Going with the flow

Ricardo M Arango of Arias Fábrega & Fábrega outlines potential legal risks when structuring future flow securitisations of credits in Panama

Securitisations have been used in Panama for close to a decade. The first securitisation in recent years was structured by the Panama branch of The Chase Manhattan Bank in 1994. It consisted of mortgage pass-through securities, which were registered with the Panamanian Securities Commission and successfully placed in the local market. Since this transaction, mortgages have been securitised by other financial institutions, using more complex structures. La Hipotecaria, a mortgage originator, for instance, has been very active in structuring collateralised 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 securitised their Visa and MasterCard receivables, repeatedly. Aracruz Trading, a Panamanian subsidiary of Aracruz Celulose, has also done several securitisations of export receivables in recent years. Securitisations gained attention in 1999 when legislation was adopted to reinforce the legal framework in order to facilitate the securitisation of future flows. There are some important legal risks to be considered when structuring future flow securitisations of credits for Panamanian originators.

A big advantage of securitised credit is the possibility of separating the credit risk of the assets from the credit risk of the originator. In well structured securitisations, investors are isolated from the bankruptcy risk of the originator and from delays in the execution of their credit, which may arise from automatic stay provisions of bankruptcy laws. By separating these risks, securitisation 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 to a bankruptcy-remote entity, whether a corporation or a trust, or in a true sale transaction. Assets that cannot be avoided or consolidated in the event of the originator's bankruptcy are also sold.

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 securitised 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 securitisation 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 securitised assets, consideration must be given to select a jurisdiction, such as Panama, where such limitations can lawfully be structured into the corporate structure of the company.

> "Limitations are imposed on the ability of the issuer to engage in activities other than the holding of the securitised credits"

True sale transactions

To protect against the risk that the issuer and its assets will be affected by the originator's bankruptcy, the transfer of the assets from the originator to the issuer must be a so-called true sale. If the transfer is a true sale, the securitised 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 characterised as a loan, a court may deem the assets to be owned by the originator, leaving the issuer, at best, with a security interest on the assets. Although as a secured creditor the issuer will have a first priority lien on the securitised 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, several conditions must be met.

First, the documentation must clearly reflect that the originator intents to sell the credits to the issuer, and the issuer intents to purchase the credits from the originator. Careful consideration must always be given to provisions in the documentation which 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.

Secondly, the credits must be identifiable: there is no absolute requirement in Panama that the credits be itemised 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 securitisations 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 recognised the validity of such sales in the context of securitisations. 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.

Thirdly, 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.

Fourthly, delivery of the purchased assets is essential to transfer title. Panamanian law is flexible on this point and allows fictitious 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.

A fifth requirement is that 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 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 notarisation or witnesses.

Finally, 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 re-characterised as a secured loan for tax purposes.

“The mere existence of a backup pledge may call into question the intent of the originator to sell the assets”

In some transactions, a backup pledge has been included in the documentation, as a precautionary measure in the event that the transfer is not recognised 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 people have also argued that the mere existence of a backup pledge may call into question the actual intent of the originator to sell the assets to the issuer.

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 in two cases.

The first is if the transfer was made within 30 days before the date of the declaration of bankruptcy of the originator and it lacked adequate consideration, it was done to create a pledge, mortgage or any other preference to secure an antecedent debt, or it was done to pay debts not yet due. The second is if the transfer was made with the intent to defraud creditors, or to hide assets from creditors' reach.

When structuring future flow securitisations, 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 (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, when the originator is a bank, the risk of interference by the Superintendent of Banks during the period of intervention must also be duly considered and dealt with in the structure.

Taxation and accounting

Securitisations 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 securitisations in Panama. Therefore tax consequences of securitisations 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 securitisations, it is likely that most future flow securitisations will be deemed to be secured loans.

If the transaction is characterised 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 12.5% withholding tax on interest payments would be applicable if the securities are held by foreign investors. Local investors would have to recognise interests received as income in their tax returns and pay income tax on such income at their applicable rates.

In securitisations 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

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Ricardo M. Arango joined Arias, Fábrega & Fábrega in 1987 and became a partner in 1995. He is a member of the firm's Executive Committee and Operations Committee. He is also head of the firm's capital markets and banking practice group and the M&A and corporations practice group. Mr. Arango's practice focuses on securities regulations; banking and finance; mergers, acquisitions and joint ventures; corporations; and taxation. In the area of capital markets and banking, Mr. Arango regularly advises clients in connection with medium term note programs, commercial paper programs, syndicated term and revolving loan agreements, 144-A Reg-S notes, securitizations and initial public offerings. He has been instrumental in the creation of many financial structures that are common place in Panama today and has acted as lead counsel in connection with the largest M&A transactions in the country. Mr. Arango has a Master of Laws from Yale Law School, a Master of Laws from Harvard Law School and a Bachelor of Laws from the University of Panama.

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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 securitisations of residential mortgages, adverse tax effects have been avoided by matching and off-setting the interest income received by the special purpose vehicle with interest payments made by the vehicle to investors.

The accounting treatment of securitisations is centred on two key issues: first, should the securitised assets remain as part of the balance sheet of the originator; and second, should the originator consolidate the special purpose vehicle in its financial statements. Generally speaking, companies in Panama apply either International Accounting Standards or USGAAP in the preparation of their financial statements. Thus, the accounting issues and uncertainties facing Panamanian originators in future flow securitisations are not any different that those being faced by originators in other large markets. What one must bear in mind in local securitisations is that the tax treatment of a securitisation will be significantly influenced by the accounting treatment of the structure. In the securitisation 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.

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Registration of securities

Securities issued by special purpose vehicles for the securitisation 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. If they are publicly offered in Panama, however, they must be registered.

Also, when structuring a securitisation, consideration must be given to avoid the special purpose vehicle being characterised as an investment company.

Although securitisations 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.