PANAMA

Mergers and acquisitions in Panama: an overview

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Companies have been bought and sold at all times. However, in recent years, the mergers and acquisitions fever that hit US markets in the late 1980s and 1990s struck home.

Many recent acquisitions in Panama resulted from the government's privatisation programme, such as the acquisition of electric generation companies by affiliates of Enron Corporation, the Coastal Corporation/Hydro-Quebec and AES Corporation, the acquisition of electric distribution companies by affiliates of Union Fenosa and Baltimore Gas & Electric, the acquisition of the government's telecom company by an affiliate of Cable & Wireless in 1997 for over US$600 million, and the acquisition of the government's cement company by an affiliate of Cemex. Other deals have been driven by fierce competition and pressure to control costs, particularly in the banking and telecoms industries, such as Banco del Istmo SA's acquisition of Primer Banco de Ahorros SA in 2000, Banco General SA's acquisition of Banco Comercial de Panamá SA in 1999, the reorganisation of the two largest broadcast television and radio companies in 1996 to form Medcom Holdings Inc, and Corporación Medcom SA's purchase of Cable Onda 90 SA, the largest pay TV operator in Panama. Yet other transactions have been fuelled by the global economy and the need to develop new international markets and expand market share, such as the acquisition of Corporación Incem SA, one of the largest cement plants in Panama by Holderbank in 2000, the acquisition of the Chase Manhattan Bank's branches by HSBC Bank USA Inc, and the expansion of Panamerican Beverages Inc, a Panamanian holding company and the largest Latin American independent Coca Cola bottler, by acquisitions in Venezuela, Costa Rica, Guatemala and Nicaragua. Finally, other transactions have just been the local byproduct of global transactions, such as the merger of BankBoston NA and Fleet National Bank and the merger of Banco Bilbao Vizcaya and Argentaria.

Some of the above transactions were structured as mergers while others as stock or asset purchases, the form of payment being either cash or securities or a combination of both. Cash stock purchases have frequently been carried out as public tender offers, primarily for tax reasons. In this brief article, we will present an overview of legal issues and topics which frequently surface in connection with mergers and acquisitions in Panama.

Taxation

One of the main concerns of any seller is taxes. The structure of an acquisition is usually influenced to a large extent by a need to make it tax-free for the seller and without adverse tax consequences for the buyer. As Panama follows a territorial system of taxation, only Panama-source income (ie generally income and capital gains realised in connection with a trade, business or real estate transaction in Panama) is taxable in Panama (see note 1). Thus, mergers or acquisitions of companies organised in Panama that do not carry any trade or business or own assets within Panama are not taxable in Panama. For this article, we shall focus only on those companies which conduct business in Panama and are thus subject to Panamanian taxation.

Mergers

The tax treatment of a merger depends on whether the merger is a stock-for-cash or a stock-for-stock merger. Stock-for-cash mergers are taxable transactions in Panama. Any income realised by the seller is taxable at ordinary income tax rates, which are 30 per cent for corporations and other legal entities (see note 2). In addition, stock-for-cash mergers may trigger a 5 per cent tax on the transfer of tangible assets (see note 3), such as inventory and equipment, and a 2 per cent tax on the transfer of real estate property (see note 4). Stock-for-stock mergers, on the other hand, are totally tax-free, provided that certain accounting parameters are followed. Shareholders of the absorbed company who receive shares of the surviving company have a tax basis on the new shares equal to their average pre-merger tax basis on the surrendered shares (see note 5).

Stock purchases

Stock purchases generally result in gains being taxed at ordinary income tax rates, regardless of whether the transaction is structured as a cash deal or an in-kind (eg stock or other assets being paid as consideration) deal. If the deal is structured as a cash transaction, the seller would generally recognise as gain the difference between the cash received and the cost of the stock sold. On the other hand, if it is structured as an in-kind transaction, to determine the realised gain, the value of the stock or assets received as consideration would be assessed either at their fair market value at the time of the transfer or at book value if their market value cannot be fairly determined.

Asset purchases

Asset purchases generally are taxable events. Gains realised on the sale or disposition of an asset are taxable at ordinary income tax rates for the sellers, except for gains on the sale or disposition of real estate which has a special tax treatment (see note 6). The transfer of tangible personal property, such as inventory and equipment, is also subject to a value added 5 per cent tax based on the book value of the asset at the time of the transfer (see note 7). The transfer of real estate is subject to a 2 per cent transfer tax or, alternatively, a 5 per cent transfer tax in lieu of income tax on the realised capital gain (subject to a method of stepped-up calculation of the basis that depends on the number of years for which the seller has held the property) (see note 8). Buyers of assets/businesses must be aware that they are jointly and severally liable for the tax liabilities of sellers in respect of the purchased assets or business.

Publicly-held companies

An important tax exemption exists for public companies, the shares of which are registered at the National Securities Commission. If the sale or disposition of the stock is made through a public stock exchange or other organised market, or if it results from the acceptance of a public tender offer, no gain is recognised on the transaction, regardless of whether it is a cash or an in-kind transaction (see note 9). The transaction is totally tax-free for the seller. However, if securities are received as consideration, the new securities retain the tax basis of the stock surrendered. Seldom are acquisitions made by purchases of large bulks of stocks through an exchange. However, in recent years, acquisitions by means of tender offers have become an increasingly common method of acquiring local companies. This was the method used in 2000 by Banco del Istmo SA to acquire Primer Banco de Ahorros SA and in 2001 by Holderbank to acquire Corporación Incem SA.

Goodwill

Goodwill is another frequent point of conflict between buyers and sellers. Buyers generally want to be able to deduct amortisation of any goodwill paid in the acquisition. However, amortisation of goodwill is only deductible if the seller recognises and pays some level of income tax on the sale (see note 10). Thus, carrying out a tax-free acquisition can often result in the buyer not being able to amortise the goodwill paid to the seller in the acquisition.

Income allocation

Companies with both Panama-source income and non-Panama-source income present unique problems and opportunities. Since Panama taxes only 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-source and non-Panama-source. In the case of an asset sale, such an allocation is relatively easy to do, based upon the location of the asset. However, Panama has yet to adopt rules of income allocation for stock purchases.

Corporate authorisations

Mergers

Panama law allows a company to be absorbed by another company, regardless of the jurisdiction of incorporation of the companies (straight merger), and also allows two companies to merge into a newly created entity (consolidation) (see note 11). Under Panama law, upon a merger becoming effective, the absorbed company ceases to exist as a legal entity by operation of law, and the surviving company assumes all the assets, rights, licences, capital, liabilities and obligations of the absorbed company by universal succession (see note 12).

Unless the articles of incorporation of a company state otherwise, for a merger to be duly authorised, a merger agreement must be executed by at least a majority of the directors of each company and approved by the holders of at least a majority of issued and outstanding shares of each company at meetings duly held (see note 13). The merger agreement must be then registered at the Registry of Companies in Panama, whereupon the merger becomes effective, unless a later effective date is defined in the merger agreement.

Stock and asset purchases

Generally speaking, the acquisition of a company, regardless of whether it is structured as a stock or an asset purchase, only requires approval from a majority of the members of the board of directors present at a meeting (see note 14). On the other hand, the sale of all or substantially all of the assets of a company generally requires both board of directors authorisation and approval by the holders of at least a majority of all the issued and outstanding shares with the right to vote (see note 15).

Bulk transfers

In purchases involving all or substantially all assets of a commercial establishment (bulk transfers), a public notice mechanism to third-party creditors of the seller's establishment may need to be complied with prior to payment of the purchase price, to enable the creditors to claim against the purchase price or to question the adequacy of the consideration (if less than the fair market value of the establishment being purchased by 10 per cent or more), in anticipation of seller having the right to receive payment free of claims from creditors (see note 16).

Labour relations

In a merger scenario the surviving company assumes all labour relations and liabilities of the absorbed company. Similarly, in stock acquisitions, the target company retains responsibility for labour relations and liabilities. Asset acquisitions present a special case. If the sale comprises all or substantially all of the assets so that the business operation is transferred, both the buyer of the assets - and new employer - and the seller of the assets are, for a period of a year following the acquisition, jointly and severally responsible for labour liabilities arising prior to the acquisition of the assets or business (see note 17). 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 condition precedent to closing, in order to be able to rehire some employees on more favourable terms to the extent permitted by law. Labour unions and employees must be notified of the employer substitution, although they cannot prevent it from taking place.

Securities laws and regulations

Privately held companies do not raise issues or trigger filing requirements under Panama's securities laws. However, where one of the companies is a publicly held company (ie a company whose shares are registered in the National Securities Commission), a host of issues and reporting obligations are triggered.

A discussion of the proposed merger or acquisition may need to be included in either or both of the acquiring company's and the target company's quarterly and annual filings (see note 18). Furthermore, publicly held companies are required to make immediate public announcements of material events which are reasonably expected to have a significant effect on its stock price, unless the board of directors or management has reasonable grounds to believe that such disclosure would be seriously prejudicial to the interest of the company and that no transaction in the stock has been or will be carried out by the persons who have knowledge of such events (see note 19). Thus, acquiring and target companies frequently face the issue of determining when negotiations have advanced to such a point that a disclosure is necessary. Company Directors, executives and other insiders are subject to insider trading regulations and prohibitions (see note 20).

If the proposed merger or acquisition must be approved by the shareholders of a publicly held company, any proxy solicitation by the board of directors of the company or by other person or group of persons is subject to special proxy solicitation rules and filings (see note 21).

Finally, when a buyer of a publicly held company elects to make a tender offer, the offer is subject to special tender offer rules intended to guarantee fair treatment to all shareholders and transparency of the transaction. The buyer must prepare a tender offer prospectus and make a filing with the National Securities Commission. The offer must remain open for no less than 30 days, creating a risk of competing offers being made. However, in the Holderbank/Incem tender offer, the National Securities Commission ruled favourably on the validity of pre-offer lock-up agreements, at least when equal treatment is granted to all shareholders.

Regulatory approval

Governmental approvals, consents, filings and notices are required in connection with the merger or acquisition of companies that operate in certain regulated industries. For instance, the merger or acquisition of the stock or assets of a bank or trust company licensed to operate in Panama must be approved by the Superintendence of Banks (see note 22). The same applies, for instance, to insurance companies, public utilities, radio and TV operators, among others (see note 23). Bank mergers and acquisitions may also generate additional potential regulatory issues, as the acquiring company must meet after the merger capitalisation and lending limit requirements. Thus, bank mergers some times result in divestiture of some of the acquired bank's assets.

Antitrust

Mergers and acquisitions that create economic concentrations, which have, or may have, the effect of unreasonably lessening, restricting, hindering or adversely affecting competition, or the ease of entry to the market by new competitors, within a given relevant market are prohibited (see note 24). If antitrust issues are a concern, buyers have to ensure that the closing of the transaction is conditional on prior approval of the merger or concentration by the Free Competition and Consumer Affairs Commission to avoid the risk of a post-acquisition break-up order.

Environmental liabilities

New environmental laws and liabilities require that the issue be given some consideration, particularly when the merger or acquisition involves a company that is likely to have environmental liabilities owing to the nature of its business activities (see note 25). Usually, the problem is one of allocating liability for activities prior to the merger or acquisition between the buyer and the seller.

Accounting

Buyers and sellers must also determine which method of accounting will be used to account for the merger or acquisition. Generally speaking, Panama corporations are required to apply International Accounting Standards (IAS) in the preparation of their financial statements (see note 26). Under IAS Rule 22, mergers and acquisitions can be accounted for using the 'purchase' method or the 'pooling of interest' method. Transactions treated as a 'purchase' require that the purchase price paid by the buyer be allocated to the net assets obtained (see note 27), and the difference between the cost and the fair market value be recorded as goodwill (see note 28). The net effect of this method of accounting being applied to mergers and acquisitions is that the financial performance of the buyer and seller are consolidated only for post-closing reporting periods. Frequently, buyers will want pooling-of-interest accounting treatment in order to combine historical information and avoid possible amortisation of goodwill and increased depreciation charges. However, pooling of interest accounting can only be used according to IAS Rule 22 if (a) the substantial majority, if not all, of the voting common shares of the combining enterprises are exchanged or pooled, (b) the fair value of one enterprise is not significantly different from that of the other enterprise, and (c) the shareholders of each enterprise maintain substantially the same voting rights and interest in the combined entity, relative to each other, after the combination as before (see note 29).

Increasing complexity

The consolidation process in the banking industry has not finished in Panama. The globalisation of the markets and free-trade alliances are also likely to result in an increase in cross-border mergers and acquisitions. Rapid changes in technology are also likely to work in that direction. Undoubtedly, the body of legislation affecting mergers and acquisitions will continue to evolve and transactions will become more and more complex.

Notes

1 Tax Code Art 694
2 Tax Code Art 701(e)
3 Tax Code, Art 1057-v
4 Law 106, December 30 1974, Art 1,
5 Executive Decree No 18, March 14 1994, Art 2
6 Law 106, December 30 1974; Tax Code, Art 701, (a) and (e); Executive Decree No 170, October 27 1993, Art 2 (e) and Arts 91-97
7 Tax Code, Art 1057-v
8 Law 106, December 30 1974, Art 1, Paragraphs 1 and 2
9 Decree-Law No 1, July 8 1999
10 Tax Code, Art 750; Executive Decree No 170, October 27 1993, Art 173
11 Executive Decree No 170, October 27 1993, Art 60
12 Law 32, February 26 1927, Art 71; Commercial Code, Arts **11**-A to 11-E
13 Law 32, February 26 1927, Art 76
14 Law 32, February 26 1927, Arts 71 and 73
15 Law 32, February 26 1927, Art 54
16 Commercial Code, Art 777
17 Labour Code, Art 14
18 National Securities Commission Regulation No 18, October 11, 2000, Art 2
19 Law Decree No 1, July 8 1999, Art 77
20 Law Decree No 1, July 8 1999, Art 268
21 Law Decree No 1, July 8 1999, Art 91
22 Law Decree No 9, February 26 1998, Art 71
23 Law Decree No 10, February 26 1998, Arts 3 and 6; Law No 24, June 30 1999, Art 15
24 Law No 29, February 2 1996, Art 19
25 Law No 41, July 1 1998
26 Executive Decree No 26, May 17 1984, Art 87
27 International Accounting Standards Rule No IAS 22, §32
28 International Accounting Standards Rule No IAS 22, §40
29 International Accounting Standards Rule No IAS 22, §16

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