



## Tax reform legislation enacted

**T**he governor of Puerto Rico has signed several new laws in an effort to balance the budget for Fiscal Year 2005-2006.

The legislation is the result of a budgetary crisis that forced the partial shutdown of government operations. This controversial legislation will surely be the discussion of taxpayers and practitioners in the forthcoming months. All these laws became effective immediately.

### Act No. 88 of May 13, 2006—Royalties

Act No. 88 amends Section 6(k) of the Puerto Rico Tax Incentives Act of 1998 to impose a 15% tax on payments made by businesses enjoying tax exemption to nonresident corporations, partnerships and individuals for the use in Puerto Rico of patents, intellectual property, formulas, “know-how” and similar property. The Secretary of the Treasury can reduce the tax rate on royalties to not less than 2%. The exempt business

making the payment is responsible for deducting, withholding and remitting the tax to Puerto Rico Treasury.

### Act 89 of May 13, 2006—2.0% Bank Tax

On August 11, 2005, the governor had signed Act No. 41, amending the Puerto Rico Internal Revenue Code to impose an additional 2.5% tax on the income of corporations and partnerships with net taxable income of \$20,000 or more. This law did not modify Code § 1016 (c), which left a maximum tax rate of 39%.

Act No. 89 corrects this oversight to reflect a maximum income tax rate of 41.5% for regular corporations and partnerships.

Continued on page 2

#### A CPA's view

## The Tax Bamboozle Act of 2006

**Y**es, that's what it is. We—you and I, and most of the hard-working, taxpaying individuals—have been taken for the proverbial ride.

### What should have been . . .

But we will get to that in a minute. First let's look at what real tax reform should have looked like: a sales tax plus **reductions** in tax rates and simplification of filings. Tax rates should have been knocked down by about half; going from 5% to 17% on active

income only. All passive income (dividends and interest) should have been untaxed, in order to promote investment and savings, as long as those investments were located in Puerto Rico. Tax deductions should have been limited to mortgage interest, education, and medical and child-related.

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*Puerto Rico Business Law Developments* thanks guest contributors Virgilio Vega III, for his article “The Tax Bamboozle Act of 2006” (page 1), and Heide Calero, for “A reply to The Economist” (page 8).

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**Tax reform . . .**

It also establishes a new tax of 2% applicable to corporations operating under the Puerto Rico Bank Act.

Its provisions apply to tax years commenced after December 31, 2005, and on or before December 31, 2006. Act 89 also provides that the rates will revert to the tax rates in effect prior to the enactment of Act No. 41 (maximum of 39%), by elimination of the 2.5% special tax and the 2% bank tax.

**Act 98 of May 6, 2006—Extraordinary Tax**

Of the laws signed by the governor, Act No. 98 is the most controversial for taxpayers and practitioners alike. It imposes a 5% “extraordinary” tax to corporations and partnerships with gross revenues in excess of \$10,000,000. The 5% applies to the net income reported for taxable years ended on or before December 31, 2005. If an extension was filed for 2005, the extraordinary tax is determined on an estimate of the net taxable income for that year, and adjusted upon the filing of the return.

Act 98 does not apply to the following:

- *conduit tax entities*, such as special partnerships and corporations of individuals,
- exempt, registered investment companies, and
- not-for-profit organizations, churches and labor unions.

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Act 98 also applies to exempt businesses, although only to the taxable income derived from operations that are not covered by their tax grants.

The extraordinary tax can be claimed as a credit against the tax liability for tax years commencing after December 31, 2005. Unused credits can be used in equal parts in the four tax years following the year in which the extraordinary tax was paid. Although this credit is available to foreign taxpayers, in order to claim it the taxpayer must be able to show inability to use the credit, or deduct the extraordinary tax, in another jurisdiction. A foreign taxpayer that is eligible to claim the tax credit, but cannot claim it due to net operating losses, is permitted to extend the period, with certain limitations, until the credit is exhausted.

### **Act 87 of May 13, 2006—5% tax on IRAs**

Act No. 87 amends Sections 1165 and 1169 of the Code, providing for a special tax rate of 5% applicable to distributions made from retirement plans and individual retirement accounts during the period of May 16, 2006, to November 15, 2006. It also provides for tax prepayment at the special rate, if made within said period.

Act 87 provides that any distribution made during the May-November period will be subject to a special tax rate of 5% in lieu of any tax imposed by Code § 1165(b)(I). The distributions made during this period, which can be of all or part of the accumulated benefits of the participant, will be considered amounts paid by reason of separation from service.

Act 87 also allows participants to prepay during the period—at the rate of 5%—the tax on all or part of their accumulated and undistributed amounts. The law authorizes distribution of the amounts necessary to pay the 5% tax. As a result, the participant's tax basis will be increased by the amount prepaid. Thus, at distribution only the earning component related to the prepaid amount will be taxable at the capital gain tax rate applicable at the time of distribution (i.e., similar to the tax treatment granted to after-tax contributions).

Act 87 applies to participants of plans qualified in Puerto Rico, regardless of the location of the retirement

trust. Although it does not limit its benefits to defined contribution plans, the law is silent as to its application to defined benefit plans. In addition, because the distribution used for the prepayment of the tax may not be considered a distributable event under federal law, it remains uncertain how dual qualified plans will be able to comply with these requirements.

Guidance from Treasury is expected shortly, specially on whether the special 5% tax will be applicable to distributions, other than a lump sum distribution, on account of separation from service (i.e., age over 59 ½, hardship, loan defaults, etc.).

Act 87 provides to IRA owners a special tax rate of 5% to be withheld at the source by the financial institution, for any distribution made during the May-November period. This special tax rate will apply in lieu of any other tax that can be imposed by the Code. These distributions may not exceed \$50,000. Any amount distributed in excess of the \$50,000 limit will be subject to tax at the regular rates. Act 87 waives the 10% penalty on these distributions. The 10% penalty is generally imposed on distributions made to individuals under the age of 60.

The new law allows the prepayment of a 5% tax on all or part of the participant's accumulated and undistributed amounts in an IRA. The participant's tax basis is increased by the prepaid amount, so that upon distribution only the additional earning component of such prepaid amounts will be subject to tax.

### **Act No. 92 of May 16, 2006—Catch-up**

Act 92 amends the deferral limits imposed by the Code to all cash or deferred arrangements qualified in Puerto Rico for participants that at the close of the plan year have reached the age of 50. The catch-up contribution is not to exceed \$500 for the taxable year commenced January 1, 2006, and \$1,000 for tax years commenced after December 31, 2006.

In addition, the catch-up contributions:

- will not affect a plan's actual deferral percentage test;
- can be matched by the employer; and
- will not affect the \$8,000 limit used for the acquisition of IRAs by plan participants. ■

Tax bamboozle . . .

### Property taxes

Real estate valuations for property tax purposes should have been updated to more current values (we are not saying market), and rates adjusted accordingly, as well the homestead exemption. Increases in revenues should have been allocated between the corresponding municipality and public education.

### Budget cuts

In addition, the central government should have cut its budget, as it is out of control. These folks have no idea what fiscal responsibility is. It is not unreasonable to ask the central government to bring expenses down to equal revenues.

### What it is . . .

But it takes political gumption to do this; and besides that would have been too easy. No, they went out of their way to work the screws.

Very few issues have been so widely studied and analyzed like the sales tax and tax reform. The Puerto Rico Society of Certified Public Accountants, the Puerto Rico Chamber of Commerce and other trade and business associations had for the last five years been submitting studies and proposals to the government on this matter. Even the House of Representatives worked on this between years 2000 and 2004. You know what they did with all that information?: ZIP. They proceeded to create a Frankenstein law with bits and pieces of everything and nothing; incoherent and so full of holes and bumps that it closely resembles our highway system.

### Tax “breaks”

For example, future or promised tax “breaks” are dependent on the revenues provided by the sales tax. That has been the governor’s explanation of where the real benefits are. Be patient, for they will be here by 2008, of course depending on “central” collections.

The Legislature estimated revenues to be generated at \$328 million for each percentage point of “central” sales tax. Sources indicate that the most they might

generate is \$228 million. That’s a \$550 million shortfall. At that clip, “breaks” are going to be hard to come by, and we will be left holding the bag.

### Redo your taxes

The new tax law does contain some actual breaks, but my math leads me to believe that they will not be neutral as far as the sales tax goes. Look at your tax return and redo the math with these new “breaks.” See how much your income tax will decrease, and compare that to an estimate of what you will pay in sales taxes. Estimate your sales tax at 7% (total) on a consumption level of about 50% of your disposable income. If you add this new tax to your tax responsibility you will see that your effective tax rate will jump up by 3% on the average. Congratulations, you are now in a new “tax bracket”: the *consumed tax victim* bracket.

### Dream

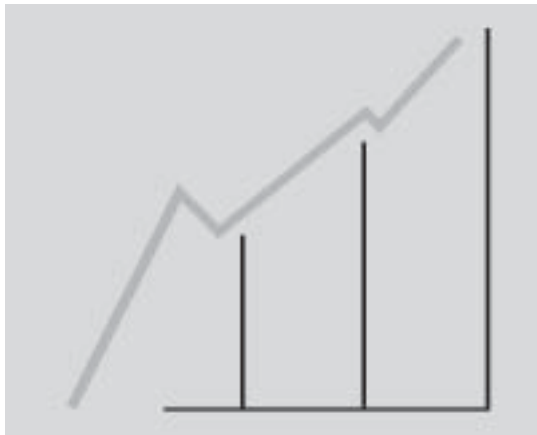
Can we join forces and sue the government for damages, lost profits, and lost faith? Dream on! For now just dream at what happens when strangers manage your checkbook. Scary, isn’t it? ■



## Prepayment tax imposed on capital gains

**A**ct No. 117 of July 4, 2006, introduced a special prepayment tax of 5% or 10% on the increase in value of capital assets.

The special tax is available for the period of July 1, 2006, to October 31, 2006.



However, the capital assets covered by this special prepayment tax of 10% available to corporations and partnerships apply only to real estate located in Puerto Rico.

### Subsequent developments

Any increase in value of such capital assets generated after an election under §§ 1014A or 1121A will be subject to tax under the provisions of law in effect as of the date of the sale. On the other hand, any loss realized on a subsequent sale of the capital assets for which an election for the special prepayment tax was made will be adjusted according to the effective tax rate applicable at the time of the sale. Said loss will be adjusted by a fraction which will include as the numerator the applicable special prepayment tax (5% or 10%) and the denominator the tax rate in effect on the date of the sale.

### Individuals, estates and trusts

Act 117 inserted a new § 1014A, under which individuals, estates and trusts may elect to prepay a the special tax without an actual sale of capital assets, and without regard to the period during which said taxpayer owned the assets.

### Assets covered

The capital assets covered are the following:

- stock or proprietary interest in domestic or foreign corporations or partnerships; and
- real estate located in Puerto Rico.

### Corporations & partnerships

In that same sense, Act 117 adopted § 1121A to provide to corporations and partnerships a special pre-paid tax of 10% on the increase in value of capital assets. As in the case of individuals, the election to opt for this special tax must be made, and the tax paid, from July 1 to October 31, 2006.



### Election form

The election to benefit from the special tax must be made by filing a form and paying the tax at the internal revenue collector offices.

At press time the Puerto Rico Treasury Department had not promulgated any regulation or administrative pronouncement on either § 1014A or § 1121A; neither had it published the form needed for making the election and prepaying the tax. ■

## Sales tax approved

**A**fter a year and a half of speculation, struggle between the Legislature and the governor, and a government shutdown, a 7% or 8% sales tax was imposed.

Act No. 117 of July 4, 2006 (known as the “Taxpayer Justice Act”), amended the Puerto Rico Internal Revenue Code of 1994 in order to establish a sale tax system in Puerto Rico. Act 117 eliminates the infamous 5% (6.6% effective rate) general excise tax.

The sales tax will be divvied up as follows:

- 5.5% to the central government, effective on November 15, 2006,
- 1.5% to the municipalities, effective immediately,
- an additional 1% to the central government, available in the event that the governor determines an insufficiency in collections for the general fund.

### Exemptions

The following items and transactions are exempted from the sales tax:

- taxable items in transit, temporarily introduced to Puerto Rico for use in films, construction, trade shows, seminars, etc, and re-exported by the importer,
- items used in manufacturing, i.e., raw materials used by manufacturing plants,
- items currently exempted from the payment of excise taxes under Section 6(c) of the Puerto Rico Tax Incentives Act of 1998,
- items sold at air or sea terminals stores,
- items acquired by the governments of Puerto Rico and the United States,
- items belonging to nonresident Armed Services personnel transferred to Puerto Rico,
- admission tickets to athletic events, shows sponsored by schools, universities, colleges and other educational institutions.

### Food

The following are subject to the sales and use tax: tobacco and its derivatives, alcoholic beverages, candies and sweets, soft drinks, prepared foods (the municipal 1.5% cut appears to apply to all foods, both prepared and unprepared) and certain baked products.

### Medicines

Prescription drugs, over-the-counter medicines, other medical items and personal hygiene items are subject to the sales tax.

### Real estate

Also subject to the tax are lease payments for real property constituting the principal residence of the tenant, as well as those derived from commercial lease.

### Services

Services are subject to the tax, except for the following:

- services rendered to a person dedicated to a business activity,
- designated professional services (attorneys, accountants, architects, etc.),
- services rendered by the government of Puerto Rico,
- interest, charges for the use of money and service charges imposed by financial institutions,
- service and insurance commissions,
- healthcare, medical and hospital services, and
- services rendered by persons whose annual volume of business does not exceed \$50,000.

## Telecommunications

Some telecommunication and incidental services will be subject to the sales tax.

## Systems

All businesses must have their systems in place by November 15, 2006. At press time Puerto Rico Treasury has not promulgated regulations, registration forms, circular letters or any other official guide on the implementation of the tax.

## Municipalities

Some municipalities already had a sales tax system in place before the enactment of Act No. 117. Because Act 117 authorizes municipalities to impose the sales tax through a municipal ordinance, some have taken the position that they do not have to do so, or that they can adopt a tax lower than the 1.5%. In addition, some mu-

nicipalities have established procedures and granted exemptions different from those in Act 117. Moreover, others are allowing businesses to keep as compensation from 3% to 4% of the tax collected. However, Act 117 requires that municipal sales taxes be consistent and comply with its list of exemptions and limitations.

The following are examples of what some municipalities have done:

- Caguas—1% sales tax since October 2005,
- Guaynabo—1.5% sales tax since July 15, 2006,
- Carolina—1% sales tax since July 1, 2006,
- Ponce—1% sales tax since July 1, 2006,
- San Juan—1% sales tax since August 1, 2006,
- Bayamón—announced a sales tax (unspecified rate). ■

## Special tax imposed on dividends

**A**ct No. 117 of July 4, 2006, added subparagraph (j) to Section 1012 of the Puerto Rico Internal Revenue Code of 1994, to impose a 5% special tax on dividends and profits.

The tax applies to dividends available and profits made from July 1 through October 31, 2006, by all domestic corporations and partnerships, as well as by foreign corporations and partnerships if 80% or more of their income is generated from the conduct of a trade or business in Puerto Rico.

### No distribution needed

Under new subparagraph (j) of § 1012, dividends are not required to be distributed to the shareholders or partners in order for the tax to apply.

### Nonresidents

Finally, Act 117 added subparagraph (d) to § 1221 of the Code, regarding the taxing of nonresident foreign individuals. New subparagraph (d) provides a special tax of 5% on dividend and profits of corporations and partnerships made from July 1 to December 31, 2006. In this case, as in that of § 1012(j), distribution is not required to be made to the shareholders or partners. ■

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# A reply to The Economist

## An overview of the other side of Puerto Rico's story

### Abstract

Rarely had the prestigious British publication, *The Economist*, taken time to look into Puerto Rico's economy. This time, it focused on several aspects of which Puerto Ricans are certainly not very proud. Lower levels of employment than in the states and high levels of public aid and welfare enrollment are undeniable. However, once the poorhouse of the Caribbean, Puerto Rico became the shining star of this area. Fifty years ago, the island underwent a quiet revolution and has become a world-class center for pharmaceutical production. Yet, this side of the story was not told. Find out other facts *The Economist* failed to fairly expose regarding Puerto Rico.

### Telling the whole story

The *Economist* portrayed Puerto Rico as a welfare island. It is no secret that Puerto Rico has a good share of folks who can't find or perhaps won't look for a job. Our labor participation rate has remained below 50% during the past 40 years but this does not mean that those who participate in the labor market are not hard working professionals and skilled workers who are proud of what they do. As US citizens, needy Puerto Ricans are entitled to receive welfare payments and some people are discouraged from working. A person can receive an average \$1,315 a month from welfare, which is more than the average \$1,236 a month he or she could earn working 30 hours a week. The *Economist* mentioned that the average length of schooling in Puerto Rico rose from 3.7 years in 1950 to 11 years in 2000. Yet, *The Economist* indicated that many Puerto Ricans have acquired few useful habits and skills over these past three decades.

It also failed to mention the more than 23,000 college degrees conferred every year to those Puerto Rican youngsters who strive to make a better living. There is no mention of the over 9,000 science and engineering degrees awarded each year and many other degrees on subjects like business, information technology, law, medicine, and accounting, among others.

In 1995, there were 165,398 students enrolled in 19 universities with 35 campuses plus 26 technical colleges

around the island. By 2003, this number jumped to 199,842 students. The *Economist* forgot to mention that many of these graduates are young people who are not "in trouble" and who consider education their key to future success. The anonymous reporter also failed to mention that many of our engineering graduates are recruited from abroad.

### Poverty is also down . . .

Despite the fuzzy picture presented by *The Economist*, there have been significant accomplishments. In 1970, the poverty rate in Puerto Rico was 65% of the population. This rate dropped to 48% by 2000. Moreover, recent poverty estimates published by the Department of Labor in 2003 indicate a poverty rate as low as 40%. Are we satisfied? The answer is No and the island strives to lower this rate.

### Not a fair comparison

Puerto Rico's economy has experienced constant transformation since the 1950s. This process has not yet ended. In all fairness, Puerto Rico aims to narrow the income gap with other states in the US mainland, including Mississippi, but the starting point is not the same. Puerto Ricans have governed themselves for a little over 50 years. All other states got self-government much earlier.

It is important to remember that between 1898 and 1944 Puerto Rico was run by the US military. Most of the economic development and growth that led to the current situation took place right after Puerto Rican leaders became governors, an event that occurred only 62 years ago.

### Overlooking the whole picture

The article focuses only on low-income families and individuals in Puerto Rico. But, how about focusing on Puerto Ricans who go to school and go to work every morning. The *Economist* implies that Puerto Rican men are lazy and who are either "getting into trouble" or hanging out in beaches, shopping malls, and Borders' bookstores. Puerto Rico's downtowns are described as crowded with shabby offices and shops full of low-income and idle hands.

Concluding that most of the island is that way is false. Commercial activities in downtowns have almost disappeared with the advent of sophisticated shopping malls outside the town centers. The Economist failed to mention that Puerto Rican tastes and needs have changed and so has the urban landscape. Throughout the island you will find single and multiple housing units ranging from \$90,000 to more than \$1 million. Border's visitors are mostly educated. Describing those who sit there to read as idle and lazy is plain nonsense and even not professional.

The Economist overlooked the fact that illiteracy rates in the island have dropped from 35% in the 1940's to 8.5% in 2003.

### **GNP is also on the rise**

The Economist also "forgot" to mention the rising GNP per capita enjoyed by the island in the last 50 years. In 1950, per capita GNP was \$325 a year. By 2005, it reached \$13,675 per person, a tremendous improvement for a small island with barely natural resources.

Similar positive accomplishments have also taken place in other areas. For instance, life expectancy for residents in Puerto Rico during the 1940s was only 46 years of age. Many diseases and lack of access to good healthcare were all too common.

Then, a turnaround took place. In 63 years, life expectancy jumped to an average 77 years of age. Once again, The Economist failed to mention this as evidence of improvements in our quality of life.

### **Strong pharma cluster**

Perhaps, US tax section 931 and later amended to section 936 by the US Congress in 1976 did not deliver as many jobs as originally expected. The Economist describes this section of the US tax code as being too advanced for Puerto Rico's stage of development at the time. Because of this tax advantage, many US pharmaceutical companies built factories that used lots of capital and employed few workers.

However, economic incentives to US multinationals triggered a good level of economic activity, enough to make Puerto Rico one of the most important pharmaceutical clusters in the world. Try to imagine Puerto Rico without the 30,000 direct jobs that the pharmaceutical industry generates alone. Add up the 96,000 additional jobs generated by related businesses that provide ample goods and services in areas such as manufacturing components, food

services, engineering consulting, medical, legal and banking services, insurance, transportation, communications, tourism and others.

It is not well known that half of the defibrillators and heart pacemakers sold in the United States are manufactured in Puerto Rico. Moreover, Puerto Rico exported over \$2 billion in scientific and medical devices in 2003, placing it eighth in the world in total exports. Sixteen out of the top 20 selling pharmaceutical drugs in the US are manufactured in Puerto Rico. Since 1997, pharmaceutical companies have invested \$1.7 billion in Puerto Rico.

Such investments indicate that worldwide investors acknowledge the talent and productivity of Puerto Ricans dealing with highly complex manufacturing processes. The manufacturing boom in the 1950s marked a turning point in the economic history of Puerto Rico. This was followed by a blossoming banking and financial sector of which Puerto Ricans are proud. Locally owned banks account for more than 70% of total assets of commercial banks, and this share has grown over time.

### **The challenge ahead**

Yes, one could probably say that Puerto Rico has a good portion of idle hands. But, why did The Economist forget to mention and failed to give kudos to the professional and skilled early risers from all walks of life that go to work every day and comprise close to 50% of all working-age adults?

The fact that public aid has risen to new levels is a fact. The Economist says that many things have gone wrong with the island. It adds that the US government assumed too big a role in the Puerto Rican economy and that some Puerto Rican households would barely survive without federal assistance. But, this is not unique to the Puerto Rican society. Similar problems have taken place for decades in several states, mostly with minorities like blacks and Hispanics.

There is still much to do in the island by both the government and the private sector. That is undeniable. However, the workers and professionals in this island deserve a balanced and professional picture from The Economist. Telling all sides of the story is of utmost importance for those who advocate professionalism in journalism. We acknowledge our defects but it is just as important to provide readers with the untold story of Puerto Rico's successes. Will The Economist accept the challenge? ■

## CONTRACTS

# Electronic Transactions Act pending governor's signature

**B**oth the Puerto Rico Senate and the House of Representatives have passed Senate Bill 651, which adopts the 1999 version of the *Uniform Electronic Transactions Act*. At press time the approved bill was pending the governor's signature to become law.

### In general

Most notably, this legislation reduces uncertainty associated with the enforceability of electronic contracts and signatures. The fundamental factor of this bill is that contracts executed electronically or online, such as through e-mail or by clicking the common *I Agree* "button," may not be denied legal effect or enforceability solely because they are in electronic form, or were fashioned electronically.

The bill adopts the version of the *Uniform Electronic Transactions Act* approved by the National Conference of Commissioners on Uniform State Laws in July, 1999, with very minor variations. Consequently, to understand the bill it is first necessary to clearly understand UETA. All of the provisions of UETA mentioned below have been adopted by the bill, except as otherwise provided.

### UETA

In 1999 the NCCUSL recommended the UETA for enactment in all states. UETA was designed as model legislation to complement existing digital signature laws at the state level, while at the same time provide a clear framework for validating and effectuating electronic records and signatures in e-commerce.

Under UETA, records created, generated, sent, communicated, received or stored by electronic means can be the legal equivalent of paper documents. Furthermore, electronic signatures can be the legal equivalent of physical signatures. The use of specific technology to create a valid signature is not necessary; the signer's intent at execution is what governs.

### Scope

The application of UETA has a generally broad scope, but does not apply to transactions governed by laws dealing with the creation and execution of wills, codicils, or testamentary trusts.

The scope of the Puerto Rico bill excludes a larger number of transactions from its application, among these:

- transactions governed by inheritance laws,
- transactions regarding family law,
- documents required to be executed in connection with court proceedings,
- cancellation of basic utility services,
- notices of breach, acceleration, repossession, execution or eviction, or the right to cure a breach related to debts secured by the debtor's principal residence,



- notice of cancellation of a medical or life insurance policy, or its benefits,
- notice of recall of a product, or of material failure of a product.

## Default rules

UETA is principally a set of default rules. Except where otherwise specified in UETA for certain policy considerations, the effect of any of its provisions may be varied by agreement of the parties. Here are the more significant rules to consider:

*Attribution:* an electronic signature is attributable to a person if it was the act of that person.

*Change or error:* if two parties agree to use a particular security procedure, and one party fails to conform to that procedure, the conforming party may avoid the effect of any changes or errors that occurred and could have been prevented had the other party also conformed. This section additionally provides a procedure for an individual to avoid any changes or errors resulting in an automated transaction with an electronic agent, if the electronic agent does not provide an opportunity for prevention or correction of the error.

*Time and place of sending and receipt:* an electronic record is sent when it enters a system outside the sender's control, and received when it enters a system designated by the recipient for the receipt of such records.

## Application

In addition to the general application of UETA, the same provides several specific rules regarding its application in certain circumstances.

*Notarization and acknowledgement:* UETA § 11 allows satisfaction of any legal requirement for notarization, acknowledgment, verification, or oath by the use of an electronic signature, provided that the same be attached to, or logically associated with, the underlying signature or record in question. The Puerto Rico bill did not incorporate § 11.

*Record retention:* an electronic record will satisfy any law that requires a record to be retained, if the

electronic record is accurate and remains accessible for later reference.

*Admissibility in evidence:* evidence of a record or signature may not be excluded from a legal proceeding solely because it is in electronic form.

*Electronic agents:* contracts may be fashioned through the use of "electronic agents." An electronic agent is defined as "a computer program or electronic or other automated means used independently to initiate an action or respond to electronic records or performances in whole or in part, without review or action by an individual."

*Transferable records:* the use of electronic negotiable instruments, referred to as "transferable records," is permitted. To create and maintain transferable records under the statute, a system must be implemented that would only allow a single (unique, identifiable and unalterable) authoritative copy of the transferable record. Any person seeking to enforce a transferable record must be in "control" of the same.

*Government agencies:* states have the option of adopting UETA §§ 17 to 19. These sections authorize government bodies to regulate the use of electronic signatures and records in transactions to which they are a party, and encourage them to adopt standards that promote consistency and interoperability. Puerto Rico did not adopt these sections either.

## Electronic Signatures Act

The federal *Electronic Signatures in Global and National Commerce Act* (known as "E-Sign") became effective on October 1, 2000. E-Sign is similar to UETA in many ways, and was enacted to resolve the lack of uniformity among state laws, and ensure the enforceability of electronic signatures and contracts in interstate commerce, regardless whether individual states adopt UETA. States may opt-out by adopting the uniform version of UETA, or alternative procedures and requirements which are consistent with E-Sign.

The Puerto Rico Legislature decided to opt-out by adopting both the uniform version of UETA and the *Electronic Signatures Act of Puerto Rico*, which provides additional provisions consistent with E-Sign. ■

## REAL ESTATE

## Legislature passes shopping center security bill

**R**ecently the Puerto Rico Legislature passed Senate Bill 410, known as the “Code of Protection and Security for Visitors, Employees and Lessees of Shopping Centers.” This bill seeks to provide the owners and administrators of shopping centers with an additional tool in their efforts to provide protection for all those who visit these centers.

### Codes of conduct

If it becomes law (at press time it was pending delivery to the governor), this new bill would give shopping centers the right to adopt and enforce codes of conduct for the safety of its customers. It provides that a shopping center may deny admittance to, and may require the removal of, any person who violates the code’s rules.

A code may contain rules reasonably intended to prevent improper conduct and other activities which could be contrary to the image, enjoyment and rights of other persons visiting the center, or that could interfere with the image or operation of the center. A legible copy of the code must be posted on all entrances, as well as in conspicuous places throughout the shopping center.

### Notices of Denial of Admittance

The bill also enables shopping center to issue *Notices of Denial of Admittance* to prohibit the entrance of particular persons, based on their previous behavior. Persons who have either violated a center’s code of conduct, taken actions which are detrimental to its image or operations, or allegedly participated in crimes committed at the center may be issued such a notice. These notices must be in writing and must contain certain information such as the reasons for the denial of

admittance, as well as the length of time they will be in effect.

### Removal

The bill also authorizes shopping centers to make someone leave the premises. The center must first let the person know (either verbally or in writing) that he or she is being asked to leave; if the person fails to do so voluntarily, the center may request the aid of the Puerto Rico Police to remove him or her.

### Crimes

In adopting this bill the Legislature provided some valuable discourse regarding the frequency of crimes committed at these centers, as well as the possibility of a court finding that a center which does not take reasonable measures (presumably, including those provided in this bill) could be held liable for the harm caused to a visiting person, who may be the victim of a crime.

The Legislature extrapolated this possibility based upon the case of *Pabón v. Axtmayer*, 90 D.P.R. 20 (1964), which involved a hotel guest. In *Pabón* the Puerto Rico Supreme Court stated that “based upon prevailing circumstances in our community, and based upon the doctrine of foreseeability of a risk or harm, it constitutes negligent behavior by a hotel owner in its obligation to provide adequate protection to its guests.” ■



## Right to claim because of difference in area

In *Ramírez v. Soto*, 2006 TSPR 100, the Puerto Rico Supreme Court revisited the old problem of the rights of a purchaser when the area of the property purchased turns out to be less than what he bargained for.

### The controversy

Let's assume that you are going to purchase a property with the understanding that its total area is 450 square meters. Just before the closing you are advised that the actual area is only 421 square meters. Due to this difference, you get a proportional reduction in price from the seller. You also sign a sworn statement where you admit to your knowledge of the reduction in area and, therefore, in price, and you agree not to make any claims against the seller; however you reserve the right to state a claim against any adjacent property.

Do you actually have the right to claim from your neighbors after having received the price reduction?



rescission of the contract, provided that in the latter case the decrease in the real estate is not less than one-tenth of the area given it.

“The same shall be done, even when the area appears to be the same, if any part of the real estate is not of the character mentioned in the contract.

“The rescission in such case shall only take place at the will of the vendee, when the inferior value of the thing sold exceeds one-tenth of the price agreed upon.”

### The ruling

In this case the court resolved that Code articles 1358-1361 apply when there is a discrepancy due to an error between the area agreed to the actual area; and that their provisions do not prevent that the buyer receive a price reduction plus the right to reclaim the missing area. ■

### Article 1358

Puerto Rico Civil Code article 1358 provides that:

“The obligation to deliver the thing sold includes that of placing in the possession of the vendee all that is mentioned in the contract, according to the following rules:

“If the sale of real property should be made with a statement of its area, at the rate of a certain price for a unit of measure or number, the vendor shall be obliged to deliver to the vendee, if the latter should require it, all that may have been mentioned in the contract; but should this not be possible, the vendee may choose between a proportional reduction in the price or the



**The Supreme Court did not decide that the purchaser was actually entitled to the additional land, only that he could claim it. The final decision will have to wait a future lawsuit.**

## INSURANCE

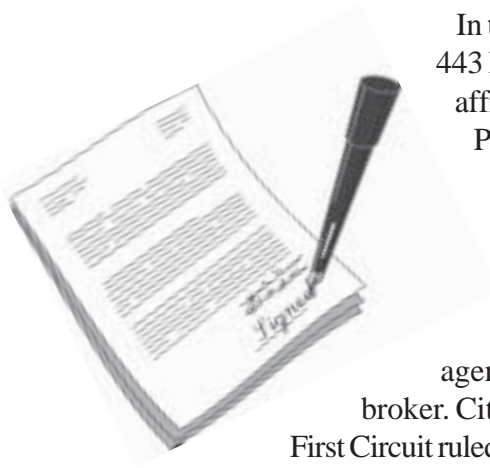
## Insurance countersignature requirement declared unconstitutional

**T**he United States Court of Appeals has recently announced its decision declaring unconstitutional the countersignature requirements of the Puerto Rico Insurance Code, as they violate the *Privileges and Immunities Clause* of the United States Constitution.

### Background

Sections 329 and 9271 of the Puerto Rico Insurance Code disallow the sole signature of a non-resident insurance agent or broker, even if locally licensed. This requirement forces counter-signature by a resident counterpart.

### Unconstitutional



In the case of *Council of Insurance Agents and Brokers v. Juarbe*, 443 F.3d 103 (2006), the U.S. Court of Appeals for the First Circuit affirmed the judgment of the U.S. District Court for the District of Puerto Rico, 363 F. Supp. 2d 47 (2005), which decided that these requirements are contrary to the U.S. Constitution. On appeal, the Council claimed that non-resident agents and brokers, some of which are licensed to sell insurance in Puerto Rico, were denied to solicit insurance unless the insurance was obtained outside of Puerto Rico or if the non-resident agent or broker placed the insurance through a resident agent or broker. Citing with approval from the U.S. District Court's opinion, the First Circuit ruled that:

“The countersignature requirements of Sections 329 and 927 [of the Code] are unconstitutional to the extent that they deny Puerto Rico-licensed non-resident insurance agents the same rights and privileges that they afford Puerto Rico-licensed resident agents. The Commissioner . . . is enjoined from denying to Puerto Rico-licensed nonresident agents the same rights and privileges possessed by Puerto Rico-licensed resident agents under the governing statutes.”

### Brokers

At oral argument, the Court of Appeals raised the issue of a technical reconsideration that had been raised at the trial level on the question of whether the judgment covered brokers as well.

The parties submitted an agreement that brokers that are situated in the same position as are the agents should also be protected by the judgment. ■

## EPA switching industry codes for toxic release inventory reporting

**T**he U.S. Environmental Protection Agency will amend federal regulations under the *Emergency Planning and Community Right-to-Know Act* and the *Pollution Prevention Act* to include the use of North American Industry Classification System ("NAICS") codes for its toxic release inventory reporting requirements.

### NAICS – SIC

The NAICS codes will eventually replace the Standard Industrial Classification ("SIC") codes currently in use. These codes are economic classification systems that the federal government uses to collect and analyze industry-related statistics.

### Reporting

The final rule, which takes effect August 5, 2006, calls for affected facilities (those industries and federal facilities with ten or more full-time employees that manufacture, process, or otherwise use listed toxic chemicals) to report NAICS codes beginning with the toxic release inventory reporting forms that are due at EPA and the corresponding state agency on or before July 1, 2007. Toxic release inventory reports cover environmental releases and other waste management information involving certain chemicals from affected facilities for the preceding calendar year.

### ✓ Note:

The final rule may be found at 68 F.R. 13,872. ■



"§ 372.38 -- Exemptions.

"(e) Certain owners of leased property. The owner of a covered facility is not subject to reporting under § 372.30 if such owner's only interest in the facility is ownership of the real estate upon which the facility is operated. This exemption applies to owners of facilities such as industrial parks, all or part of which are leased to persons who operate establishments in any SIC code or NAICS code in § 372.23 that is subject to the requirement of this part, where the owner has no other business interest in the operation of the covered facility."

**LABOR UPDATE**

U.S. Supreme Court:

## Arbitrator to decide on validity of contract as a whole

In *Buckeye Check Cashing, Inc. v. Cardegna et al.*, no. 04-1264 (February 21, 2006), the United States Supreme Court reviewed the issue of whether a court or an arbitrator should consider the claim that a contract containing an arbitration provision is void.

### Previous decisions

Previously, in *Prima Paint Corp. v. Flood & Conklin Mfg.*, 388 U.S. 395 (1967), the Court had held that an arbitration provision is severable from the remainder of the contract. In addition, it resolved that unless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator in the first instance. And in *Southland Corp. v. Keating*, 465 U.S. 1 (1984), the Court had stated that the arbitration law applies in both federal and state courts.

### **Buckeye**

The controversy in *Buckeye* was that one of the provisions of the contract was considered illegal by the respondents. As a consequence, they claimed that the whole agreement, including the arbitration provision, was invalid. The Supreme Court reaffirmed that regardless of whether the challenge is brought in federal or state court, a challenge of the validity of the contract as a whole, and not specifically the arbitration clause, must go first to the arbitrator.

### ✓ **Note:**

The case also clarifies that state and territorial courts have to defer issues concerning the validity and arbitration agreements to the arbitrator. A party who is denied recourse to arbitration may seek enforcement of said agreement in federal court by means of the Federal Arbitration Act. ■

“It is true, as respondents assert, that the *Prima Paint* rule permits a court to enforce an arbitration agreement in a contract that the arbitrator later finds to be void. But it is equally true that respondents' approach permits a court to deny effect to an arbitration provision in a contract that the court later finds to be perfectly enforceable. *Prima Paint* resolved this conundrum—and resolved it in favor of the separate enforceability of arbitration provisions. We reaffirm today that, regardless of whether the challenge is brought in federal or state court, a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator.”

## U.S. Supreme Court rules on retaliatory acts

**I**n *Burlington Northern and Santa Fe Railway v. White*, 2006 U.S. Lexis 4895, the United States Supreme Court ruled that the scope of the anti-retaliation provision extends beyond workplace-related or employment-related retaliatory acts and harm.

A Burlington employee filed a complaint with the Equal Employment Opportunity Commission because her duties were reassigned after she reported to her supervisor certain incidents regarding gender-based discrimination and sexual harassment. After the employer received the EEOC notice, she was suspended from her job without pay, although 37 days later she was reinstated with back pay.

### Scope to be applied

The U.S. Court of Appeals affirmed the District Court judgment favoring both retaliation claims. It applied the retaliation standard in the same manner as the discrimination offense, where the action must “result in an adverse effect on the terms, conditions, or benefits of employment.” However, the different federal circuits have used diverse scopes in the application of the aforementioned standard. Based on those grounds, the Supreme Court defined the proper scope that should be applied by the courts when a retaliation action or harm occurs.

### Supreme Court

The Supreme Court concluded that the anti-retaliation provision does not confine the actions or harms it forbids to those related to the employment or occur at the workplace. Moreover, it stated that the anti-retaliation provision protects an individual not from all retaliation, but from retaliation that produces an injury or harm. The plaintiff must show that a reasonable employee would have found the challenged action materially adverse, “which in this context means it well might have ‘dissuaded a reasonable worker from making or supporting a charge of discrimination.’”

### Retaliatory action

In this case the reassignment of duties was considered as a retaliatory action. But the reassignment of duties is not always actionable; it depends on the circumstances of the particular case.

The suspension without back pay was also considered materially adverse in this case, even though the employee was reinstated with back pay. The decision was based in the fact that the fear of economic hardship could induce an aggrieved employee to accept substandard conditions of employment. ■



## BANKING

## Powers of banks in Puerto Rico to be extended

**S**enate Bill 814, pending the governor's signature at press time, adopts what is known as a "wild card" provision, which will permits banks operating in Puerto Rico to engage in any activity allowed to national banks.

### Banking business

Both the Puerto Rico Bank Act and the National Bank Act contain lists of activities that banks may engage in. In addition to what is to be expected, like lending money and receiving deposits, banks may invest in certain types of stock and may own real estate for particular purposes. Both laws also have a catch-all provision, the likes of "any other related activity." Of course, it is the government regulators who decide what activities are so related and which are not. In the case of Puerto Rico, the regulator is the Commissioner of Financial Institutions; and the Comptroller of the Currency is his federal counterpart for national banks.

### Amendments

Sometimes the text of the law itself limits the scope of the power of a regulator to attach an activity to traditional banking acts. An amendment to the law is essential in these cases; although on occasions, as will be seen later, regulators—particularly the feds—can be enormously creative.

In order to keep up with the Joneses, state legislatures came up with the *wild card* clause idea. The term "wild card" was originally used in Poker and other card games to denote a card that could stand for any other, but has since evolved to depict any unidentified or unpredicted factor. Why should national banks be allowed to do things that states did not let their local boys do? Since nothing could be done about that (states have no jurisdiction over national banks), the solution was to adopt by reference whatever the Comptroller finds to be acceptable, without having to amend the state's banking statute every time.

### Senate Bill 814

Senate Bill 814 does just that. After the long list of permitted acts, it inserts a provision that sanctions that banks on the island may engage in "any activity expressly authorized to a national bank by federal law or administrative ruling of the Office of the Comptroller of the Currency," albeit subject to:

- the same limitations as federal law or the Comptroller may impose,
- any local licensing requirement applicable to the activity, and
- giving notice to the Commissioner of Financial Institutions (who may within 30 days condition the activity).



## Real estate

One of the areas in which the Puerto Rico Bank Act and the National Bank Act are very specific is ownership of real estate. In the case of Puerto Rico, banks on the island may hold real estate only for the following purposes, and no other:

- establish their offices and branches (although they are allowed to lease out unneeded space—like the top 16 floors);
- serve as employee residences (makes you think of the old Royal Bank bachelors' quarters on the top floor of San Juan branch); and
- receive property in mortgage foreclosure procedures, deeds in lieu of foreclosure, or in payment of unsecured debt.

Banks must dispose of the latter group in five years, subject to extension by the Commissioner.

Can a bank own a hotel (other than one repossessed)? It's not listed. But keep reading.

## Hotels

On December 5, 2005, the Comptroller of the Currency issued *Interpretative Letters* # 1044 and 1045, ruling that a national bank can legally develop a 150-room hotel to provide lodging for its out-of-area visitors. These visitors were identified as employees, customers, vendors, shareholders and directors. The ruling pointed out that the visitors in question routinely visited the city on bank-related business; and that prior to the ruling they were housed in commercial hotels. The bank intended to use more than 50% of the occupied rooms to lodge such visitors; and it aimed to let the rest of the rooms to the general public. The 150 rooms were explained as necessary because that was the smallest number of rooms that the hotel management company would agree to manage.

The Comptroller indicated that the hotel was acceptable because such building “qualifies as bank premises and, therefore, is permissible under 12 U.S.C. § 29 [of the National Bank Act].” “The hotel would be constructed on existing bank premises, currently used as a parking lot and adjacent to the bank’s corporate headquarters in downtown. The bank would remain the sole owner of the real estate and would be the sole owner of all improvements resulting from the development.” “The Bank would . . . contract with a national hotel management company to manage the hotel.”

The bank’s business objectives were described as reducing its annual lodging expense for visitors, and improving the overall quality of their visit.

## Condo

A similar ruling—*Interpretative Letter* # 1042—sanctioned ownership of a condominium building to house the same type of visitors (auditors were added to the list this time). ■



Got it?

## FDIC joins BIF and SAIF to form DIF

**B**IF" was the "Bank Insurance Fund" and "SAIF" was the "Savings Association Insurance Fund," both administered by the "FDIC," which, of course, stands for "Federal Deposit Insurance Corporation."

### Deposit insurance

As their names imply, BIF insured the deposits in commercial banks, while SAIF did likewise for those held in federal savings associations (remember them?).

### FIRREA

BIF and SAIF were the offspring of the 1989 *Financial Institutions Reform Recovery and Enforcement Act* (known as "FIRREA"). Through FIRREA Congress did away with the Federal Savings and Loan Insurance Corporation (the entity that then insured savings associations' deposits) and transferred the

money to the new SAIF fund, to be administered by the FDIC. FIRREA also created BIF to keep the funds apart.

### Merger

The *Federal Deposit Insurance Reform Act of 2005* required that the FDIC merge both funds not later than July 1, 2006; which it has done under the name of "Deposit Insurance Fund," or "DIF." The FDI Reform Act was the same law that raised the limit on deposit insurance for retirement accounts from \$100,000 to \$250,000, and indexed the amount to inflation. ■

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