



M&A ACTIVITY IN PANAMA – KEY LEGAL ISSUES TO CONSIDER

Ricardo Arango and Julianne Canavaggio
Arias, Fábrega & Fábrega

OVERVIEW OF RECENT M&A ACTIVITY

Panama's economy is experiencing a period of unprecedented growth, fuelled largely by a spike in foreign direct investment (FDI) entering the country. Investors and foreign businesses have continued to seek out Panama as an FDI destination, driving the investment rate to around 30 per cent, significantly higher than the region's 22.7 per cent average. This influx of foreign capital has fed into the economy, generating a growth rate of approximately 7.5 per cent for 2010, and a 9.5 per cent approximate growth for 2011, which would make it the fastest growing economy in the region. One of the major factors allowing Panama to maintain its growth levels is the prevalence of M&A activity. Many major multinational corporations have established regional offices or headquarters in Panama, taking advantage of the tax, immigration and employment incentives granted to potential investors. The insurance, industrial services, telecoms and media and dairy sectors were also major FDI destinations.

GENERAL INTRODUCTION TO THE LEGAL FRAMEWORK FOR M&A

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.

DEVELOPMENTS IN CORPORATE AND TAKEOVER LAW AND THEIR IMPACT

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 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 TRANSACTIONS

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.

FINANCING OF M&A: MAIN SOURCES AND DEVELOPMENTS

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. However, it is worth noting that due to the global economic crisis, banks have taken a more cautious approach to lending.

EMPLOYMENT LAW

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 prior to 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. Thus, 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 LAW

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. A brief description of the tax treatment of each follows.

Stock-for-stock mergers are tax-free transactions, provided that (i) no cash is paid out (except up to 1 per cent of the value of the transaction for adjustments of fractional shares) and (ii) 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 per cent 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 per cent 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 per cent advance capital gains withholding. If the 10 per cent capital gains tax on the realised capital gain is less than the 5 per cent 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 per cent 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 per cent 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 date no rules regarding purchase price and/or income

allocation have been enacted.

Stock purchases are subject to a 10 per cent capital gains tax on Panama source gains in the same manner that stock for cash mergers are taxed, including the 5 per cent 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 per cent 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 per cent, and the transfer of real estate is subject to a 2 per cent transfer tax. In addition, buyers of an ongoing 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 per cent dividend tax (20 per cent 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, then in addition to paying the 10 per cent dividend tax on Panama-source income, it is also subject to a 5 per cent 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. However, amortisation of goodwill is 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. However, 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, 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 the following 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).

OUTLOOK

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.