a pretext to steal private property. Article 176 provides some procedural protections, most likely to prevent such abuses. Customs must obtain a court order before seizing suspected smuggled goods from private property (unless the act of smuggling is in progress and witnessed by customs officials). All seized goods must be delivered promptly against receipt to the customs administration or to the district administration office. However, Article 178 denies any compensation for damage caused by customs officials during a seizure.

#### **E. Appeals Process**

Article 18 grants the right to appeal to individuals that disagree with a decision taken or fine assessed by customs. The first appeal is to the central ACD and must be filed within 10 days. The ACD must review the appeal and issue a decision within 20 days. If the importer still objects, he may appeal to the Customs Arbitration Administration within 15 days but must pay a fee equal to two percent of the contested amount. The Customs Arbitration Administration is a three-member body within the Ministry of Finance whose members are appointed by the President. The opinion of the Customs Arbitration Administration is final, unless the contested amount is greater than 50,000 Afghanis, in which case the party has a right to appeal to a commercial court (Article 20).

#### **IV. OTHER TYPES OF TAXES**

There are other types of taxes that the government of Afghanistan has chosen not to pursue. However, they are common in other countries, so it is worth a brief discussion.

##### **A. Wealth Tax / Personal Property Tax**

A *wealth tax* is paid by a taxpayer on his net worth—all assets minus any liabilities. Assets generally include real property (such as land, houses, and other buildings), cash, bank accounts, and financial securities (such as stock or bonds). Liabilities generally include any debts of the person such as a home mortgage or other bank loan. A wealth tax is usually imposed either on the total net worth of a person or on the net worth over a fixed amount (i.e. only net worth in excess of 500,000 Afghanis would be subject to the tax).

Generally, a wealth tax will enhance vertical equity because those with more wealth will pay more taxes. This will help reduce the disparity between taxpayers while raising revenue for the government. A wealth tax also helps horizontal equity because it is based on a broad set of characteristics. If a tax is only based on income within a particular time period, there can easily be situations where those with widely different wealth (and thus widely divergent abilities to pay

taxes), but the same income, are taxed equally. However, a wealth tax would capture some of this disparity since those with similar incomes but different wealth would be taxed differently.

A wealth tax tends to be difficult to administer and collect. Besides the basic challenge of having taxpayers self-report and pay taxes, a wealth tax is made harder to administer because of the difficulty in measuring “wealth.” As mentioned above, wealth can consist of a number of assets. While some of these assets may have market values, others may not. Furthermore, certain valuable assets can be easily hidden from the tax authorities. The fact that wealth taxes are hard to administer is one of the reasons they are infrequently used. Wealth taxes are imposed by a small number of countries, including France, India and Norway.

One notable but unintended consequence of a wealth tax may be to lessen the desire of individual taxpayers to accumulate wealth. If an increase in wealth is accompanied by an increase in taxes, depending on the rate of the tax, it may not be worthwhile for taxpayers to work hard to accumulate wealth. This needs to be balanced when a wealth tax is being implemented. Another effect of the wealth tax might be to encourage charitable giving. By allowing charitable gifts to reduce taxable wealth, the government can encourage charitable gifts.

## **B. Real Property Tax**

A *real property tax* is a tax paid by the owner of real property based on the value of that property. “Real property” generally means all immovable objects attached to land such as buildings, houses, or even crops that grow on land. The value of the property is usually determined by looking at the market value of such property, which can either be determined by looking at a recent sale of the property or by having an “appraiser” estimate the value of the property. Real property does not include “personal property” (such as furniture, vehicles, or jewelry) or “intangible property” (such as money, stocks, bonds, or bank deposits).

One of the criticisms of a real property tax is that it is based on the value of the real property and needs to be paid yearly even though the property has not produced any income. For example, a real property tax might be imposed on a house. If the owner of the house does not have enough cash to pay the tax, he may be forced to sell the house to raise money. Furthermore, market conditions may cause a property to increase in value and consequently increase the tax payable on such property. The taxpayer may have to pay more in taxes even though he has not gained anything tangible. Of course, this can happen in reverse where the value of the real property declines (and the tax payments decline) but the property itself is still being used for the same purpose by the taxpayer. Another criticism is that property tax is not fair to those whose income level changes significantly. For example, if a farmer’s harvest is poor in one year, the property tax burden might be the same as in a year with a very good harvest.

One advantage of property taxes is that they are generally easier to collect than other taxes. It is difficult to hide real property and the taxing authority usually retains the ability to seize the property if taxes are not paid. However, it is more difficult to create the appropriate systems to keep records and properly assess the value of real property. This can be a significant cost and hurdle in the implementation of a property tax.

Property taxes are generally transparent and easy for taxpayers to understand. One confusing factor, however, is the measurement of market value. Often, the methods used for a tax assessment are not the same as would be used by a real estate broker or a potential purchaser of the property, which can lead to confusion on the part of the taxpayer. Additionally, a clear policy on how often assessments of market value occur is necessary to ensure transparency.

Property taxes are used in many countries, including the United States, Canada and Holland. Often, property taxes are imposed by state or local governments rather than by a national or federal government. Local administration of property taxes reduces the burden of assessing the value of property because a local government has more familiarity with the property in the region. Afghanistan currently does not have a real property tax.

### **C. Excise Tax**

An *excise tax* is a tax imposed on goods produced in a country and sold in the same country. Excise taxes are like customs duties in that they are based on the value of the good and not on any characteristic of the taxpayer. They are levied on the producer of the good, although the consumer will indirectly pay for the tax, since the producer will increase the purchase price to account for such tax. The tax is considered an indirect tax on the ultimate consumer.

Excise taxes, like customs duties, are “flat” taxes: each category of goods is taxed at the same rate. The differences in tax rates are based on the characteristics of the good, not on the characteristics of the taxpayer. Since each good is taxed the same (one brand of cigarettes is usually taxed the same as another brand) such a tax seems inherently “fair.” However, like a sales tax, excise taxes will impact those with lower incomes more severely than those with higher incomes. For example, if an excise tax causes the price of cigarettes to increase by 2 Afghanis per packet, someone making 100 Afghanis per week may buy fewer cigarette packets, but a person making 3,000 Afghanis a week will probably not buy fewer packets.

Excise taxes are relatively easy to administer, provided the producer of a good is known. Excise taxes are also imposed on a small number of goods (not on all goods like a sales tax), which eases the administrative burden on the tax authority.

Like customs duties, excise taxes are another example of taxes that can be used to influence behavior. Taxes on tobacco have been commonly used in Western Europe and the United States to discourage people from smoking. A higher tax on cigarettes increases the cost of a packet of cigarettes, which in turn lowers sales and discourages smoking. Goods that are typically subject to excise taxes include tobacco, firearms, and petrol. Many countries impose excise taxes on goods, including the United States, Japan and Western European nations.

### **Discussion Questions**

What do you think about wealth, real property, and excise taxes? Do you think Afghanistan should institute these taxes in some form?

## V. SKILLS APPLICATION: HOMEWORK ASSIGNMENTS

### *Research and analysis assignments*

1. Find an article about the tax system of another country. Write a three-page essay comparing what you have learned about that country's tax system with Afghanistan's tax system. In what ways does the Afghan tax system seem advantageous? In what ways does it seem disadvantageous? Prepare a 5-minute class presentation explaining your findings to your classmates. Ideally, the class will learn a little about the tax systems of many different countries.
2. After reviewing the different types of taxes that a government could use (income tax, customs duty, wealth tax, real property tax, and excise tax), prepare a three-page essay discussing the merits and drawbacks of each type of tax for Afghanistan. You may also include a discussion of the different approaches to setting tax rates (head tax, progressive tax, flat income tax, and consumption tax).
3. Prepare a three-page analysis of Afghanistan's customs collection procedure. Identify any aspects that are particularly inefficient or efficient and steps in the process where corruption is most likely to occur. How could you modify the collection procedure to address these inefficiencies and eliminate opportunities for corruption?

## Glossary

### ***Assessment***

The amount at which an item is valued.

### ***Capital***

Financial wealth used to start or maintain a business.

### ***Capital asset***

An asset that is used to make more money, such as cash, stocks, and bonds.

### ***Dividend***

A distribution of a portion of a company's earnings to a class of its shareholders.

### ***Duty free zone***

A specified area where foreign goods are brought into a country without import duties to be further processed or re-exported.

### ***Exports***

Goods produced in one country that are shipped to another country and sold.

### ***Gross receipts***

Total revenue before deducting expenses but commonly after deducting withholding taxes for employees.

### ***Horizontal equity***

A principle that calls for similarly situated taxpayers to be treated similarly under the tax laws (e.g. taxpayers with similar incomes should pay similar amounts of tax).

### ***Imports***

Goods produced abroad that are shipped into a country and sold.

### ***Legal persons***

Corporations, limited liability companies, and other legal entities.

### ***Natural persons***

Individuals, sole proprietors, and the partners of a partnership.

### ***Net income***

The income that a firm has after subtracting costs and expenses from its total (gross) revenue.

### ***Operating loss***

A loss resulting from a firm's primary business operations, not including expenses and income such as interest.

***Resident***

A person that has his or her principal home in Afghanistan at any time during the fiscal year or that is present in Afghanistan for at least 183 days during the year or that is a government employee assigned abroad for any part of the fiscal year.

***Security deposit***

A payment given to another party to guarantee the performance of an obligation (such as the payment of a debt).

***Tariff***

A schedule of tax rates for different categories of goods.

***Vertical equity***

A principle that calls for the tax laws to make appropriate distinctions between taxpayers that are situated differently (e.g. taxpayers with different amounts of income should pay different amounts of tax).

## **Sources Consulted**

Afghanistan Customs Code (2005)

Afghanistan Income Tax Law (2005)

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## CHAPTER 8: AFGHANISTAN'S FINANCIAL SYSTEM AND ITS LAWS

### I. INTRODUCTION

#### Reading Focus

What is the role of a financial system in a country's economic development? Why is it important for us to understand how the financial system works? What role can the law play in ensuring that the financial system works efficiently?

A free, vibrant, and self-sustaining economy is critical to the stability and prosperity of Afghanistan. In order to foster this development, there must be a robust financial system that is subject to rigorous regulation under a consistent legal framework. We have already studied the discrete concepts that form the basis of the formalized system of commercial law in Afghanistan. In Chapter IV, we discussed the importance of contract enforcement to commercial development. As we saw in Chapter V, the legal form of business organization and investment or debt contracts governs who has the rights to the **assets** and profits of the business. However, in order to gain a complete picture of how the Afghan economy works, it is also important to consider how the combination of the legal concepts of contract and business organizations interact with the regulatory schemes put in place by the Afghan government.

The purpose of this chapter is to focus on the laws and regulations that govern Afghanistan's growing financial system. The economy in Afghanistan is developing rapidly. Businesses and the transactions they conduct are becoming more and more complex, creating a pressing need to move beyond family ties and community reputational incentives that have controlled commercial behavior in the past, and requiring a wider variety of laws to regulate them. A consistent and transparent regulatory framework is critical to the sustained development of Afghanistan's economy, especially with regard to creating a predictable environment that is appealing to foreign investors.

This chapter will begin with some introductory coverage of the workings of a modern financial system. Next, the chapter will cover Afghanistan's banking law and bankruptcy law. In the banking law section, we will explore the roles of banking institutions in such a financial system, beginning with the role of a central bank and then looking at the function of commercial banks. The section on banking will conclude with a discussion of the new laws governing Afghanistan's central bank and commercial banks. In the secured transactions section, we will first go over some basic credit concepts before delving into the proposed legal framework for governing collateral-based borrowing. Because there is currently no bankruptcy law in force in Afghanistan, the aim of this section will be to familiarize you with the procedure and goal of bankruptcy law in a developing economy, and will end with some suggested guidelines for an eventual bankruptcy system.

Finally, this chapter will conclude with a brief exploration of the informal and formal credit markets in Afghanistan, as well as the impact that international microcredit initiatives have had on Afghanistan. The discussion of these two coexisting systems should raise some important questions in your mind regarding the future path that Afghanistan should take in order to best promote sustainable economic growth.

## II. BASIC CONCEPTS OF A FINANCIAL SYSTEM

Imagine living in a world in which there are no financial institutions, no financial markets, and no financial assets. In such a world, **bartering** of goods and services would be the only means by which value could be transferred. You would not be able to borrow against future income in order to purchase a home or a car, or to start a business or finance an education. Without money or banks, there would be no way for you to save some of your current income in order to handle future expenses, and you would not be able to accumulate wealth over time.

The financial system exists to fill these and many other critical needs that arise out of an industrial economy's demand for some separation in time between the use of resources, the production of goods and services, and the actual consumption of those goods and services. In other words, the financial system is a network of markets, institutions, laws, regulations, and techniques that moves scarce resources—land, labor, management skill, and capital—to their highest-value use in order to maximize production of the goods and services needed by society.

In order to understand how the financial system works, consider the following situation. Suppose that you would like to own a radio. In a system of bartering, you might offer to watch your neighbor's children for a week in return for her radio. However, once you have the radio, its value is difficult to save or convert. For example, imagine that now you decide what you would really like is to buy a desk for your house. Unless you are able to find someone who has a desk but would prefer a radio to exchange with, you will not be able to obtain the item that you desire. This simple example illustrates the limitations of a barter economy.

The financial system solves these limitations by performing seven critical functions:

- A. Savings function,
- B. Wealth function,
- C. *Liquidity* function,
- D. *Credit* function,
- E. Payments function,
- F. Risk protection function, and
- G. Policy function.

### A. Savings Function

The global system of financial markets and institutions provides a place for the public's **savings**. In addition to the most obvious method of savings—putting money in the bank—value can also be “stored” in the form of bonds, stocks, and other financial claims.

## **B. Wealth Function**

Whereas savings represent the flow of funds, the accumulated savings held by society in the form of stocks, bonds, and other financial assets accumulated over time is referred to as **wealth**. When businesses and individuals choose to save, the financial instruments sold in the market provide an excellent way to store wealth until the funds are needed for spending. Although a common way to store wealth is to purchase things, like cars or homes, such items lose value over time and carry great risk of loss. The benefit of bonds, stocks, and other financial instruments is that they are not subject to those same risks—they do not wear out over time from use and their risk of loss is less than for other forms of stored wealth.

## **C. Liquidity Function**

Now that we have wealth stored in the form of financial instruments, the financial system also provides a means of converting those instruments into cash when it is needed for spending. This is called **liquidity**. For instance, if you wanted to buy a car but held your wealth in bonds, the financial marketplace allows you to sell the bonds for cash. You would then use this cash to purchase the car.

## **D. Credit Function**

In addition to providing liquidity and facilitating the flow of savings into investment instruments to build wealth, the financial system also furnishes **credit** to finance consumption. Credit is essentially a loan of funds in exchange for a promise of future payment.

There are two common instances in which consumers need credit. The first is for the sake of convenience. For example, in many countries around the world, consumers pay for everyday purchases using a credit card to save themselves the trouble of carrying cash. Credit cards give a consumer instant access to short-term credit when contracting for the purchase of goods or services. Rather than paying for purchases at the market, the bookstore, or the bakery with cash, consumers simply use their credit card. They then pay off the amount that they have spent at the end of the month in one lump sum.

The second use for credit is to facilitate the purchase of big items, such as a home or a car. Often, consumers do not have sufficient funds at the time the purchase needs to be made, and so credit allows them to finance the purchase in return for promises of future payments. You can also think about this in terms of borrowing against future income.

## **E. Payments Function**

The financial system also provides a mechanism for making **payments** for goods and services. As was mentioned above, the credit card is one common service offered by banks to help their customers to consume. Another instance is the debit card, which functions when a customer pays immediately for purchases by electronically deducting the amount from his account in a bank. Finally, checks represent the third instrument provided by banks to serve as a

stand-in for cash. The global trend has seen a rapid increase in electronic means of payment, while the use of checks is steadily declining.

## **F. Risk Protection Function**

As was discussed in Chapter V, the corporate form limits exposure to **risk** by permitting shareholders and institutions alike to diversify their investments. The financial system likewise offers businesses, consumers and governments the opportunity to limit their risk exposure by allowing them to engage in risk sharing and risk reduction. Risk sharing occurs when risk exposure is transferred from someone willing to accept that risk in return for a price (insurance), while risk reduction usually takes place when wealth is diversified across a wide variety of different assets to limit the extent of overall losses.

Significantly, the financial system also allows businesses and consumers to “self-insure” by building up wealth as protection against future losses.

## **G. Policy Function**

Lastly, the financial system provides a channel through which the government can further its various economic interests, like stabilizing the economy, stimulating growth, and avoiding inflation. In the regulations that we will study later in this chapter, you will see how the government can, through its central bank, affect the borrowing and spending habits of the public, impact the growth of jobs, regulate production and control prices.

### **Discussion Questions**

Think about the seven functions of the financial system that we have just discussed. Which functions are new to you? Which functions do you think are the weakest in Afghanistan’s financial system? If you could choose to improve the efficiency of one of these functions in Afghanistan, which would it be and why? How would you accomplish this?

### **Finance Fundamentals**

#### **The Various Roles of Money in an Economy**

An advanced industrial economy cannot function efficiently without money. Bartering—when people exchange goods or services for other goods or services—can still be an effective way for people to exchange products. For instance, in rural areas where many people own goods such as livestock, those goods can more easily be exchanged for other goods or services. However, as economies develop and people move into cities, these trades become more difficult. People do not have the ability to keep goods such as livestock that can be easily traded. Money then becomes a much more effective medium of exchange.

When money becomes the primary means to exchange and store value, banking begins to play an important role in an economy. People use banks to store the money for which they do not have

an immediate need. In return, the bank pays interest on the money a person deposits with the bank. The bank in turn loans that money to people or businesses that want to expand their business or make a major purchase. Banks make a profit by charging a higher interest rate on their loans than they pay on their customers' deposits. By making loans, banks allow people and businesses to make use of productive resources that they would otherwise not have the ability to purchase. This allows an economy to grow and allows businesses to create jobs. One growing business often generates increased sales for other businesses because it purchases more goods and services to produce its own goods and services.

Money can also serve as a more effective standard of value. As economies grow and more products become available, it becomes more difficult to compare the relative value of different products in a barter system. I may know that a merchant recently exchanged two water buffalo to another person for eight sheep, but that might not tell me how many kilograms of rice I should expect to pay for two water buffalo. When transactions are done in currency, two different sales are more easily compared. If I know that another person paid 5000 Afghanis for a computer recently, I can probably expect to pay a similar amount for a similar computer.

### III. BANKING LAW

#### The Banking System: An Overview

##### A. Introduction

On October 7, 2002, the interim government of Afghanistan marked the first anniversary of its accession to power by issuing new banknotes through Da Afghanistan Bank, the central bank of Afghanistan. Originally founded in 1938, Da Afghanistan Bank was responsible for the issuance of all notes, the execution of all government loans, and the lending of money to cities and to other banks in Afghanistan. In 1975, all the banks in Afghanistan were nationalized as a result of complications and uncertainties arising from the absence of a comprehensive law that provided clear terms for borrowers and lenders.

Under the auspices of the United Nations' International Security Assistance Force, plans are now underway for Afghanistan's first modern **stock exchange**. In the past, a stock exchange referred to a physical location where traders of stocks and securities would gather. Now, a stock exchange is more commonly understood as a formalized communications network that facilitates this kind of economic activity, thereby creating liquidity. The Kabul International Stock Exchange will bring together cash equities exchanges and foreign exchanges, and will be Afghanistan's first forum for the listing and trading of securities.<sup>42</sup>

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<sup>42</sup> Afghanistan Currency and Banking, available at <http://www.afghanistans.com/Information/Economy/CurrencyBanking.htm>

Now, before addressing the specific Afghan context, we will first address the two components to a functioning banking system: a country's central bank, and its network of commercial banks.

## **B. The Central Bank**

One of the most important financial institutions in any modern economy is the central bank. A central bank is a government agency that has important public policy functions in monitoring the operation of the financial system, controlling the growth of a nation's money supply, and enhancing the performance of its economy. Generally speaking, a central bank fulfills four fundamental functions:

- ❖ Control of the money supply,
- ❖ Market stabilization,
- ❖ Lender of last resort,
- ❖ Establishment, execution and maintenance of economic policy.

One of the most important functions that a central bank performs in a financial system is its regulation of the money supply in order to avoid severe **inflation**. Inflation is the rise in general price levels that is usually attributed to an increase in the volume of money or the availability of credit. In the absence of effective controls, money in the form of paper notes could expand virtually without limit. Recall that one of the functions of money is to act as a store of value. While the **marginal cost** (the cost of an additional unit of output) of creating additional units of money is essentially zero, if the money that is printed far exceeds the economy's capacity to produce goods and services, then inflation will occur, rendering money essentially worthless. The central bank is responsible for making sure that each Afghani in circulation in the Afghan economy is backed by the economy's corresponding capacity to produce goods and services.

A second crucial function of a central bank is its stabilization of the money and **capital markets**. In order for this stability to be maintained, the financial system must be able to transfer savings from financial institutions to those who require funds for investment, so that the economy can grow. However, in order for these transfers to occur, the public must have confidence in the financial institutions so that they will be willing to commit its savings to them. Therefore, if the financial markets are volatile and unpredictable because of an unstable currency or because the financial institutions are not well regulated, then the collapse in public confidence that will result will inhibit the healthy flow of investment capital, which will in turn slow down the country's economic growth. The central bank plays a key role in seeing that the economy grows by ensuring a stable flow of funds to fill investment needs through various forms of market intervention, including regulating the availability of credit and infusing the market with fresh capital as needed from time to time.<sup>43</sup>

Many central banks also perform the essential function of serving as a "lender of last resort." This entails the provision of liquid funds to financial institutions when alternative

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<sup>43</sup> Rose, Peter S. & Marquis, Milton H. Money and Capital Markets: Financial Institutions and Instruments in a Global Marketplace. New York: McGraw-Hill Irwin, 2006.

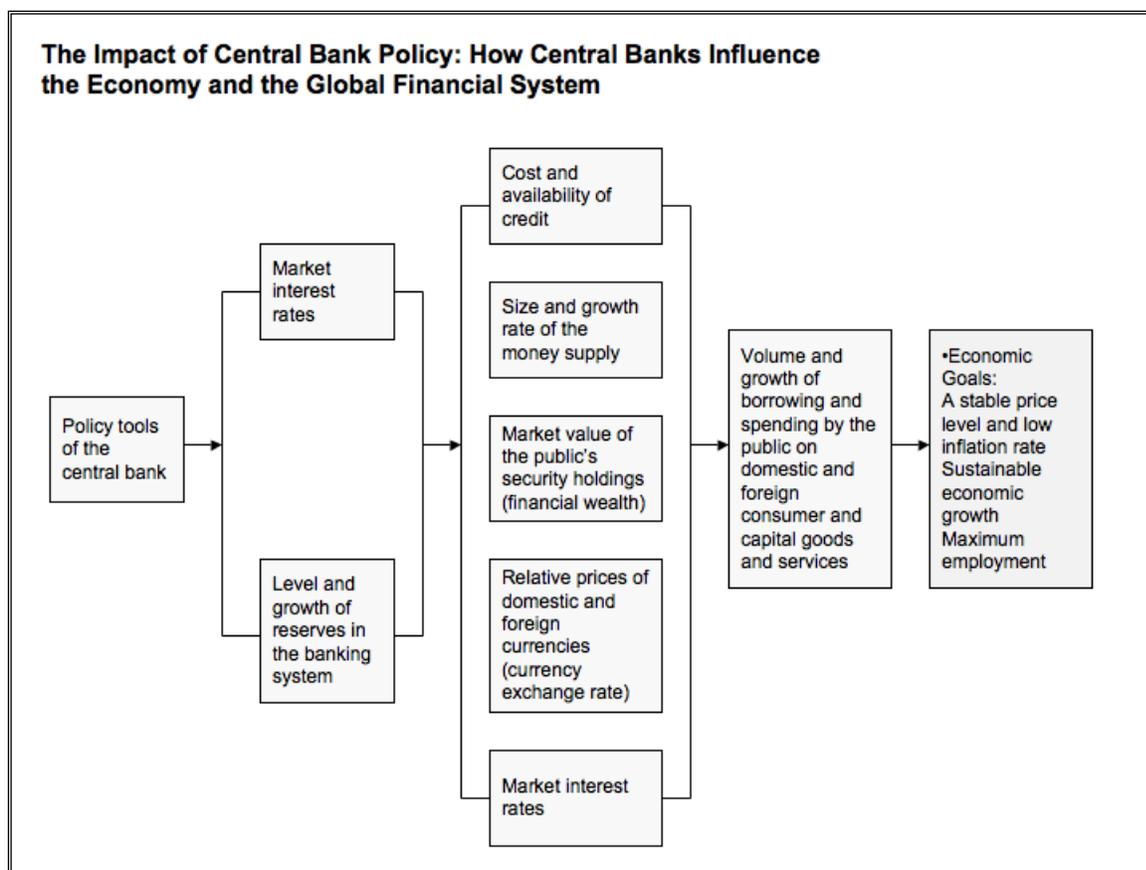
sources of funding have dried up. This function is especially crucial in times of sudden, unexpected economic turmoil, during which panic can prompt devastating **illiquidity**. By providing funds to financial institutions in order to cover their short-term cash deficiencies, the central bank can keep the financial system functioning even in a struggling economy.

Finally, central banks are able to establish, execute and maintain the economic policies of the state by influencing conditions in the financial system. Central banks are able to accomplish this by making the following adjustments:

- ❖ Changes in the cost and availability of credit to businesses, consumers, and governments by altering interest rates,
- ❖ Changes in the volume and rate of growth of the money supply,
- ❖ Changes in the financial wealth of investors as reflected in the market value of their holdings,
- ❖ Changes in the relative prices of domestic and foreign currency (currency exchange rates), and
- ❖ Changes in the public's expectations regarding future money and credit conditions and currency values.

These adjustments are also commonly referred to as the “policy tools” of the central bank. For example, suppose that the central bank sees that the public's demand for goods and services has been reduced and wants to slow the growth of the economy to match this decline. If the central bank raises **interest rates**, then borrowers will find that credit is less available and more expensive to obtain. Therefore, they are likely to restrain their borrowing and spending, which will result in a slowing of the economy's rate of growth.

However, what if the central bank wants to stimulate the economy instead? One important policy tool that it can use to accomplish this is its ability to control the currency exchange rates. By lowering domestic interest rates relative to foreign interest rates, the central bank will encourage spending over savings, which has the effect of putting more money into circulation. This in turn causes the home currency to fall relative to foreign currency prices, making the country's exports cheaper and more sought after abroad, thereby stimulating domestic production and creating more jobs.



### C. The Commercial Bank

The commercial bank is a privately owned financial institution that offers the public deposit and credit services. In most developed economies, banks play a critical role in the functioning of its financial system. They provide the principal means of making payments through the checking accounts, credit cards, and electronic transfer services they offer. Banks also have the ability to create money from the reserves entrusted to them through the public's deposits. By making loans and investments from their excess reserves, banks are able to keep liquid investment capital flowing into the economy while generating income. Commercial banks are also the most important source of consumer credit to individuals and loans to small businesses.

Prior to 2003, the banking sector in Afghanistan was in shambles, with little formal economic activity. Late in 2003, the Central Bank of Afghanistan resumed the licensing process for the formation and establishment of local and foreign commercial banks in the country. In September 2004, with the support of the Central Bank, the Afghanistan Banks Association (ABA) was formed with eight member banks. The goal of the ABA was to improve the functioning and organization of the banking system in Afghanistan. Today, it counts 17 licensed banks among its members.<sup>44</sup>

<sup>44</sup> Afghanistan Banks Association website. Available at <<<http://www.aba.org.af/>>>

In 2003, two banking laws were officially adopted to create a financial system that could support greater economic development: Da Afghanistan Bank Law and the Afghanistan Banking Law.

*Da Afghanistan Bank Law: Overview and Scope of Application*

Article 2 of Da Afghanistan Bank Law (the Central Bank Law) establishes Da Afghanistan Bank as the central bank of Afghanistan, and as a “juridical person with full capacity under the law [who] may conclude the relevant contracts, acquire and dispose of movable and immovable property, and issue its own **securities** and otherwise borrow, and be a party to legal proceedings.” which would regulate the monetary system and the commercial banks of Afghanistan.

As stated in the law itself, the goal of Da Afghanistan Bank is “to achieve and to maintain domestic price stability.” Put another way, the job of Da Afghanistan Bank is to prevent price inflation in Afghanistan’s market. Other official objectives of Da Afghanistan Bank include “fostering liquidity, **solvency** and proper functioning of a stable market based financial system, and to promote a safe, sound and efficient national payment system.” This means that Da Afghanistan Bank is also responsible for ensuring that it puts enough money into the financial system that the market is able to operate.

The Central Bank Law clearly states that all other purposes of Da Afghanistan Bank will be subordinate to its primary goal of anti-inflation price stability. Similarly, Da Afghanistan Bank is tasked with supporting the economic policies of the government of Afghanistan and creating conditions for sustainable economic growth without undermining its primary mission of domestic anti-inflationary price stabilization. Therefore, Da Afghanistan Bank must balance conflicting objectives. If the bank provides more money to the system, then credit becomes relatively cheap to borrowers. This creates more liquidity and spurs economic growth, but it can also lead to high inflation. If the bank provides less money to the system, credit becomes relatively expensive to borrowers. Economic growth is slowed, but inflationary pressure is reduced. Da Afghanistan Bank must attempt to keep the money supply at a level that allows for reasonable growth without encouraging excessive inflation.

## **Da Afghanistan Bank Law – Article 2**

### **Objectives and Basic Tasks of Da Afghanistan Bank**

1. The primary objective of Da Afghanistan Bank shall be to achieve and to maintain domestic price stability.
2. The other objectives of Da Afghanistan Bank, which shall be subordinated to the primary objective of Da Afghanistan Bank, shall be to foster the liquidity, solvency and effective functioning of a stable market based financial system, and to promote a safe, sound and efficient national payment system.

Without prejudice to its primary objectives, Da Afghanistan Bank shall support the general economic policies of the State, and promote sustainable economic growth.

The basic tasks of Da Afghanistan Bank for which Da Afghanistan Bank shall be responsible are:

- a. To formulate, adopt and execute the monetary policy of Afghanistan;
- b. To formulate, adopt and execute the foreign exchange policy and exchange arrangements of Afghanistan;
- c. To hold and manage the official foreign exchange reserves of Afghanistan;
- d. To print and issue afghani banknotes and coins;
- e. To act as banker and adviser to, and as fiscal agent of, the State;
- f. To issue or register the license and to regulate and supervise banks, foreign exchange dealers, money service providers, payment system operators, securities service providers, securities transfer system operators and such others as shall be submitted to its oversight in accordance with the law;
- g. To establish, maintain and promote sound and efficient systems for payments, for transfers of securities issued by the State or Da Afghanistan Bank, and for the clearing and settlement of payment transactions and transactions in such securities.

Finally, Article 1 of the Central Banking Law provides important definitions of terms that you will likely encounter as you become more involved in Afghanistan's financial system.

### **Discussion Questions**

What is a conflict of interest? How might the law's ignorance of these conflicts undermine the public's confidence in government agencies? Why might issues of conflicts of interest be especially critical in the context of the governing body of the central bank? Do you think that Article 25 adequately deals with these concerns? If not, what additions would you propose?

### *Organization of Da Afghanistan Bank*

Next, Chapter II describes the organizational requirements of Da Afghanistan Bank. Most notable is the Central Banking Law's establishment of a "Supreme Council" as the bank's highest policy and decision making body, with all seven members to be appointed for five year terms by the President of Afghanistan with the consent of the Parliament (Article 7). Articles 6 through 26 establish the functions, powers, membership conditions, and compensation of the Supreme Council. Article 25 explicitly addresses conflicts of interest, revealing the law's commitment to preserving the independent integrity of Da Afghanistan Bank.

### **Da Afghanistan Bank Law – Article 25**

#### **Conflicts of Interest**

1. The Governor, the Deputy Governors and the Comptroller General of Da Afghanistan Bank shall devote the whole of their professional services to Da Afghanistan Bank, and none of them shall occupy any other office or employment, whether remunerated or not, except as nominee or agent of Da Afghanistan Bank.
2. No former Governor, Deputy Governor or Comptroller General of Da Afghanistan Bank shall serve another financial institution during a period of one year following their departure from Da Afghanistan Bank, without the prior written approval of the Supreme Council.
3. No member of the staff of Da Afghanistan Bank shall simultaneously have other employment, whether gainful or not, without the prior written approval of Da Afghanistan Bank.
4. No Governor, Deputy Governor, officer or member of the staff of Da Afghanistan Bank shall accept any gift or credit for himself, or on behalf of any person with whom he has family, business or financial connections, if the acceptance thereof would result, in diminishing his impartial devotion to his duties.

### Functional Logistics of Da Afghanistan Bank

Chapter III covers how the financial affairs of Da Afghanistan Bank should be handled. It sets its initial authorized capital at eight billion Afghanis (Article 27), provides guidelines on the calculation and allocation of the Bank's net profits and losses (Articles 28-30), and provides for capital infusions from the Minister of Finance in the event of a shortfall in the Bank's capital (Article 31). Chapter IV covers all aspects of the Afghan currency, including a treatment of its related criminal offenses.

### Monetary Policy Functions of Da Afghanistan Bank

Finally, we reach the most important sections of the Central Banking Law. Recall that the power to implement economic policy was one of the seven functions of a financial system that we discussed earlier in this chapter. The central bank plays an important role in fulfilling this function. Chapter V gives Da Afghanistan Bank the tools that it needs to execute its monetary policies.

Article 62 awards Da Afghanistan Bank broad dominion over monetary policy: "Da Afghanistan Bank shall be responsible for the formulation, adoption and execution of the monetary policy of Afghanistan" while Article 69 awards similar power to the Bank over the country's exchange rate policy.

### Da Afghanistan Bank's Relations with the State

Chapters VII and VIII deal with the relations between Da Afghanistan Bank and the government and other banks, respectively. Under Article 76, Da Afghanistan Bank shall act as banker and adviser to, and fiscal agent of, the State. Chapter VII also establishes a close relationship between the central bank and the Minister of Finance, requiring the Minister of Finance to consult with Da Afghanistan Bank on its annual plan for domestic and external public sector borrowing, including the amounts to be contracted and disbursed under such a plan, as well as the terms and conditions of such borrowing (Article 77). In addition, Da Afghanistan Bank is required to deliver to the Parliament and publish a policy statement every six months that describes and explains the monetary policies that the Bank intends to pursue for the next six months, and that reviews and assesses the execution of the monetary policy that was pursued in the six months preceding the policy statement (Article 105 (2)). Despite the close relationship between Da Afghanistan Bank and the state mandated by the Central Bank Law, the law also expressly prohibits Da Afghanistan Bank from carrying out any transaction that will extend financial assistance to or for the benefit of the State (Article 76 (1)), and from granting any financial assistance to the State or to any of its State Agencies (Article 81).

### Da Afghanistan Bank's Relations with Banks

Articles 83 and 84 of Chapter VIII give Da Afghanistan Bank the task of licensing, regulating and supervising domestic Afghan banks and cooperating with any foreign supervisory authorities with bank branches operating in Afghanistan. As was discussed in the preceding

section, a central bank often functions as a “lender of last resort.” Article 86, reproduced in its entirety below, gives Da Afghanistan Bank this critical power.

### **Da Afghanistan Bank Law – Article 86**

#### **Lender of Last Resort**

Da Afghanistan Bank may, on the determined terms and conditions, act as lender of last resort for domestic or foreign financial institutions that are account holders, by granting to them or for their benefit, for periods not exceeding three months, financial assistance that may take the form of loan, swap, repurchase and contingent commitments; each such commitment must be secured by assets specified in Article 69 unless Da Afghanistan Bank decides that an unsecured commitment would be justified by exceptional circumstances; No such commitment shall be made by Da Afghanistan Bank unless: (a) in the opinion of Da Afghanistan Bank, such commitment is dictated by the liquidity requirements of the account holder and by the public interest; and (b) the Minister of Finance has concurred with the commitment within 24 hours after a proposal therefore was submitted to him by Da Afghanistan Bank. The period for commitment may be extended by Da Afghanistan Bank on the condition that the account holder takes the measures concerned to satisfy Da Afghanistan Bank's liquidity requirements.

#### *Commission for Settling Financial Disputes*

By this point, it should be clear that a country’s central bank wields enormous power. Therefore, to prevent it from functioning unchecked, the last section of the Central Banking Law that we will study is Chapter XII, which provides for the establishment of an oversight committee that has jurisdiction over, among other things, the decisions and orders of Da Afghanistan Bank. The Commission is composed of three lawyers and three professional accountants who are given lifetime appointments by the President, at the recommendation of the Governor of Da Afghanistan Bank and the Minister of Finance, respectively (Article 108). Moreover, the Commission is also vested with the power to adjudicate any financial disputes that may arise between financial institutions if the institutions so consent via a prior written agreement (Article 107).

#### **Discussion Question**

What do you think the drafters of Article 86 meant when they stipulated that Da Afghanistan Bank may only make unsecured commitments if it is “dictated by the...requirements...of the public interest?” What do you think Da Afghanistan Bank would consider to be in the public interest? What do you consider to be in the public interest?

### Law of Banking of Afghanistan: Overview and Scope of Application

The Law of Banking of Afghanistan of 2003 (the Banking Law) was adopted at the same time as Da Afghanistan Bank Law to create a framework under which the commercial banking system would be regulated. The Banking Law addresses several issues related to the operation of commercial banks. It determines the activities that are prohibited for banks and non-banks as well as the sanctions that can result from violations of the Banking Law, and it establishes a procedure for public consultation in conjunction with the adoption of banking regulations. This procedure helps to ensure that the public has a voice in determining how banks will be run. The Banking Law also sets out the conditions under which foreign entities may invest in banks in Afghanistan and establishes how banks operating in Afghanistan must cooperate with foreign regulators.

The Banking Law places Da Afghanistan Bank in charge of enforcement of its provisions, and it provides Da Afghanistan Bank with the power to promulgate regulations related to banks and the commercial banking industry. There are a broad range of enforcement procedures that Da Afghanistan Bank can take against banks that fail to meet their legal requirements.

The Banking Law provides detailed requirements that must be met by all banks operating in Afghanistan. It establishes the specific registration, licensing and permit procedures that all banks must meet. It also creates procedures for newly established companies and companies that are already in existence to receive the necessary authorization to operate in the banking industry as well as provides the standards that those companies must meet in order to operate legally. In the event a bank does not comply with the law, procedures are established for the revocation of banking licenses and permits as well as requirements for the publication of decisions related to such revocations. This provides banks with greater assurance that the revocation of a banking license will only occur due to actual violation of the law.

Organization, ownership and administration of banks are important areas that are covered by the Banking Law. The law specifies how the bank entity must be structured including what organizational documents, such as charters and bylaws, are required. These documents determine the internal rules by which the bank will operate. Banks are also required to maintain a certain capital structure to limit the likelihood of **insolvency**. This means that every bank must at any time be able to show that its assets exceed its liabilities by at least the amount of capital that was invested in the bank by its owners.

The Banking Law also requires that no bank decrease its capital and reserves through a share repurchase or distribution of capital to its owners without the authorization of the central bank. Management of the bank is required to have a certain structure, and a variety of boards and committees are mandated to ensure proper monitoring of bank functions by its management and owners. The ownership and control of a bank is governed by other additional principles such as the requirement that managers disclose any conflicting commercial interests and that all employees refrain from using any confidential knowledge they have gained through their work at the bank for personal gain.

The operation of a bank requires the application of several common banking principles. The activities a bank is allowed to undertake are limited to ensure that the interests of the public are protected. Key banking principles include such things as the requirement that banks must meet all conditions required by law, as a condition of their licensing, or as required by the central bank. Banks must also maintain sufficient capital and liquid assets, keep proper records, and monitor the risk of their business and investments to their assets.

Activities that banks are generally allowed to undertake include: receiving money deposits; extending credit; buying and selling a variety of financial instruments and commodities; entering into guarantees and letters of credit; providing services related to money, securities, and other financial instruments; safekeeping valuables; and providing financial information. The methods that banks are allowed to use while undertaking these activities are further regulated by the law, and a variety of activities are specifically prohibited to ensure that banks do not undertake activities that will be in conflict with their activities as a bank.

A final key component of the Banking Law establishes a special procedure for bankruptcy that applies only to banks and mandates that other bankruptcy law does not apply to banks. Essentially, this procedure gives Da Afghanistan Bank the power under certain conditions to appoint its own manager for a bank that is not fulfilling its legal obligations. Since failure of a bank can have severe consequences for the bank's customers, this procedure is designed to allow Da Afghanistan Bank to protect customers and the economy in Afghanistan in general from the failure of a large or important bank.<sup>45</sup> Banks are seen as particularly important to the rest of the economy because many businesses rely on banks to finance their operations. If a bank fails and those businesses are unable to obtain credit, then the failure of the bank could cause many of the businesses that the bank serves to go out of business. The potential for this contagion effect is one of the reasons that special bankruptcy procedures apply to banks.

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<sup>45</sup> Available at

<<[http://www.centralbank.gov.af/pdf/6Banking%20Law%20\\_english%20Version\\_%20Final\\_Dec\\_.pdf](http://www.centralbank.gov.af/pdf/6Banking%20Law%20_english%20Version_%20Final_Dec_.pdf)>>

**Advanced Reading: An Interview with Anwar-ul-haq Ahady, Governor of the Central Bank of Afghanistan**

By David Kruger

*Excerpted from Asian Development Bank Review, Vol. 35, 2003.*

***Background***

Like much of Afghanistan, the country's banking system was devastated during 2 decades of conflict. The man charged with rebuilding the sector is Anwar-ul-haq Ahady, Governor of the Central Bank of Afghanistan, and Alternate Governor for Afghanistan in the Asian Development Bank (ADB). Mr. Ahady, who spent 23 years as a banker and professor in the United States, returned to Afghanistan in March 2002 to take up his current position. He spoke with David Kruger about his progress so far and the challenges that lie ahead. Excerpts:

***It has been more than 18 months since the Karzai Government took office in Afghanistan. How is the rebuilding of the country proceeding?***

You can look at it from an institutional point of view or from a physical point of view. In terms of institutional rebuilding, at least the central bank has started its rebuilding. We finished a currency conversion; we rebuilt our macroeconomic research unit, which provides the information for monetary policy. We have established a supervision department, which is the prerequisite for having a two-tier banking system, whereby commercial banks would be separate from the central bank. And we have had a pretty stable exchange rate. Prices have actually declined this year. So as far as the institution of the central bank is concerned, I think we have made significant progress. We are about to build a new banking system in the sense that we have received applications at least from three banks and they are ready, they have been reviewed, we are ready to issue them licenses, but we are waiting for the passage of the central bank law and the banking law in general.

***What is the main challenge facing the central bank now?***

The main challenge is to establish a new banking sector that is unlike that which existed in the past. In the past, we had commercial banks being part of the central bank. Now we will have commercial banks that are separate from the central bank. But I think we have made significant progress in that area, and I'm pretty confident that by the end of the year we will have a vibrant, privately owned banking system in Afghanistan. Our very serious problem is human resources. We do not have too many qualified people in Afghanistan. We are trying to hire some Afghans who have studied abroad in neighboring countries and have a decent education.

***How will the entry of commercial banks benefit Afghanistan and its people?***

These banks are supposed to compete with each other, and through competition, we hope they will offer better services, a more consumer friendly environment, and lower prices. This is the

benefit you would expect from any privately owned, free market, and competitive economic environment. The second benefit would be that the Government would not be involved in any losses that these banks might incur. We would hope that we will change the banking culture from one of being dominated by bureaucratic procedures to one that is dominated by initiative, competition, and result orientation.

***Are you confident the new national currency, the afghani, has gained acceptance?***

It has been very successful. It took us 3 months to exchange our old banknotes for new banknotes. The new banknotes have been accepted countrywide. Of course, there are still some transactions in US dollars and Pakistani rupees, but I think transactions in afghani are increasing. The exchange rate has been very stable for the past 6 months, and I think we have been able to gain the confidence of the people in the currency. I am expecting that within a year or a year and a half or so, the national currency will be the only currency used in the country for major transactions.

***One goal of the introduction of the new currency was to gain greater control over monetary policy. Has that been achieved?***

Yes, definitely. In the past we had no control over the printing of money. We actually did not even know how much money was in circulation. Conducting money policy on a sound economic basis was very difficult. Now on a daily basis I know what is the amount of money in circulation, what is the exchange rate, what is the government expenditure, how much I should sterilize. I can make those decisions with better data and with greater confidence.

***The Government has adopted a no-deficit policy. Can you explain the policy and its goals?***

The no-deficit policy is that the Government will not spend more than the revenue it generates. In the past, the Government spent a lot more money than its revenues and the worst part of that was that the deficit was financed by printing money. That's why the afghani depreciated so rapidly. To give you some perspective, in the 1970s, before the communist coup, one US dollar was equal to about 40 afghanis. By the time I took over, one dollar was about 40,000 afghanis. And the main reason was because there was so much money printed. In the 1970s before the communists took over, there were 16 billion afghanis in circulation. When the Karzai administration took over, the total amount of money in circulation was about 13,000 billion afghanis. This was money being printed without any foreign exchange support so of course the value of the afghani deteriorated very rapidly. If the Government were to have a deficit and it were monetized, the same thing would happen with the new currency.

***How does the security situation in the country affect your policy decisions and the implementation of new policies?***

A prerequisite for economic prosperity is security. Security could be a lot better, and it should have been better. And I think it should have been the No. 1 priority. I find it difficult to accept this argument that economic prosperity will enhance security. I don't think there is going to be

any economic prosperity unless there is security. The state of security is not as good as it should be, but the Government does realize this and is attaching very high priority to improving security.

***One area in which ADB is working with Afghanistan is the establishment of a national payments system. How is that progressing?***

There are three elements to the national payments system. One is the international element, and I think now the central bank is capable of doing all sorts of international payments. We can receive money from abroad and send money from Afghanistan in no time; we don't have any problem in that regard. There are payments to be made within the city of Kabul. Once again the central bank has no problem making these payments. Then there is payment to be made in the provinces. The central government does not have a problem. It has its employees, its branches throughout the country; but to be able to send money to those branches, security conditions would have to be met. We have asked President Karzai to talk to the governors to provide a high level of security for the banks and I think they have agreed to that. Recently, we completed our connection with about 32 central bank branches in the provinces. We are connected to those branches now through computers and through satellite. But we need to repair our branches in the provinces, and for that we need more equipment, and we have asked ADB to support us in that project.

**Further reading:** For an interesting speech given by Central Bank Governor Anwar ul-Haw Ahady before the International Monetary Fund in September 2002, see: <http://www.imf.org/external/am/2002/speeches/pr41e.pdf>.

#### IV. BANKRUPTCY LAW

Bankruptcy law generally has two functions. First, when a borrower becomes insolvent and is unable to pay its debts as they become due, bankruptcy law facilitates the fair and orderly **liquidation** of assets in order to pay the claims of the borrower's **creditors**. Second, in cases where businesses have a chance to achieve viability, bankruptcy law facilitates the necessary reorganization of the company's debts and assets in order to protect it from pursuit by creditors.

In a developing economy such as Afghanistan's, it is especially important to have an efficient and effective bankruptcy system. One compelling reason is that bankruptcy law allows for the efficient reallocation of the debtors' resources, thereby preventing the perpetuation of unviable businesses that inhibit the productive redistribution of assets and human capital. Another related reason is that a predetermined set of rules governing insolvency and liquidation encourages investment by giving creditors confidence that they will see their claims honored in the event that the company is no longer profitable.

Aside from several provisions that address liquidation in the new Company Law (see Chapter V), Afghanistan has not yet adopted a bankruptcy law. A 2009 World Bank study gave Afghanistan the lowest ranking out of the 181 countries that it surveyed in terms of the ease of

closing a business. The absence of a bankruptcy law increases risks to people attempting to open a business and may serve to deter entrepreneurs since they cannot be certain how expensive it will be if they are forced to close the business.

While the development of a bankruptcy system has taken relatively low priority behind other pressing legislative needs facing Afghanistan, this will change as the availability of commercial credit becomes more widespread and Afghanistan's economy continues to grow and mature. A bankruptcy law will be increasingly important as the banking industry becomes more advanced and requires that its loans based on secured transactions receive priority over other creditors when a business is closed.

Since 2004, the government of Afghanistan has been in the process of drafting a bankruptcy law based largely on the U.S. Bankruptcy Code. The law is focused on creating a coherent means of distributing assets when a company becomes insolvent. Adoption of such a law will allow entrepreneurs who are starting a business to more accurately assess the cost of closing that business.

**Commentary: The Integration of Bankruptcy Law into the Wider Commercial Law System**

*Excerpted from Commercial Law & Microeconomic Reform: A Practical Guide to Program Implementation (2007)*

To be effective, the content and implementation of the Bankruptcy Law must be compatible and coordinated with other aspects of a country's legal system. Whether a Bankruptcy Law will contribute to the realization of an economy's goals of financial stability and minimization of investment risk is significantly related to such matters as corporate governance, enforcement of contracts, property law, and secured transactions law.

Bankruptcy Law shares with other commercial laws certain fundamental necessities, such as the ability to execute judgments, the need for competently administered registries for real and movable property, and the existence of sound implementing and supporting institutions such as courts, administrators and valuation professionals.

Reforms to secured transactions laws in particular can increase the access to credit of the many segments of society currently excluded or forced to rely on high-cost informal credit.

Moreover, to be properly implemented, an insolvency system's procedural and substantive rules must be in step with the capacity of the relevant courts or agencies.

## **V. FORMAL V. INFORMAL CREDIT SYSTEMS**

For a variety of social, political and historical reasons, the Afghan economy is an overwhelmingly informal one, dominated by institutions, networks and relationships that are largely unrecorded and unregulated by the state. Until now, this textbook has emphasized the

formal system over the informal because it is the basis upon which the state of Afghanistan was founded. However, the credit sector is a prime example of an area in Afghan society where the formal and informal systems cannot be so easily untangled.

### Discussion Question

Given the developing state of Afghanistan's economy, what is the virtue of having a bankruptcy law written as soon as possible? How might a bankruptcy law provide stability and security to the financial system? What impact would a predictable and enforceable bankruptcy law have on foreign direct investment in Afghanistan? What about on local investment by Afghans?

The concept of formal credit is most simply understood as credit that is delivered and then repaid within a set system of rules. Sources of formal credit may include financial institutions such as banks, non-governmental organizations that issue microcredit, and even the government. Informal credit, on the other hand, is credit borrowed and lent beyond the boundaries of formally regulated systems, and as such is largely unmonitored. Informal credit transactions occur most commonly between friends, relatives and other social relations, and is the means by which the vast majority of Afghans gain access to credit. Informal credit is characterized by a high degree of flexibility, both in terms of the form that it can take as well as the terms of repayment.

One dynamic that informs the availability of informal credit in Afghanistan is the religious and moral obligation embedded in Islam to help those in need. Moreover, informal credit is so heavily based on the nature of the social relationship that exists between the transacting parties that repayment terms are frequently not set and there are very few repercussions that come with defaulting on the loan. Generally, the maintenance of the social ties between the parties takes precedence over the actual business substance of the transaction as a means of guaranteeing future help should the need arise. As a result, borrowers will repay the loan when they can, and lenders accept this arrangement with the expectation that should they face similar constraints in the future as borrowers, they will receive the same lenient treatment.

The widespread belief among international aid organizations that there is a strong and unmet demand for credit in Afghanistan has led to the growth of one particular form of formal credit: microcredit financing. However, the belief that formal microcredit is a suitable substitute for informal credit is simplistic. Whereas microcredit is issued for the purposes of funding entrepreneurial innovation and initiative, a series of studies conducted by the Afghanistan Research and Evaluation Unit has revealed that informal credit is mostly used to meet consumption needs that are immediate and personal, and not for purposes that we would consider to be wealth-enhancing for the country, such as starting a small business.<sup>46</sup> When used for consumption smoothing, especially in preparation for specific events such as marriage, informal credit fulfills a diverse range of household survival functions that often have little to do with income generation. Given this finding, it seems unlikely that informal credit systems will disappear even with the advent of formal credit.

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<sup>46</sup> Klijn, Floortje & Pain, Adam. "Finding the Money: Informal Credit Practices in Rural Afghanistan." Afghanistan Research and Evaluation Unit, June 2007, ix.

Second, the idea that a formal credit system is a substitute for the informal system overlooks some of the systemic advantages that informal credit offers over the formal system. Its flexibility, its availability and its relative risk-neutrality are all significant features. Indeed, as you may recall from our earlier discussion of secured transactions, the requirement of collateral in order to secure a loan under a formal lending system effectively precludes the poor, and in particular, the landless, from accessing credit.

Moreover, this finding also debunks the idea that informal and formal credit systems work in parallel by responding to disparate needs. There is evidence to suggest that the formal microcredit system is actually parasitic upon the informal credit system. Borrowers of microcredit who are under pressure to repay under the strict timetables imposed by issuers of formal credit often turn back to informal credit in order to meet those obligations. Ironically, this puts them more in debt rather than less.

#### **Discussion Question**

Do you think that it is possible to reconcile the informal and formal credit systems in Afghanistan? Can you think of other areas in Afghanistan society where such clashes between formal and informal systems exist? Do the points raised in this section about the complicated relationship between these two systems change your perceptions of formal versus informal institutions in Afghanistan? In what ways?

## Glossary

### ***Asset***

Something valuable that an entity owns, benefits from, or has use of, in generating income. An asset can be (1) something physical, such as cash, machinery, inventory, land and building, (2) or something intangible, such as copyright, patent, trademark, or goodwill. Assets shown on their owner's balance sheet are usually classified according to the ease with which they can be converted into cash.

### ***Bartering***

Trading in which goods or services are exchanged without the use of cash.

### ***Bond***

Written and signed promise to pay a certain sum of money on a certain date, or on fulfillment of a specified condition. All documented contracts and loan agreements are bonds.

### ***Capital markets***

The financial market that works as a conduit for the supply and demand of capital. It channels the money provided by savers and banks (the supply) to borrowers (the demand) through a variety of financial instruments (bonds, stocks) called securities.

### ***Credit***

A contractual arrangement whereby a creditor exchanges goods, services, or money against a debtor's promise to pay later.

### ***Creditor***

An entity to whom money is owed. These entities provide credit to debtors in return for a promise of repayment later.

### ***Inflation***

Sustained, rapid increase in the general price level over months or years that is accompanied by a corresponding decrease in the purchasing power of the currency.

### ***Interest rates***

Annual cost of credit computed as the percentage ratio of interest to the principal. Commercial banks generally determine their own interest rates on loans, and the central bank of a country can also set its own interest rate. In general, interest rates rise in times of inflation, greater demand for credit, tight money supply, or due to higher reserve requirements for banks. A rise in interest rates for any reason tends to slow business activity (because credit becomes more expensive).

### ***Illiquidity***

See definition for liquidity.

### ***Insolvency***

See definition for solvency.

***Liquidation***

The process by which a firm sells off its assets in order to pay its creditors. The liquidation process is initiated either by the shareholders (voluntary liquidation) or by the creditors after obtaining court's permission (compulsory liquidation).

***Liquidity***

Measure of the extent to which a person or firm has (or has the ability to quickly access) cash to meet immediate and short-term obligations. Illiquidity refers to the difficulty that an entity has in converting its assets to cash in order to meet its monetary obligations.

***Marginal Cost***

The increase or decrease in the total cost of production, from making one additional unit of an item.

***Securities***

Investment instruments that are bought and sold in financial markets, such as bond and stocks.

***Solvency***

Financial soundness of an entity that allows it to discharge its monetary obligations as they fall due. Insolvency is the inability of an entity to fulfill its obligations as they fall due.

***Stock***

Also known as “shares.” A stock is some evidence of ownership that represents an equal proportion of a firm's capital. It entitles its holder (the shareholder) to an equal claim on the firm's profits and an equal obligation for the firm's debts and losses.

***Stock exchange***

Organized and regulated financial market where securities (eg. bonds, stocks) are bought and sold at prices governed by the forces of demand and supply. Stock exchanges basically serve as (1) primary markets where corporations, governments, municipalities, and other incorporated bodies can raise capital by channeling savings of the investors into productive ventures; and (2) secondary markets where investors can sell their securities to other investors for cash, thus reducing the risk of investment and maintaining liquidity in the system.

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