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Restructuring a Sovereign Debtor's Contingent Liabilities

Lee C. Buchheit
Mitu Gulati

Abstract

How should the contingent liabilities of a sovereign be treated in a general restructuring of the debts of that sovereign? This question has played only a minor role in past sovereign debt restructurings because the size of such contingent liabilities has in most cases been small. In recent years, however, slathering government guarantees on third party debt has become the tool of choice for many countries in their efforts to quell an incipient panic in their financial markets. Some of those sovereigns are now, or may soon be, in the position of needing to restructure their debts. Ignoring large contingent liabilities in a sovereign debt restructuring may plant a land mine on the road to debt sustainability once the restructuring closes. That said, the answers to the questions of whether and how to restructure contingent liabilities are not obvious. Is the restructurer to assume that some, all or none of those contingent liabilities will eventually wind up as direct claims against the sovereign? Even if the underlying instrument can be successfully restructured, the guarantee will typically stand as an independent obligation of the guarantor that will require separate treatment in the restructuring.

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Restructuring a Sovereign Debtor's Contingent Liabilities

Lee C. Buchheit[1]
Mitu Gulati

How should the contingent liabilities of sovereigns (like government guarantees of the debts of State-owned enterprises or even private sector entities) be treated in a general restructuring of the debt of that sovereign? This question has played only a minor role in the sovereign debt restructurings of the last thirty years because the aggregate size of such contingent liabilities -- in comparison to the overall debt stocks -- has in most cases been very small.[2] Slathering explicit government guarantees on third party obligations, however, has recently become the tool of choice for many countries in their efforts to quell an incipient panic in their financial markets.[3] In addition, implicit government guarantees (the warm-arm-wrapped-over-the-shoulder; the wink; the nod; the unvoiced "all will be well in the end" glance in the direction of the creditors) are now ubiquitous. Systemically important financial institutions, state-owned or sponsored enterprises and sub-sovereign political units may all borrow under the shadow of an implicit sovereign guarantee. Inevitably, some of those sovereigns will need to restructure their own debts one day and this component of their balance sheets, or perhaps better said their off balance sheets, will need to be addressed.

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[1] Cleary Gottlieb Steen & Hamilton LLP (New York) and Duke University School of Law, respectively. For comments, thanks to Juan Pablo Bohoslavsky, Carlos Esposito, Anna Gelpern, Yuefen Li, Rodrigo Olivares-Caminal, and Ignacio Tirado.

[2] The primary treatises that address sovereign restructurings devote little attention to the matter of how to restructure sovereign guarantees. *See, e.g.,* Mauro Megliani, SOVEREIGN DEBT: GENESIS-RESTRUCTURING- LITIGATION (2012 draft; on file with authors); Rodrigo Olivares-Caminal, LEGAL ASPECTS OF SOVEREIGN DEBT RESTRUCTURING (2010); Philip R. Wood, INTERNATIONAL BONDS, LOANS, GUARANTEES, LEGAL OPINIONS (2007).

[3] Our primary source for data on this topic is a 2012 Report by Houlihan Lokey, available at the website of the Institute for International Finance (http://www.iif.com/events/recent/); *see also* Dalvinder Singh & John Raymond Labrosse, *Developing a Framework for Effective Financial Crisis Management,* 2 OECD J. (2012) (reporting data on the increase in contingent liabilities in the EU as a function of the 2007 financial crisis).

This problem is not limited to sovereigns. States, provinces and municipalities can also issue guarantees, often with little or no public awareness that the local taxpayer's credit has been engaged to repay the debt until it is too late.[4]

The Motivations

The traditional motivation for issuing a sovereign guarantee is to allow the beneficiary to piggy-back on the credit standing of the sovereign. Entities that could not by themselves borrow in the credit market, or a project that would not, on a stand-alone basis, have been bankable, are thus given access to financing at tolerably low interest rates. The alternatives for the sovereign often boil down to two -- finance the enterprise/project through a sovereign borrowing followed by a relending to the enterprise/project, or wrap a sovereign guarantee around a direct borrowing by the debtor. The former places the liability squarely on the shoulders and the balance sheet of the sovereign, driving up debt-to-GDP ratios and requiring compliance with legal restrictions (such a statutory debt ceilings) on sovereign borrowing. The latter can often be accomplished off-balance sheet and outside the ambit of legal restrictions.

The dangers of unrestricted sovereign guarantees, and the need for greater transparency in governmental accounting for these arrangements, are gradually receiving more attention. UNCTAD's recently issued Principles on Responsible Sovereign Lending and Borrowing expressly address the problem. Principle 11 states:

> Disclosure and publication
>
> Relevant terms and conditions of a financing agreement should be disclosed by the sovereign borrower, be universally available, and be freely accessible in a timely manner through online means to all stakeholders, including citizens. Sovereign debtors have a responsibility to disclose complete and accurate information on their economic and financial situation that conforms to standardized reporting requirements and is relevant to their debt situation. Governments should respond openly to requests for related information from relevant parties.

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[4] See Mary William Walsh, *Crushed by Promises -- Bonds Arranged in Obscurity Return to Haunt Taxpayers*, N.Y. TIMES, B1, B6, June 26, 2012:

> The "full faith and taxing power" of communities, a solemn pledge, was being used to guarantee revenue bonds for non-essentials like solar-power projects, apartment buildings and a soccer stadium -- things bailout weary taxpayers might walk away from if the guarantees were called.

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> Legal restrictions to disclosing information should be based on evident public interest and to be used reasonably.

And Implication 3 to Principle 11 explains:

> Debtors should make public disclosure of their financial and economic situation, providing among others the following information: (i) accurate and timely fiscal data; (ii) level and composition of external and domestic sovereign debt including maturity, currency, and forms of indexation and covenants; (iii) external accounts; (iv) the use of derivative instruments and their actual market value; (v) amortization schedules and, (vi) *details of any kind of implicit and explicit sovereign guarantees*. Sovereign borrowers may wish to consider disclosing information by way of international norms, such as the IMF's Special Data Dissemination Standard.[5]

The European Union Council issued a Directive in 2011 with this text:

> For all sub-sectors of general government, Member States shall publish relevant information on contingent liabilities with potentially large impacts on public budgets, including government guarantees, non-performing loans, and liabilities stemming from the operation of public corporations, including the extent thereof.
>
> Member States shall also publish information on the participation of general government in the capital of private and public corporations in respect of economically significant amounts.[6]

The Eurozone financial crisis that started in 2009 added a new twist on the motivation for sovereign guarantees. Some of the Eurozone peripheral countries like Greece began to experience heavy outflows of bank deposits. The resources of the local central banks were unable to supply adequate liquidity to the banking systems. The solution? Local banks would

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[5] UNCTAD, 2012 Principles on Promoting Responsible Sovereign Lending and Borrowing, Principle 11 (Disclosure and Reporting), Implication 3 (emphasis added). Other principles also touch upon the issue, such as Principle 4 (Responsible Credit Decisions), Implication 3 and Principle 13 (Adequate Management and Monitoring). The text of the Principles is available at http://www.unctad.info/upload/Debt%20Portal/Principles%20drafts/SLB_Principles_English_Doha_22-04-2012.pdf

[6] *See* Council Directive on 8 November 2011 on Requirements for Budgetary Frameworks of the Member States (November 23, 2011, Article 14, Part 3).

issue debt instruments to themselves, obtain a government guarantee and then use the instruments as collateral for loans from the European Central Bank. The sovereign guarantee in this context does not serve the conventional purpose of persuading a creditor to lend to an otherwise credit-impaired debtor; after all, in these situations the creditor and the debtor are the same entity -- the issuing bank. The guarantee is simply a passport into the ECB discount window.[7]

The Challenge

The central problem with contingent liabilities is that they are contingent. Neither the beneficiary of the guarantee (the creditor) nor the sovereign guarantor will ordinarily know at the outset whether the primary obligor (the borrower) will eventually be able to repay the debt on its own.[8]

Therein lies the challenge for the sovereign debt restructurer. If one forces the beneficiary to call on the sovereign guarantee as a means of bringing the liability into the main restructuring in order to treat it in a manner identical to other debts, the sovereign may be taking on its own shoulders a liability that, left on its own, would never have emerged from the cocoon of contingency. Why? Because the primary obligor may have paid it at maturity without government assistance.

Leaving large contingent liabilities out of the main debt restructuring, however, may plant a land mine on the road to debt sustainability once the restructuring closes. Is the restructurer to assume that (i) some, (ii) all or (iii) none of those contingent liabilities will eventually wind up as direct claims against the sovereign? The answer to that question may dramatically affect whether the main debt restructuring will achieve its primary aim of returning the country to a sustainable debt position.

For its part, the creditor/beneficiary of a state guarantee has a right to feel more aggrieved about being dragged into a sovereign debt

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[7] *See ECB Caps Use of State-Backed Bonds as Collateral*, REUTERS, July 3, 2012, available at http://uk.reuters.com/article/2012/07/03/uk-ecb-collateral-idUKBRE8620V920120703; Sonia Sirletti & Elisa Martinussi, *Italy Banks Said to Use State-Backed Bonds for ECB Loans*, BLOOMBERG, Dec. 21, 2011, available at http://www.bloomberg.com/news/2011-12-20/italian-banks-are-said-to-use-state-guaranteed-bonds-to-receive-ecb-loans.html

[8] But sometimes they will know. In the Greek debt restructuring of 2012 described below, for example, 36 bonds guaranteed by the Hellenic Republic (but only 36 out of hundreds of state-guaranteed obligations) were declared eligible to participate in the restructuring of the Republic's debt. One criterion used in selecting these bonds was a general recognition that the primary obligors did not have the capacity to service the debts out of their own resources. For details on the Greek restructuring, including regarding the guaranteed bonds, see Jeromin Zettelmeyer, Christoph Trebesch & Mitu Gulati, *The Greek Debt Exchange: An Autopsy* (2012 draft), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2144932

restructuring than does a direct creditor of the State. The beneficiary of such a guarantee by definition holds "two name paper"; the beneficiary enjoys the credit of both the State and the primary obligor. By roping the beneficiary of a State guarantee into a debt workout, the additional credit protection resulting from the independent obligation of the primary obligor to pay the debt is lost.

The Options

There are at least four possible ways of treating explicit contingent liabilities in a debt restructuring of the sovereign:

1. Ignore them. Under this approach, the sovereign deals only with guarantees that are actually called by the beneficiary before the debt restructuring closes. No pressure is put on beneficiaries to call the guarantees; no effort is made to force the liabilities into the restructuring.

2. Entice them. The sovereign may declare that paper bearing its guarantee will be eligible to be tendered in the restructuring transaction. Naturally, this leaves it in the discretion of the holders whether to tender now or wait and take their chances when the scheduled maturity date of the paper arrives. The sovereign may attempt to entice holders into the restructuring by offering them a small premium over the consideration being offered to direct creditors. Such a sweetner can be justified as the consideration paid to the beneficiary of a State guarantee in return for the beneficiary's release of the primary obligor.

3. Pressure the beneficiaries to call. Careening to the other extreme, the sovereign debtor could attempt to pressure the beneficiaries to call on their State guarantees in order to bring the resulting -- now actual, no longer contingent -- liabilities into the sovereign's debt restructuring. Presumably, this could only be done by threatening to repudiate any post-closing call of the guarantee. In the case of guarantees that are governed by the law of the sovereign's own jurisdiction (and our research suggests that a surprising number of Eurozone sovereign guarantees specify local law for the guarantee even where the underlying instrument is governed by foreign law), pressure can be applied by passing a law mandating the terms on which the guarantee will be settled.

4. Call or don't call; you will receive the same consideration. The fourth option is to tell beneficiaries that they are free to call or not as they choose, but if they elect to call on the State guarantee after the debt restructuring closes, the sovereign will honor it by delivering consideration having a net present value equal to what the creditor

would have received had the claim been brought into the main restructuring.

The Problems

Each of these options has its own set of problems.

Leaving the guarantees out of a restructuring altogether (Option 1) places the sovereign at risk that the financial predicates underlying the debt restructuring could be undone. A large slug of liabilities coming onto the balance sheet of the sovereign unexpectedly in the future could render obsolete the debt sustainability analysis upon which the financial terms of the main restructuring was based. This is a risk both to the sovereign debtor and to the other creditors that join the restructuring.[9]

But forcing the beneficiaries to call on the explicit guarantees (Option 4), even if legally possible (which it probably won't be), compels the beneficiaries to give up their claims on the primary obligors. As noted above, this works a special hardship on guaranteed creditors in comparison with their direct creditor counterparts.

Enticing the beneficiaries to join the restructuring by offering them a sweetner (Option 2) may bring in some of the beneficiaries, but probably not all of them unless the sweetener is embarrassingly sweet.

[9] The existence of guarantees that pop up after a debt restructuring has closed can be an embarrassment, or worse, for the debtor country. This happened in Belize shortly after that country's debt restructuring closed in 2007. *See Belize Bank: A $10 m Mystery*, THE ECONOMIST, May 15, 2008, available at http://www.economist.com/node/11377008. A heated scandal ensued. Local activists in Belize sought to block payments on the guarantee (which had quickly become direct obligations of the sovereign because the underlying obligor was unable to pay). The creditor, Belize Bank, however, took the position that it was entitled to full payment and the Government subsequently conceded this in arbitration proceedings in the United Kingdom.

Finally, telling beneficiaries that they will receive the same consideration in settlement of their guarantees regardless of when they may call on those guarantees (Option 3) may not be a credible threat. If things begin to improve in the debtor country after the restructuring closes, will the government really be eager to default on an item of guaranteed debt soon thereafter? Probably not.

The Practice

There has been no consistent practice in previous sovereign debt restructurings on this issue. The workouts of commercial bank sovereign loans in the 1980s generally followed Option 1 above. Beneficiaries were not required, nor even encouraged, to call on their sovereign guarantees.[10]

In its 2012 debt restructuring, Greece invited, but did not attempt to coerce, holders of a small segment of State guaranteed debt to participate in the restructuring (Option 2). See "The Greek Case" below.

When the Highly Indebted Poor Country initiative got under way in the mid 1990s, the HIPC rules required that all contingent liabilities of the debtor countries be brought into the settlement (Option 3). To our knowledge, however, the HIPC rules did not confide to the sovereign debtors how they were to achieve this if a creditor/beneficiary simply declined the offer.

At least one country has chosen Option 4 (promise equal treatment of the creditor whenever the guarantee may be called). Grenada, in its debt restructuring of 2005, had outstanding government guarantees in an amount equal to 10% of the country's total stock of debt. Grenada could not legally force the beneficiaries to call on the guarantees, but it did expressly warn the beneficiaries that they should expect no better treatment if they elected to stay out of the restructuring and call on the guarantee after the restructuring closed. As described in a 2006 article:

[10] The telex sent by Mexico addressed to "The International Banking Community" on December 8, 1982 (at the very beginning of the global debt crisis of the 1980s) contained draft "Restructure Principles". The debt subject to the restructuring referred to principal maturities falling due within a specified time period, "but, in the case of any Debt which arises from a guarantee, endorsement, aval or similar instrument, only such payment obligations which are invoked and payable" during that time period. This practice appears to have been followed by the other sovereign debt restructurings of that era.

> Grenada's solution to this dilemma had three elements[11]:
>
> ● Beneficiaries of all government guarantees were given the option to call upon their guarantees at any time prior to the expiration date of the [restructuring exchange] offer. The face amount of any guarantee called by a beneficiary would then be exchanged, at par, for the new bonds being issued in the exchange.
>
> ● A beneficiary calling a guarantee in these circumstances was required to subrogate the Government to all of the beneficiary's claims against the primary obligor and any collateral securing the debt of the underlying project.
>
> ● If a beneficiary elected *not* to call on a government guarantee during the offer period, however, the disclosure document for the exchange warned that any subsequent call on the guarantee would be discharged by the delivery to the beneficiary of the same bonds being issued in the exchange on terms comparable to those reflected in the exchange offer (or, at the Government's option, by delivery of other consideration having an equivalent value).

The Greek Case

In the spring of 2012, the Hellenic Republic restructured approximately €206 billion of its bond indebtedness in the hands of private sector creditors, the largest sovereign debt restructuring in history. More than 130 separate series of bonds were declared eligible to participate in this restructuring including 36 series of bonds bearing the express guarantee of the Hellenic Republic. The Hellenic Republic offered no special compensation (over and above the consideration offered to holders of direct Hellenic Republic bonds) to the holders of guaranteed bonds in return for the surrender of the holders' claims against the primary obligors, nor were any contractual measures taken to coerce the holders of the guaranteed bonds into participating in the transaction.

[11] *See* Lee C. Buchheit & Elizabeth Karpinski, *Grenada's Innovations,* 4 J. INT'L BANKING AND REG. 227, 231 (2006).

At the time of this debt restructuring, the Hellenic Republic had put its guarantee on hundreds of outstanding debt instruments (loans and bonds), but only 36 were declared eligible to participate in the 2012 restructuring. One of the criteria used by the Republic to select these 36 series of bonds was their classification by Eurostat (the statistical office of the European Union) as "central government debt" for Eurostat reporting purposes.

Preventive Measures

What preventive measures could a sovereign take to deal with this problem? One possible step would be for the sovereign to insert into its standard form of guarantee a contractual provision to the effect that the guarantee will be deemed automatically called (or will be callable at the option of the sovereign guarantor) in the event of the announcement of a generalized debt restructuring by the sovereign. We have never seen such a provision, however, and we doubt whether it would be well received by prospective beneficiaries of the guarantees.

Alternatively, a sovereign could attempt to preserve the economics of "two-name paper" by telling a beneficiary who joins the sovereign's debt restructuring that if the exercise by the sovereign of its subrogation rights against the primary obligor produces a recovery after the restructuring closes, the proceeds of that recovery will be paid first to the beneficiary up to the amount of the financial loss it realized by joining the restructuring, and thereafter to the sovereign. The exercise of these subrogation rights, however, ought logically to be placed in the hands of a third party such as a trustee. The sovereign cannot be trusted to pursue the primary obligor aggressively (particularly if it is a state-owned enterprise), while the beneficiary would have no economic incentive to pursue a primary obligor to recover anything more than the beneficiary itself could claim as its make-whole amount.

A third option would be for the sovereign to include in its guarantees some form of collective action clause that would permit a supermajority of the beneficiaries of that guarantee to agree to a settlement of the guarantee as part of the sovereign's main debt restructuring. A decision taken pursuant to such a collective action clause would then bind any dissenting beneficiaries of the guarantee.

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