By Arias Fábrega & Fábrega

Panama

Structuring future flow securitizations in Panama

Securitizations have been used in Panama for close to a decade. The first securitization in recent years was structured by the Panama branch of The Chase Manhattan Bank in 1994. It consisted of mortgage pass-though securities, which were registered with the Panamanian Securities Commission and successfully placed in the local market. Since this transaction, mortgages have been securitized by other financial institutions, using more complex structures. For instance, La Hipotecaria, a mortgage originator, has been very active in structuring collateralized mortgage obligations, some of which have achieved investment grade. Future flow cross-border transactions have also been done by Panamanian originators. The two largest Panamanian banks, Primer Banco del Istmo and Banco General have securitized their Visa and MasterCard receivables repeatedly. Aracruz Trading, a Panamanian subsidiary of Aracruz Celulose, has also done several securitizations of export receivables in recent years. Securitizations gained attention in 1999 when legislation was adopted to reinforce the legal framework in order to facilitate the securitization of future flows. This article briefly discusses some of the most important legal risks to be considered when structuring future flow securitizations of credits for Panamanian originators.

BANKRUPTCY

A major advantage of securitized credit is the possibility of separating the credit risk of the assets from the credit risk of the originator. In well-structured securitizations, investors are isolated from the bankruptcy risk of the originator and from delays in the execution of their credit that may arise from automatic stay provisions of bankruptcy laws. By separating these risks, securitization structures have permitted the creation of instruments whose credit rating is higher than the general credit rating of the originator. To achieve this objective assets are typically sold: (1) to a bankruptcy-remote entity, whether a corporation or a trust; (2) in a true sale transaction that cannot be avoided or consolidated in the event of the originator's bankruptcy.

BANKRUPTCY-REMOTE ISSUER

To avoid the risk that the issuer will itself become bankrupt, limitations are imposed on the ability of the issuer to engage in activities other than the holding of the securitized credits, including, for instance, limitations to borrow money, to incur other obligations, to dispose or encumbrance its assets and to file for bankruptcy. Some of these limitations must be in the Articles of Incorporation of the issuer, while others are imposed as covenants in the securitization documents. Legal issues may arise under the laws of the jurisdiction of incorporation of the issuer as to the legality and enforceability of some of these limitations. When setting up a special purpose vehicle to hold securitized assets, close consideration must be given to selecting a jurisdiction, such as Panama, where such limitations can lawfully be introduced into the corporate structure of the company.

TRUE SALE

To protect against the risk that the issuer and its assets will be affected by the origina-

About the author

RICARDO M ARANGO

Partner of Arias, Fábrega & Fábrega since 1995. Areas of Practice: capital markets, mergers and acquisitions, and banking. Admitted: 1983, Republic of Panama; 1986, New York. Education: University of Panama Law School (Bachelor of Laws, 1983); Harvard Law School (Master of Laws, 1984); Yale Law School (Master of Laws, 1985). With White and Case, New York, from 1985 – 1987. Boards: Secretary, Banco Latinoamericano de Exportaciones, S.A. (banking); Director, Corporación La Prensa, S.A. (newspaper); Director, The Panama Stock Exchange (stock exchange). From 1997 to 1999 headed the Presidential Commission that drafted Panama's 1999 Securities Act. Member: Association of the Bar of the City of New York (Secretary, Committee on Inter-American Affairs, 1986 – 1987); American Society of Corporate Secretaries; Panama and American Bar Associations.

tor's bankruptcy, the transfer of the assets from the originator to the issuer must be a true sale. If the transfer is a true sale, the securitized assets will not be deemed to be part of the originator's bankruptcy estate and will not be subject to claims from the originator's creditors. However, if the transfer is not a true sale and it is characterized as a loan, a court may deem the assets to be owned by the originator, leaving the issuer, at best, with a security interest in the assets. Although, as a secured creditor, the issuer will have a first priority lien on the securitized assets (assuming that proper actions were taken to perfect the security interest), it will be subject to bankruptcy laws and may not escape delays in the execution of its credit. To achieve a true sale in a future flow transaction, the following conditions must be met:

- the parties must have the intent to sell the credits;
- the credits must be itemized or ascertainable;
- the purchase price must be fixed or ascertainable and consist of money;
- there must be a delivery of the credits;
- notice of sale must be given to the debtor; and
- the assignment must be in writing and have a date certain.

Intent. The documentation must clearly reflect that the originator intends to sell the credits to the issuer, and the issuer intends to purchase the credits from the originator. Careful consideration must always be given to provisions in the documentation that create recourse against the originator, obligations on the part of the originator to repurchase any assets and rights of the originator to any surplus collections on the assets. These provisions need to be drafted in ways that do not place into question the intent of the parties or the character of the transaction.

Identification of credits. There is no absolute requirement in Panama that the credits be itemized in the sales agreement, as long as they are ascertainable from the documentation without need for any further agreement between the originator and the issuer. Future flow securitizations are valid in Panama, as there is no requirement that the credits or receivables be in existence on the date of the sale. Future credits can be sold in Panama, subject to the condition that the credits come into existence. Any doubts as to the legality of future flow transactions were put to rest in 1999 when legislation expressly recognized the validity of such sales in the context of securitizations. Such sales are lawful even if the agreements pursuant to which the credits will be generated have not been executed at the time the future credits are sold.

Purchase price. The purchase price must be stipulated in the sales agreement or at least be ascertainable from the documentation without need for any further agreement between the originator and the issuer. The purchase price must be, in whole or in part, paid in money. Since the US dollar is legal tender in Panama, the purchase price may be expressed in US dollars and investors need not be concerned with currency exchange risks.

Delivery of credits. Delivery of the purchased assets is essential to transfer title. Panamanian law is flexible on this point and allows fictitious or constructive delivery of intangible assets. Under the traditional rules of contracts, delivery of intangible assets is deemed to have occurred if the sales agreement is prepared in the form of a public deed (escritura publica) before a Notary Public in Panama. To facilitate compliance with this requirement, in 1999 legislation was adopted allowing delivery of intangible assets by the simple acknowledgment of the signatures of the seller and buyer in the sales agreement before any Notary Public.

Notice to debtor. Notice of sale must also be given to the debtor of the receivables. Although previous legislation required that debtors acknowledged receipt of this notice before a Notary Public in the presence of two witnesses, under the legislative changes introduced in 1999 this notice can now be given to debtors in any written form, without the requirements of notarization or witnesses.

Enforceability. The sales agreement must be in writing and the signatures of the seller and buyer must be acknowledged before a Notary Public for the assignment to be effective against third parties, including other creditors of the originator.

If the above requirements are met, there is a true sale of credits under Panama law, which is isolated from the bankruptcy risk of the seller, even if the transaction is recharacterized as a secured loan for tax purposes.

In some transactions, a backup pledge has been included in the documentation as a precautionary measure in the event that the transfer is not recognized as a true sale by a court. Although a backup pledge gives the issuer clear prior rights to the assets over any other creditor of the originator, the issuer may not escape delays in the exercise of its rights over the assets in the event of bankruptcy of the originator. Some have also argued that the mere existence of a backup pledge may place into question the actual intent of the originator to sell the assets to the issuer.

AVOIDANCE AND CONSOLIDATION

If the transfer of the credits from the originator to the issuer is a true sale, it can only be avoided by a bankruptcy court:

A)If the transfer was made within 30 days prior to the date of the declaration of bankruptcy of the originator and:

i) it lacked adequate consideration;

ii) it was done to create a pledge, mortgage or any other preference to secure an antecedent debt; or

iii) it was done to pay debts not yet due; or

B)If the transfer was made with the intent to defraud creditors, or to hide assets from creditors' reach.

When structuring future flow securitizations, investors need to confirm that none of these circumstances is present at the time of the transfer of the receivables from the originator to the issuer.

In Panama, executory contracts (ie, contracts that have not been performed by either one of the parties) are generally terminated by operation of law upon the declaration of bankruptcy of one of the parties. Sales agreements between an originator and the issuer for the transfer of receivables, however, even if executory, can either continue in existence or be terminated upon the declaration of bankruptcy of the originator, at the issuer's option.

Finally, a word of advice. When the originator is a bank, the risk of interference by the Superintendent of Banks during the period of intervention in the event of its insolvency must also be duly considered and dealt with in the structure.

TAXATION

Securitizations must be structured to be tax-efficient, thereby avoiding double taxation of the issuer and the investor. There are no specific provisions dealing with the taxation of securitizations in Panama. Therefore tax consequences of securitizations must be established by applying general rules of taxation. Although the tax authorities in Panama have not issued regulations or opinions on the tax implications of securitizations, it is likely that most future flow securitizations will be deemed to be secured loans.

If the transaction is characterized for tax purposes as a loan, no taxable interest would be implied on the loan if the proceeds of the loan are not used by the originator in Panama, as such interest would not be deemed Panama source income. On the other hand, if the proceeds of the transaction are used by the originator within Panama, there is a risk that the tax authorities may tax the transaction as a loan. If the transaction is taxable, a 6% withholding tax on interest payments would be applicable if the securities are held by foreign investors. Local investors would have to recognize interests received as income in their tax returns and pay income tax on such income at their applicable rates.

In securitizations where the originator is a bank licensed to operate in Panama, taxation has been avoided, even when the proceeds of the transaction are used by the originating bank in Panama, by selling the receivables first to an affiliated offshore bank and then having the offshore bank sell the receivables to the issuer. This tax-free structure can be achieved because it takes advantage of a provision in the tax laws which exempts from income tax interest payments made on a loan by a bank in Panama to a bank outside of Panama.

In domestic securitizations of residential mortgages, adverse tax effects have been avoided by matching and offsetting the interest income received by the special purpose vehicle with interest payments made by the vehicle to investors.

ACCOUNTING

The accounting treatment of securitizations is centered on two key issues: first, whether the securitized assets should remain as part of the balance sheet of the originator; and second, whether the originator should consolidate the special purpose vehicle in its financial statements. Generally speaking, companies in Panama apply either International Accounting Standards or US Gaap in the preparation of their financial statements. Thus, the accounting issues and uncertainties facing Panamanian originators in future flow securitizations are not any different from those faced by originators in other major markets. What one must have present in local securitizations is that the tax treatment of a securitization will be significantly influenced by the accounting treatment of the structure. In the securitization of credit card receivables of Primer Banco del Istmo and Banco General, for instance, both institutions treated the transaction as an on-balance-sheet transaction.

REGISTRATION OF SECURITIES

Securities issued by special purpose vehicles for the securitization of credit are generally considered securities within the meaning of Panama's securities law. If the securities are not offered in Panama, or are offered pursuant to an exemption from registration, they need not be registered with the National Securities Commission. However, if they are publicly offered in Panama, they must be registered.

Also, when structuring a securitization, consideration must be given to avoid the special purpose vehicle been characterized as an investment company.

Although securitizations tend to be complex and costly structures, companies and investors in Panama are becoming more familiar and comfortable with these structures and instruments, and it is expected that the number of both local and cross-border transactions will continue to grow.