

SECURITIZATION: PANAMA SUBSTANTIVE AND FORMAL REQUIREMENTS

The repackaging of future accounts receivable as securities has been used by Panamanian banks to fund their local operations by taping into non-Panamanian capital markets. In 1996 Banco Del Istmo S.A. used future Visa and Mastercard receivables to back a US\$55 million bond issue made by a New York trust and placed in the offshore capital markets by BT Securities Corporation, a subsidiary of Bankers Trust Company.

In 1997 an important infrastructure project in Panama was financed by the issue of US\$131 million bonds by PYCSA Panamá S.A., a single purpose company incorporated in Panama holding a 30 year government concession to build and operate a toll highway. These bonds were backed by future receivables from the exploitation of the toll road, a chattel mortgage on the originator's movable equipment, a pledge of the said company's stock, and an assignment of all contracts relating to the construction and operation of the toll road.

In addition to touching upon some of the substantive issues that were dealt with in structuring these transactions, this paper focuses on a number of formal requirements that must be met to perfect and ultimately enforce the security interests, which are critical under Panama law and are often overlooked in the early stages of negotiating a term sheet. Anticipating these formal requirements can often save time when pressed to go to market with a bond issue that relies on the quality of the Panamanian security package.

1. True Sale of Future Receivables.

Articles 1122 and 1284 of the Civil Code provide that the sale of future property, including incorporeal rights, is valid under Panama law. If the object is sufficiently determined or, at least, determinable, and the possibility of it coming into existence is real and not merely a "wish" or "desire", the contract will generally be considered a perfected sale, subject to the condition precedent that the object actually come into existence.

While Panama law has not adopted precise rules as to when an object will be considered "determined" or "determinable", it is generally recognized that if the contract contains elements that would allow a reasonable man to identify the object sold, without having to

subsequently enter into a new contract, the object is “determinable”. In the case of future credit card receivables it is adequate that reference be made “to all or a percentage of the credits arising against VISA or MASTERCARD as a result of cash advances or other payments made by the originator in Panama to or on behalf of VISA or MASTERCARD cardholders during a determinable period of time”.

In addition to meeting a test of “determinability” in respect of the object sold, it is essential that the price be fixed in the contract or also be “determinable” and that it consist of money or a monetary equivalent. Generally this does not present a problem and since the U.S.A. Dollar is legal tender for all debts in this country, the uncertainty of exchange rates will not have an impact.

The goal in the securitization of these future receivables is to create cash inflows that are more than adequate to service the repayment obligations before an intervening event, such as the bankruptcy of the originator or simply a slowdown in credit card financing, affects the generation of such receivables. Accordingly, not only is it important that title pass effectively and automatically to the buyer as soon as the receivables are generated, without any subsequent act being required on the part of the seller or buyer to perfect the sale, the amount of receivables sold must be adequate to create sufficient reserves to cover such interruptions. To the extent this is accomplished we have a true sale as opposed to a “promise to sell”, which generally requires another act or contract to transfer title and effectively bind buyer and seller.

A perfected sale under Panama law creates an obligation on the part of the buyer to pay the price and an obligation on the part of the seller to deliver the object sold. Since the originator in the Banco Del Istmo transaction actually sells beforehand the receivables and receives a discounted value upon drawdown of the facility, there is no question the originator has received the purchase price.

Seller’s obligation to deliver may be met by applying the rules contained in Articles 1232 and 1234 of the Civil Code, which provide that delivery of chattels and particularly incorporeal rights (such as credits), shall be deemed to have taken place solely by reason of the execution of the sale contract in the form of an escritura pública, which is a document prepared by and executed in the presence of a Panamanian notary public. Practitioners should therefore be aware that the sale contract will have to be executed in Spanish and preferably in Panama.

Therefore, by execution of an *escritura pública* and prepayment of the purchase price as the receivables are generated title to the credit should be held to automatically and effectively transfer from the originator to the trustee for the benefit of the bondholders, retroactively as of the date of the *escritura pública*. In addition the use of the *escritura pública* also has the advantage that the certainty of the date is fixed and cannot be challenged in case of a subsequent bankruptcy of originator. This is important since the law of sales provides that the assignment of rights and credits must have a date certain in order to affect the rights of third parties, such as the creditors of the assignor.

In the Banco Del Istmo case the receivables are sold as they are generated by the Bank that continues to operate a credit card business. In the Pycsa case the right to generate and collect the receivables was assigned to a trustee under a Civil Law fideicomiso, which is similar to a Common Law trust. In the latter case the trustee or fiduciario receives the proceeds of the trust in its own name and is bound by the terms of the fideicomiso to apply the proceeds in a pre-determined manner.

2. Real Security Interests.

Panama law contemplates the creation of contractual liens on or in respect of specifically identified property that may be enforced by sale and the proceeds thereof applied to satisfy a secured debt with preference to the satisfaction of other obligations. A bond issue may be secured under Panama law by creating a preferred lien in the form of a real property mortgage or a pledge. Both security interests are firmly rooted in the Civil Law. In addition Panama law permits the creation of a chattel mortgage, but as we shall see below, this security interests is not as effective as the real property mortgage and pledge.

As a general rule, the real property mortgage creates a security interest on or in respect of “immovable property”, which principally refers to land, improvements and anything permanently attached to land. Over the years the definition of an “immovable” has been stretched by statute to cover a number of items that are not immovable by nature, such as machinery and equipment, administrative concessions for the construction and exploitation of public works, railroads, port facilities, etc.

Any property susceptible of being appropriated (possessed) and which does not qualify as an “immovable” and in general any property that may be taken from one point to another without damaging an immovable to which it is attached, will be deemed to be a “movable” and may be pledged as security for an obligation. By statutory fiction the definition of a movable has been extended to include rights and obligations, causes of action, and shares or quotas issued by companies.

(a). The Real Property Mortgage.

The principal difference between the real property mortgage and the pledge is that a pledge under Panama law requires actual delivery of the pledged property to the debtor or to a third person appointed depositary of the property. A mortgage, on the other hand, is a non-possessory lien, which means that the owner does not have to deliver or give up the use of the property to the debtor or to a third party acting as a depositary.

Property that qualifies as an “immovable” and is located in Panama may only be encumbered by a mortgage created in strict accordance with Panama law. In order to create this security interest the record owner of the land must enter into a bilateral mortgage contract with a lender, by means of an *escritura pública* executed in Spanish before a notary public in Panama, which must be filed and recorded at the Public Registry Office. Recordal of the mortgage contract is an essential requirement for the perfection of the lien and serves to give notice that the lender has a preferred security interest outranking subsequently filed mortgages and affecting purchasers that subsequently take title to the encumbered property.

One of the principal advantages of a real property mortgage is that enforcement is by way of an abbreviated or summary proceeding known as a *juicio ejecutivo hipotecario*.¹ However, in order to be able to enforce the lien the obligation secured must (at the time of enforcement) qualify as a *título ejecutivo*, which means that it must express on its face a clear and past due obligation to pay a liquidated (determined or determinable)² amount of money. If the mortgage contract fails to meet this test, enforcement would have to be pursued in a lengthy civil action known as a *juicio ordinario*.

Establishing a “clear” obligation may not be an easy task since modern financing tools are not always simple straight forward contracts that can easily be translated into Spanish and

converted into an *escritura pública*. Not only does translation in itself create a risk, there is also the real risk that a court may actually not be able to understand the terms and conditions of the secured obligation without taking into account other related contracts that are often not recorded with the mortgage. Since it is debatable whether a court can take into account such documents, when drafting financing documents one must keep in mind that it may ultimately be necessary to reflect the terms and conditions of the secured obligations in the mortgage itself, either by including a short summary or by incorporating them in a promissory note that in turn would be filed as an exhibit to the mortgage.

When a mortgage is contracted as security for subsequent disbursements or future obligations, it is possible to execute and record the mortgage at the time of closing notwithstanding the fact that the mortgage contract will not satisfy the requirements of a *título ejecutivo* because, among other things, the amount of indebtedness, the applicable interest rates and the repayment schedule have not been fixed. Since recorded mortgages are satisfied in the order of filing at the Public Registry Office, this type of mortgage (known as an *hipoteca de máximo*) can be used to address the uncertainties referred to before, given that the Civil Code permits a creditor to subsequently file at the Registry notices of disbursement (known as marginal annotations) of the future obligations without losing the preference afforded by the early filing date.

Another drafting concern relates to the requirement that the underlying obligation be past due in order to enforce the lien by way of a *juicio ejecutivo*. Therefore it is necessary that the events of default listed in the mortgage contract be readily determinable by the courts without having to engage in complicated fact finding procedures that are really not appropriate for such summary proceedings.³

b). The Pledge.

Movables that are situate in the Republic of Panama and that are susceptible of being possessed and delivered may be pledged under Panama law by the owner as security for a principal obligation.

A pledge must be created in writing either by executing a notarial instrument or *escritura pública* or by executing a private document. However, a pledge will not affect third persons

unless the certainty of the date results from the date of the *escritura pública* or unless the private document is deemed to have a “date certain” in accordance with the requirements of the Code of Civil Procedure. There are a number of ways to provide such certainty, but the easiest is to have the signatures of the parties to the pledge acknowledged by a Panamanian notary and two witnesses.

Article 814 of the Code of Commerce provides that pledges securing bank loans are deemed to be valid and to affect third persons as of the date of the private document that creates the security interest without having to authenticate the signatures of the parties. However, Article 527 of the Code of Civil Procedure provides that if a third person applies to a court to have pledged assets attached the court must immediately deny the request upon presentation by the secured creditor of a deed of pledge having a “date certain”. Therefore, even though a pledge securing a bank loan will be deemed to be valid without authentication and will ultimately outrank other unsecured creditors in the event of liquidation, in order to immediately exclude such creditors by application of Article 527 banking creditors will more than likely require authentication of the signatures of all parties before a Panamanian notary.

Delivery of the pledge to the creditor or to a third person chosen by the parties to act as depositor is an essential condition. Delivery may be real (actual physical dispossession) or symbolical. If the pledge consists of bills of exchange or negotiable instruments (*títulos a la orden*), the pledge may be created by endorsement of the corresponding language creating the security interest on the document. If the pledge consists of shares, obligations or other nominative instruments (*títulos nominativos*) delivery may be accomplished by simply delivering the instruments to the pledgee or to a third person acting as a depositary.

Meeting the delivery requirement may be particularly difficult when the property is fungible or needed on a day to day basis in debtor’s business. For instance, actual delivery of inventory, such as spare parts or fuel, to a third person acting as depositary, with authority to hold and release as necessary, may create practical custodial problems and may require the depositary to actually take possession of a warehouse or fuel deposit to be able to discharge his duty as such. While theoretically possible, such options are often too expensive and impractical.

Enforcement of the security interest created by way of a pledge is predicated on the principal that the pledge grants the creditor the right to be paid with the value of the

pledged assets and with preference to other creditors. Accordingly, in order to realize value it is essential that upon default the pledged assets be sold to pay the pledgee. Underlying this principle is the notion that by way of an arms' length sale the value of the pledged assets will be realized, not only for the benefit of the pledgee but also to protect the pledgor. Appropriation of the pledged assets by the creditor is against public policy. Accordingly, the standard remedy provided in the Code of Civil Procedure to enforce a pledge is by way of a judicial auction (*juicio ejecutivo prendario*), where presumably market value will be realized.

The extent to which the parties may contractually provide for a private sale remedy has often been the subject of much debate. The Code of Commerce, which by definition applies in cases where more speedy remedies are required, originally recognized that the parties had some leeway to contractually fix a special method to realize the value of the pledged assets. In 1997 Article 820 of the Code of Commerce was revised to provide that: "In the event of default and if a special sales mechanism had not been contractually provided, mortgagee or the depositor of the pledge are entitled to sell the pledged movables subject to giving of 30 days notice to the owner and effecting the prior appraisal required by Article 821 of the said Code." Careful drafting of the private sale provisions of a pledge agreement will be necessary to avoid violation of the rules against appropriation and to ensure realization of fair market values.

c). The Chattel Mortgage.

Only movables susceptible of being specifically determined or individualized and of being described with sufficiency may be mortgaged under Decree Law 2 of 1955 (the "Chattel Mortgage Statute). The Chattel Mortgage Statute is an attempt to create a non-possessory lien on movable property. Since the statute was created principally for consumer lending it has a number of limitations that a practitioner should be aware of when evaluating the effectiveness of this security interest.

Since the purpose of this statute is to permit encumbered movables to remain in possession of their owner, the property must be capable of being "specifically identified and described" in the chattel mortgage contract and must be recorded at the Public Registry Office. Recordation, in theory, serves to give notice to the public that a particular chattel is encumbered and may not be sold or encumbered a second time. In practice, however, the indexing system at the Public Registry Office is inadequate when it comes time to

determine if a particular asset is encumbered or free of liens. This is not the case in the real property mortgage since the recordation of land is by predetermined plots that are easily identifiable in a search.

The fact that the chattel mortgage must include a description of the encumbered movables raises a number of practical considerations as well. To begin with, it is not possible to create the security interest until the movable property is actually manufactured, assigned identification numbers and delivered into the possession of the owner. As a result, such mortgages are often subject to numerous amendments for the purposes of adding new inventory and releasing obsolete property. Furthermore, small inventory items, particularly spare parts, often do not have adequate descriptive elements and must be identified in generic terms, the effectiveness of which is subject to doubt. At the end of the day, the costs and impracticalities of having to do this over a period of time makes this a relatively unattractive security interest, particularly as lenders move on to other projects and tend not to update the information of record.

Finally, but certainly not the least of concerns, is the fact that the Chattel Mortgage Statute provides that the mortgage may not exceed a four year term unless the lender is a banking entity and the loan is earmarked for industrial development or agricultural or agro-industrial projects. This limitation has given way to the practice of filing extensions every four years, which would require that the parties execute and file an amendment with the Public Registry Office, something which the debtor should undertake to do as a condition in the loan agreement. To what extent renewal notices are legal is a question that has not been resolved by our courts.

3. Bankruptcy considerations.

The bankruptcy rules of the Code of Commerce establish an orderly court supervised liquidation procedure that has as an objective the apportionment of assets amongst creditors in accordance with certain legally established priorities. A court ordered or supervised reorganization is not an option under present law except if the bankrupt debtor is a licensed bank, a finance company or insurance/reinsurance company, the liquidation of which is subject to special statutes.

A company will be deemed “insolvent” under the bankruptcy provisions of the Code of Commerce if it has suspended one or more debt payments. The Civil Code, on the other hand, requires not only the suspension of payments but also a negative balance sheet. The Code of Commerce is the statute that more than likely will be applied by our courts in the event a Panamanian organized project owner or originator of receivables becomes insolvent. Therefore we will limit our comments to the regime created by this statute.

The declaration of bankruptcy has, among other things, the effect of rescinding all executory bilateral contracts, that is contracts in which the parties owe each other reciprocal obligations. This rescission operates as a matter of law, with the result that the contracting party that has performed its part of the contract will be left with a right of action to recover damages against the non-performing party as a creditor of the debtor’s bankruptcy estate, subject however to the benefits of any pledge or mortgage that was granted as security for performance of the rescinded obligations.

A true sale of future receivables should not be affected by the automatic rescission provision mentioned above, at least in respect of receivables that have been generated prior to the date of the declaration of bankruptcy. All such receivables would automatically belong to the trust for the benefit of the bondholders as soon as generated and any excess amounts that were received prior to bankruptcy and kept by trustee as a reserve would belong to the trust to the exclusion of the other creditors. Of course, after declaration of bankruptcy the originator’s business will cease to generate receivables so that it is imperative that the ratio of receivables purchased to debt outstanding be maintained rather high.

The declaration of bankruptcy also has the effect of permitting the bankruptcy court to review acts or contracts that may have been executed by the debtor after a state of insolvency came about, presumably in an attempt to defraud creditors. The fixing of a date of insolvency is also important for the purpose of establishing a period of time (the “suspicious period”) during which certain acts of the bankrupt debtor may be reviewed and set aside by the court for the benefit of the bankruptcy estate. These “suspicious acts” include: (i). contracts that are gratuitous and those which may be deemed to be without consideration if one takes into account the excess value given by the bankrupt for the corresponding value received; (ii). the granting of a pledge or mortgage or other security interest with a view to creating a lien or preference in respect of previously contracted obligations; (iii) the pre-payment of debts not yet due, or the payment in kind of debts that are past due. A finding that debtor performed or executed these acts with an “intent to

defraud a creditor” is not necessary and accordingly all of the aforementioned contracts will be voided for the benefit of the bankruptcy estate solely on a finding that they were performed or executed during the “suspicious period”. It is therefore important that the security instruments strictly comply with the formal requirements mentioned above if for no other reason than to unequivocally fix the date of execution.

The liquidation procedure and the priorities amongst creditors are determined in accordance with Articles 1660 – 1663 of the Civil Code. The general rule is that all liens created or recognized in respect of a particular property may be satisfied out of the proceeds of the judicial sale of the affected property pursuant to an enforcement action (juicio ejecutivo) or by way of liquidation in a bankruptcy proceeding. Creditors having as a security interest a mortgage or pledge are entitled to have their credits liquidated separately from the general liquidation of the bankruptcy estate and with priority out of the proceeds of the property that has been pledged or mortgaged. Any value remaining after the enforcement sale will be distributed a pro rata amongst unsecured creditors after satisfying liens for property taxes, past due insurance premiums, labor claims, Social Security quotas and amounts due to the Panamanian Government.

(Footnotes)

1 This is a summary proceeding whereby the court determines on the face of the instrument that there is in fact a debt that is past due and payable and in the absence of proof that the debt has been paid will order the judicial sale of the encumbered property.

2 The amount of past due interest will be deemed to be determinable even if the total amount is not included in the document. In addition, amounts that may be determined by applying an arithmetic formula supplied in the contract will also be deemed to be determinable (Art. 1640, Code of Civil Procedure).

3 Even though a basis exists in recently enacted rules of procedure to determine certain additional facts to support a finding that an event of default has occurred, because of lack of procedural safeguards it is unlikely that a court would allow the use of this procedure to determine other than the most non-controversial facts.