

Taking advantage

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Julianne Canavaggio of Arias Fábrega & Fábrega outlines the key legal issues to consider when planning M&A activity in Panama

Panama's economy is experiencing a period of unprecedented growth, fuelled largely by a spike in foreign direct investment entering the country. Investors and foreign businesses have continued to seek out Panama as an FDI destination, driving the investment rate to around 30%, significantly higher than the region's 22.7% average. This influx of foreign capital has fed into the economy, generating a growth rate of approximately 7.5% for 2010, and a 9.5% approximate growth for 2011, which would make it the fastest growing economy in the region.

Two important mega-infrastructure projects, the \$5.25 billion Panama Canal expansion and the construction of a metropolitan transportation system, have both been key contributors to this growth. Furthermore, whereas other Latin American countries went through recessions during the financial crisis of the past few years, Panama was one of the few countries to maintain positive growth rates.

One of the main factors allowing Panama to maintain its growth levels is the prevalence of M&A activity. Many multinational corporations have established regional offices or headquarters in Panama, taking advantage of the tax, immigration and employment incentives granted to potential investors. These companies include Procter & Gamble, Halliburton, AES, Hewlett-Packard, Maersk and Hyundai, to name a few.

It is no coincidence that the economy's most important sectors have been the target of a lot of this M&A activity. The banking sector, for example, saw the purchase of BNP Paribas' Panama branch by the Bank of Nova Scotia. The insurance, industrial services, telecoms and media and dairy sectors were also big FDI destinations.

The legal framework

The relevant Panamanian laws and regulations governing business combinations include Law No 32 of 1927 (the Corporations Law), Law No. 4 of 2009 (the Limited Liability Company Law) and the Commercial Code, which is supplemented by the Civil Code. As combinations generally cause taxable events, the Tax Code and its regulations (especially Executive Decree 18 of 1994, which establishes a special regime regarding stock-for-stock mergers) and Law No 18 of 2006, which created a special capital gains regime are also pertinent. In the case of publicly-traded companies, Decree Law No 1 of 1998 and its regulations (the Securities Law) govern tender offers, proxy statements and rules of disclosure, among other matters.

Business combinations in Panama are usually structured as stock or asset purchases, tender offers, or mergers, but other techniques can also be used. One example is the capitalisation of stock of two operating companies to a holding company incorporated for that purpose with joint participation in the holding company. In the case of publicly-traded companies, combinations usually involve a two-step process that begins with a tender offer (either for stock, cash or a combination of both) followed by an actual merger. Several recent bank mergers have followed this format.

The impact of corporate and takeover law

Corporate and takeover law can be divided into two kinds of transactions: mergers and stock and asset purchases. In the case of mergers, Panama law allows a company to be absorbed by another regardless of the place of incorporation of the firms (merger by way of absorption). It also allows two companies to merge forming a new consolidated body. Once a merger becomes effective, the absorbed company ceases to exist as a legal entity and the surviving company assumes all the assets, rights, licences, capital, liabilities and obligations of the absorbed company by universal succession.

Unless the articles of incorporation state otherwise, a merger agreement must be executed by a majority of the directors of each company and approved by the holders of a majority of issued and

“Panama generally follows a territorial system of taxation; only Panama-source income is taxable”

outstanding shares of each firm. The merger agreement must then be registered with the Registry of Companies in Panama, bringing it into effect, unless a later effective date is defined in the merger agreement.

With stock and asset purchases, unless the articles of incorporation state otherwise, the acquisition of a company, regardless of whether it is structured as a stock or an asset purchase, generally requires approval from a majority of the directors of the acquiring company. On the other hand, the sale of a company, if it represents all or substantially all of the assets of the seller, generally requires approvals from both a majority of the directors and from the holders of the majority of all the issued and outstanding shares with the right to vote of the selling company.

Foreign involvement in M&A

The globalisation of markets and free-trade alliances has resulted in a general increase in the past few years in cross-border M&A activity. In almost all of the more recent M&A transactions in Panama, local companies have been the targets of foreign and multinational corporations. Political instability in nearby Latin American countries, especially Venezuela, Argentina, and Ecuador, has also been a substantial driver for inbound investments into Panama, as individuals and companies seek to diversify their country risk.

Generally, there are no foreign ownership restrictions in Panama. Due to issues of national security and national interest concerns, however, ownership of local companies by foreign governments or nationals is restricted in certain industries including aviation, radio and TV, and retail trade, among others. In the case of the retail services market, foreign participation is generally prohibited with very few exceptions.

Significant transactions, trends and industries

Despite the global financial crisis, recent years have seen periods of unprecedented growth in the Panamanian economy. As previously mentioned, multinational companies (such as Procter & Gamble, Caterpillar, AES, Halliburton, LG, Hewlett-Packard, Maersk, Roche, Hyundai, Peugeot/Citroën, Pan-American Life Insurance Company, Western Union and 3M) have taken advantage of incentives in taxation, immigration, labour and employment, enacted specifically to benefit multinationals who establish regional offices or headquarters in Panama.

“Goodwill is a frequent point of conflict between buyers and sellers”

Most important sectors of the Panamanian economy have been subject to cross-border acquisitions. The banking sector, which is Panama's stronghold, saw the sale of the commercial, retail and private banking operations of BNP Paribas' Panama branch to the Bank of Nova Scotia, Panama branch, and the reorganisation and purchase of Stanford Bank, which was the first banking reorganisation to be carried out in Panama. In the second quarter of 2011 there was also a buy-out of the majority stake in Stanford Bank.

The Panama Stock Exchange (Bolsa de Valores de Panamá), and Latin Clear (Central Latinoamericana de Valores) went through a strategic reorganisation. The two exchanges became indirect wholly-owned subsidiaries of Latinex Holdings, a newly-created corporation whose shares were registered with the Panama National Securities Commission and listed on the Panama Stock Exchange. The aims of the reorganisation were twofold: crystallising the evident synergies between the exchanges, and better positioning the two to compete as part of a unified group in the Central American and Andean markets.

The reorganisation was implemented through a complex array of transactions including reverse mergers, terminating the public listing and registration of both entities, and public registration of Latinex Holdings' shares. The Panamanian Stock Exchange and Latin Clear are, respectively, the only licensed stock exchange and clearance and depository agency in the country. The most significant banking groups and broker-dealers in Panama are participants in the Panamanian Stock Exchange and in Latin Clear.

As of December 31 2009, the balance of all assets under custody by Latin Clear was \$4.6 billion and as of March 31 2010, the total amount of principal of the debt securities listed on the Panamanian Stock Exchange was approximately \$2.8 billion. This was the first time that a reorganisation of this magnitude and complexity, involving the most important players of the Panama securities market, had been attempted in the country.

In the aviation sector, LAN Airlines acquired 98.9% of Aerovías de Integración Regional, Colombia's second largest airline. In industrial services, Empresas Hopsa sold a majority interest in Mortero Seco Panama, a premixed dry mortar plant, to local and regional investors.

In the ports sector, Oiltanking Colon, a privately-owned independent oil storage company, in connection with the acquisition of 100% stake in Colon Port



About the author

Julianne Canavaggio is a senior associate of Arias Fábrega & Fábrega (ARIFA), where she has worked for eight years. She is a rising star at the firm, particularly in the areas of mergers, acquisitions and joint ventures; corporations; banking and finance; and securities regulation.

She joined ARIFA from Baker & McKenzie (Houston), where she focused on mergers and acquisitions. She has participated as leading senior associate in the most important M&A transactions handled by the firm in recent years.

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Terminal and Colon Oil and Services. Both companies are engaged in the storage terminal business and will be managed and operated by Oiltanking. The aim of the terminal is to accommodate the increasing demand for marine fuels by vessels transiting the Panama Canal and calling the ports in the area. The first phase of the terminal was commissioned in the third quarter of 2011.

The terminal consists of 300,000 barrels of tank capacity for the storage and handling of marine fuels along with an exclusive 260-metre jetty with a draft of 12.5 metres and the ability to receive Panamax vessels. Oiltanking Colon is a wholly-owned subsidiary of Oiltanking, the second-largest independent tank storage provider for petroleum products, chemicals and gases worldwide. Oiltanking is itself a subsidiary of Marquard & Bahls, Germany, a leading privately-owned petroleum company.

In the food and beverage industry, the two principal dairy players were sold to foreign investors. Sociedad de Alimentos de Primera (Bonlac) was acquired by Colombia's Grupo Casa Luker in early 2011. Bonlac is a leading player in fresh dairy products and fruit based beverages. In 2005 it acquired Pascual, the leading local biscuit and sweet factory, and in 2008, through Pascual, Casa Luker acquired the pasta manufacturing facilities of La Suprema. In mid-2011 Casa Luker also acquired the operations which make up the Café Duran Group, including those of Esteban Duran Amat, Torrefactora Coclé and Bianchi Vending Panamá, which make up approximately 75% of the coffee market in Panama. This was the fourth large acquisition by Luker in Panama.

The second dairy player which sold to foreign investors was Grupo Industrias Lácteas, mainly Industrias Lácteas (a leading company with a more than 50-year tradition in the Panamanian dairy and juice-based beverage categories), Conservas Panameñas Selectas, Plásticos Modernos, and Elisía, to The Coca-Cola Company and Coca-Cola Femsa, the largest public bottler of Coca-Cola products in the world in terms of sales volume.

This transaction represents an important step in the growth strategy of Coca-Cola Femsa. It is the first incursion of The Coca-Cola Company into the milk and value-added dairy products category, one of the most dynamic segments in terms of scale and value in the non-alcoholic beverage industry in Latin America. It further reinforces the company's non-carbonated product portfolio in the juice-based beverage segment.

In the pharmaceutical industry, Interbank Group, acting through a subsidiary in Panama acquired Inkafarma, a Peruvian chain of pharmacies, with nearly 400 retail stores in the country and 30% of the market share, through a series of Inkafarma companies located in multiple jurisdictions. In the automotive industry, Chile's Grupo Gildemeister acquired a majority stake in Grupo Los Tres Holding Corporation and its automobile distribution business throughout Central America, through the acquisition of Grupo Los Tres Holding

Corp and its operating and offshore subsidiaries throughout Central America.

In recent years, M&A deals in Panama have had many drivers. Certain deals have been instigated by the need to consolidate in a very competitive environment, others have been undertaken to control costs and exploit synergies or have been fuelled by the global economy and the need to develop new international markets and expand market share. Some of the largest transactions in Central America have included a Panamanian target company, independent of whether it is an operating company or a holding company registered in Panama with operations in the region.

M&A financing in Panama is usually provided by local and international banks, as there are no limitations in Panama on international lending. It can also come from local and international securities issues. It is worth noting, however, that due to the global economic crisis, banks have taken a more cautious approach to lending.

Employment

In a merger scenario, the surviving company assumes the labour relations and liabilities of the absorbed company. Similarly, in stock acquisitions, the target company retains responsibility for labour relations and liabilities.

Asset acquisitions, however, present a special case. If the sale comprises all or almost all of the assets, causing business operations to be transferred, both the buyer of the assets – the new employer – and the seller are, for a one-year period following the acquisition, jointly and severally responsible for all labour liabilities that arise before the acquisition of the assets or business. Furthermore, employees retain all their rights and benefits and no adverse changes can be made to their terms of employment.

In many asset acquisitions, and insofar as may be legally feasible, buyers require sellers to terminate all or certain labour relations as a precondition to closing a deal, in order to rehire some employees on more favourable terms. Labour unions and employees must be notified of the employer substitution even though they cannot prevent it from taking place.

Tax

One of the main components of any sell-side deal structuring is taxation. The structure of an acquisition is usually influenced to a large extent by the need to make the transaction tax effective for the seller, without causing adverse tax consequences to the buyer. As Panama generally follows a territorial system of taxation, only Panama-source income (generally income and capital gains realised in connection with a trade, business or real estate transaction in Panama) is taxable. Thus, mergers or acquisitions of companies organised in Panama that do not carry out any trade or business or own assets within the country are generally not taxable.

Mergers or acquisitions are generally structured as either stock-for-stock transactions, stock-for-

cash transactions, or a combination of both. Acquisitions can also be fashioned as a straight purchase of shares or a purchase of assets.

Stock-for-stock mergers are tax-free transactions, provided that no cash is paid out (except up to 1% of the value of the transaction for adjustments of fractional shares), and certain other accounting parameters are followed. In a stock-for-stock merger, the shareholders of the merged company keep a tax basis on the shares of the surviving company that they receive equal to their average pre-merger tax basis of the surrendered shares. Stock-for-cash mergers, on the other hand, are not tax-free transactions. Gains realised by sellers in these transactions, which are deemed to be gains from Panama-source income, are subject to a 10% capital gains tax. The capital gain is the difference between the selling price allocated to Panamanian sources and the tax basis of the shares owned by the selling shareholder.

Furthermore, the law requires buyers to withhold 5% of the total purchase price allocated to Panamanian sources (as an advance of the capital gains tax) and directly pay this amount to the tax authorities within 10 days of the transfer of the shares. It is important to note that the buyers, as well as the target company whose shares are being acquired, are jointly and severally liable with the buyer for the payment of the 5% advance capital gains withholding. If the 10% capital gains tax on the realised capital gain is less than the 5% advance withholding, sellers can request a tax credit for the difference.

This credit must be used the same fiscal year than the capital gain is realised. Alternatively, sellers can choose to treat the 5% advance capital gains withholding as the final and definitive capital gains tax payable in connection with the sale of the shares. In practice, most sellers pay the 5% purchase price capital gains withholding, as it is difficult to request and use the tax credit on the same year that the transaction took place. Notably, although the capital gains tax only applies to gains from Panamanian sources, to this date no rules regarding purchase price and/or income allocation have been enacted.

Stock purchases are subject to a 10% capital gains tax on Panama source gains in the same manner that stock for cash mergers are taxed, including the 5% advance withholding obligation. The Department of Revenue of the Ministry of Economy and Finance has repeatedly taken the position that capital gains tax applies to the sale of the shares not only of Panamanian corporations, but also of any upstream company, regardless of its jurisdiction of incorporation, as long as this company, directly or through one or more subsidiaries, has Panama-source income.

Asset purchases are generally taxable events in Panama. Gains realised on the sale or disposition of assets located in Panama are generally subject to a 10% capital gains tax. In addition, the transfer of chattel property, such as inventory or equipment, is subject to a value added tax equal to 7%, and the

transfer of real estate is subject to a 2% transfer tax. In addition, buyers of a going business concern must be aware that they will become liable for past taxes of the business, even if they are buying the assets of the business and not the stock of the company.

Frequently, M&A transactions involve either a pre-closing dividend to exclude assets from the transaction or a post-closing dividend to distribute gains to shareholders. In this regard, as a general rule, corporations in Panama are subject to a 10% dividend tax (20% if the shares are issued to bearer), on Panama-source income. Thus, income that is not Panama-source income is generally not subject to dividend tax in Panama. However, due to a recent tax reform, if the company paying the dividend engages in commercial or business activities in Panama that requires the company to obtain a business licence (*aviso de operación*), then in addition to paying the 10% dividend tax on Panama-source income, it is also subject to a 5% dividend tax on non-Panama-source income.

Goodwill is another frequent point of conflict between buyers and sellers. Buyers generally want to be able to claim a tax deduction for the amortisation of any goodwill paid in the acquisition. Amortisation of goodwill is, however, only deductible in Panama if the seller recognises the goodwill as income on its annual tax return.

Companies with both Panama-source income and non-Panama-source income present a unique tax issue. Since Panama taxes only apply to Panama-source income, any gain realised on the sale or disposition of stock or assets of these companies should be allocated between the two kinds of income (Panama and non-Panama-source). In the case of an asset sale, such an allocation is relatively easy to do, since it is based upon the location of the asset. But Panama has yet to adopt rules of income allocation for stock purchases. As such, in cross-border stock purchases or mergers, transactions are often structured so that the sale of Panama-based assets or operations are segregated and sold separately from the operations in other jurisdictions.

Competition law

In Panama, there is no mandatory merger-control approval process; the process is entirely voluntary. That said, with the new antitrust and competition regime established by Law 45 of 2007 (the Competition Law), economic concentrations created by the mergers of conglomerates within the Panamanian market have come under increasing, albeit still limited, scrutiny by regulators.

The Competition Law prohibits economic concentrations whose effects may unreasonably restrict or harm free competition. An economic concentration is defined as the merger, acquisition of control, or any other act pursuant to which corporations, associations, shares,

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trusts, establishments or any other kind of assets are combined, and which occurs between suppliers or potential suppliers, customers or potential customers, and other competing or potentially competing economic agents. The law applies to any acts or practices that may unreasonably restrict or harm free competition, and whose effects take place in Panama, regardless of where those acts have been carried out or perfected.

The Competition Law does not prohibit all economic concentrations but only those whose effects may unreasonably restrict or harm competition. In addition, the Competition Law expressly provides that some business combinations shall not be deemed prohibited economic concentrations: (i) joint ventures formed for a definite period of time to carry out a particular project, which is also contemplated in other jurisdictions; (ii) economic concentrations among competitors that do not have harmful effects on competition and the market; and (iii) economic concentrations involving an economic agent that is insolvent, if certain conditions are met, which is, roughly speaking, equivalent to the so-called failing company exemption prevalent in other jurisdictions.

Moreover, economic concentrations with restrictive effects on competition may obtain clearance from the Competition Authority if the restrictive effects of the concentrations are outweighed by their contribution to obtaining further efficiencies, such as: (i) improvements in the commercialisation and production systems; (ii) fostering technical and economic progress; (iii) improvements in the competitiveness of the industry; and (iv) contributions to consumer interests.

If advance verification for the economic concentration is sought and approved, the economic concentration cannot be subsequently challenged. If no advance verification is sought, and after the consummation of the transaction the Competition Authority considers the economic concentration to unreasonably restrict or harm free competition, within three years following the effective date of the transaction the Competition Authority may file a lawsuit with a specialised superior court seeking that conditions be imposed on the parties to ensure competitiveness in the marketplace, or seeking a partial or complete divestiture of the concentration (or both).

Evolution

As Panama's growing economy continues to attract significant foreign direct investment, multinational corporations seeking to take advantage of the country's unique geographical position, its free market system, and investor-friendly climate, will cause the prevalence of cross-border mergers and acquisitions in Panama to increase.

Undoubtedly, the body of legislation affecting M&A in Panama will continue to evolve as transactions involve more international parties and they become more and more complex.