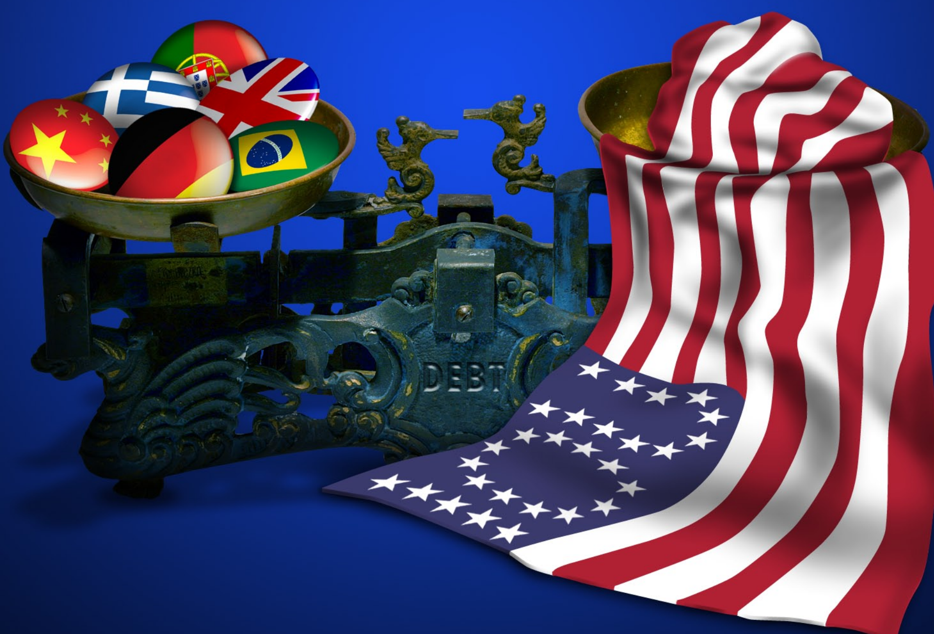
IS U.S. GOVERNMENT DEBT DIFFERENT?



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Direct and Indirect U.S. Government Debt

Steven L. Schwarcz[1]

My presentation focuses on two issues. First, I comment on the draft paper by Professor Charles W. Mooney, Jr., "United States Sovereign Debt: A Thought Experiment on Default and Restructuring," which explores the restructuring of U.S. Treasury Securities ("Treasuries")—the classic form of direct U.S. government debt. Second, I discuss an important type of indirect U.S. government debt—financing raised by the federal government through special-purpose entities (SPEs)—and the possible consequences of such indirect financing.

I. Comments On Professor Mooney's Paper

A. Specific Comments.

Let me begin with specific comments, most critically what terms of the debt should be restructured. Prof. Mooney's paper only mentions restructuring the principal amount of Treasuries, ignoring their interest rate and maturities. Extending debt maturities, however, could help the government avoid default by readjusting debt repayment

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to revenues. At the same time, it arguably would be more constitutionally permitted than reducing the principal amount,[2] especially if the extended maturities accrue interest at a market rate so that, economically, there would be no "actual loss."[3] Extending debt maturities would also be less politically and commercially disruptive than reducing the principal amount, because the debt would eventually be honored.

Prof. Mooney may wish to compare the ability of large Treasuries holders to quickly exit the market with the increasing corporate debt-restructuring problem caused by distressed-debt trading. Not only are large investors able to quickly divest their claims, at a discounted price. More significantly, buyers of those claims often include opportunistic investors, such as hedge funds, who increasingly have been trying to "game" the system for short-term advantage. This has been undermining some of the long-term debtor restructuring goals of the federal Bankruptcy Code.[4]

Regarding post-default enforcement of Treasuries, Prof. Mooney's paper observes that the offering circular for Treasuries provides, with respect to the commercial book-entry system, that the federal government does not "have any obligation to any person or entity that does not have an account with a Federal Reserve Bank." But query whether that restriction might itself be unconstitutional because it "questions" enforceability of the debt. Moreover, if that restriction were held to be unconstitutional, at least two additional questions would arise: Would investors be deemed to, and could they even, waive the unconstitutionality?

I am not convinced, as is Prof. Mooney, that default should be equated with invalidity. Section Four of the Fourteenth Amendment provides that the "validity of the public debt of the United States . . . shall not be questioned."[5] Prof. Mooney observes that the plurality

2 *Cf. infra* note 5 and accompanying text.
3 *Perry v. United States,* 294 U.S. 330, 358 (1935).
4 *See* Harvey Miller, *Keynote Address: Bankruptcy And Reorganization, Through The Looking Glass Of 50 Years (1960 – 2010)*, presented March 12, 2012, at the annual Induction of Fellows of the American College of Bankruptcy, United States Supreme Court, at 12-13 (expressing concern over distressed-debt trading).
5 U.S. CONST. amend. XIV, §4.

in Perry held that Congress lacks the authority to "alter or destroy" the federal government's obligations to repay borrowed funds. But to question the "validity" of public debt appears more closely tied to questioning the premise of the debt. One could distinguish that from changing when the debt is payable or paid, for example. When a debtor refuses to pay, it acknowledges the debt but does not pay. In contract law, a parallel to this would be the distinction between the legality of a contract and breach of a contract.

Finally, Prof. Mooney raises the possibility of the federal government selectively defaulting on debt held by some but not all foreign nations. Query whether that might constitute unfair discrimination by the federal government in violation of the Most-Favored-Nation clause of the WTO agreement, resulting in trade sanctions under the WTO dispute settlement regime?[6]

Next, I consider more general questions raised, or at least inspired, by Prof. Mooney's paper.

B. More General Comments.

A critical question is the extent to which the federal government might be able to achieve a consensual restructuring of its Treasuries. The biggest obstacle to a debtor attempting to consensually restructure its debt is the holdout problem: that one or more creditors may strategically hold out from agreeing to a reasonable debt-restructuring plan, hoping they either will receive full payment of their claims or that the imperative of other creditors to settle will persuade those creditors to allocate to the holdouts more than their fair share of the settlement.[7]

In order to help solve the holdout problem, sovereign nations often insert so-called collective action clauses (CACs) into their debt instruments. These clauses permit a super-majority vote by holders of

6 It also should be noted that some recent bilateral Free Trade Agreements negotiated by the U.S. government have included Most-Favored-Nation (MFN) treatment clauses with regard to sovereign debt issued by the parties.
7 Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy,"* 59 UCLA L. REV. 322, 328 (2011).

those instruments to change the key terms of the instruments.[8] I have found no evidence, however, that Treasuries contain collective action clauses.[9] The federal government might wish to consider the pros and cons of including these types of clauses in future issuances of Treasuries—a potential negative being that even acknowledging the possibility of the need to restructure its debt (by including CACs) might increase financing cost and panic the Treasuries market.

Absent collective action clauses, the federal government can still solve the holdout problem at a later date, if and when needed. In a state-debt context, I have argued that a "minimalist" approach to government debt restructuring could be used to help solve this problem (possibly without significantly increasing the cost of debt) by legislatively imposing supermajority voting by classes of claims.[10] Logically, the federal government could legislate a similar solution to the holdout problem.

The federal government should be able, constitutionally, to enact such legislation. The Constitution's Contracts Clause applies only to state, not federal, action. And, as explained below, I do not believe such legislation—even if retroactively applied to Treasuries or other forms of federal government debt—would constitute a "taking" under the Fifth Amendment.

Certainly Congress has power under the Bankruptcy Clause of the Constitution to retroactively impair contractual obligations.[11] I would not rely on that power, however, because it is questionable (as Professor Mooney acknowledges) whether the Bankruptcy Clause

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8 Steven L. Schwarcz, *Sovereign Debt Restructuring Options: An Analytical Comparison*, HARV. BUS. L. REV. 301 (Fall 2011 issue), also available at http://ssrn.com/abstract=1872552.

9 Although one conference participant had vaguely recollected that federal law under which Treasuries are issued might reserve the federal government's right to amend the terms of outstanding Treasuries, neither that participant nor I could find the source of that right. *Cf.* 31 C.F.R. §356.33(c) (enabling the federal government to change the terms, pre-issuance, of new issues of Treasuries). Newly issued Treasuries could include provisions that enable the federal government to amend their terms, but that likely would greatly increase government financing costs.

10 *See A Minimalist Approach to State "Bankruptcy," supra* note 7.

11 Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188 (1902).

would apply to federal government debt. But even without that power, the legislation's retroactive application should not violate the Fifth Amendment because retroactive federal legislation is constitutional (and not a "taking") so long as it does not completely destroy property rights in a way that the affected parties could not have anticipated.[12] The consensual relinquishment of rights under supermajority voting should not constitute complete destruction of creditor rights. The only right that is completely destroyed is an individual creditor's right to be a holdout; that right, however, is arguably an unreasonable private expectation that should not be protected.[13]

My other general comment responds to questions raised in the conference of how the federal government might accelerate revenues in order to pay maturing Treasuries. One such approach might be securitization, in which the government securities—or monetizes—future revenues. In a famous example, David Bowie securitized the revenues coming due under his future song royalties. The federal government might similarly consider securitizing future tax revenues, for example.[14] To the extent a federal-revenue securitization is structured under specific enabling legislation, the legislative certainty would reduce financing costs compared to corporate securitizations, which rely on an imperfect patchwork of case-law, statutes, scholarly articles, and soft law.[15]

Next consider an important type of *indirect* U.S. government debt—financing raised by the federal government through special-purpose entities.

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12 *See* E. Enters. v. Apfel, 524 U.S. 498, 528–29 (1998) ("[L]egislation might be unconstitutional if it imposes severe retroactive liability on a limited class of parties that could not have anticipated the liability . . . ."); United States v. Riverside Bay Homes, 474 U.S. 121, 128 n.5 (1985); Speckmann v. Paddock Chrysler Plymouth, Inc., 565 F. Supp. 469 (E.D. Mo. 1983).

13 *See* Jan G. Laitos, *Legislative Retroactivity,* 52 WASH. U. J. URB. & CONTEMP. L. 81, 100 (1997).

14 By way of analogy, my experience is that some municipalities, over the past decade, have been securitizing their tax revenues.

15 *See generally* STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (3d ed. 2002 & supplements).

II. Federal Government Financing Through SPEs

A. Introduction.

Restructuring Treasuries would be only part of the U.S. government debt-restructuring picture. I have been examining the growth of federal government financing through the use of special-purpose entities ("national SPEs").[16] It is possible this growth not only will continue but accelerate. By way of analogy, most U.S. state debt is no longer in the form of general obligation bonds but debt issued by state-sponsored SPEs.[17]

Consider the following examples of national SPEs.

B. Taxonomy.

1. Government Sponsored Enterprises (GSEs).

The most prominent national SPEs are the so-called government sponsored enterprises, such as Fannie Mae and Freddie Mac (used for promoting home ownership).

2. SPEs Used in the 2008 Financial Crisis.

In order to stabilize and bring liquidity back to the commercial paper markets during the 2008 financial crisis, the U.S. Federal Reserve created, among other facilities, the Commercial Paper Funding Facility ("CPFF") to operate as a lender of last resort for those markets. Because the Fed traditionally used its lender-of-last-resort powers

16 Steven L. Schwarcz, "Special-Purpose Entities in National Finance" (draft on file with author).

17 *Cf.* Steven L. Schwarcz, *The Use and Abuse of Special-Purpose Entities in Public Finance*, 97 Minn. L. Rev. (forthcoming 2012, issue no. 2) (discussing SPEs used for state-government financing); Cheryl D. Block, *Congress and the Accounting Scandals: Is the Pot Calling the Kettle Black?*, 82 NEB. L. REV. 365, 435-42 (2003) (identifying the problem of national SPEs). Also compare Jonathan Rosenbloom, *Can a Private Corporate Analysis of Public Authority Administration Lead to Democracy,* 50 N.Y.L. SCH. L. REV. 851 (2005-2006) (raising normative questions about state SPEs).

under Section 13(3) of the Federal Reserve Act to only make loans to banks, it structured the CPFF as a series of Fed loans to State Street Bank and Trust Company, which then made back-to-back loans to a newly-created special-purpose entity, CPFF LLC. CPFF LLC used the back-to-back loan proceeds to purchase commercial paper from corporations and other commercial paper issuers.[18]

Similarly, the Money Market Investor Funding Facility (MMIFF) was designed to provide liquidity to U.S. money market investors during the financial crisis. Under the MMIFF, the Federal Reserve Bank of New York could provide senior secured funding to a series of special-purpose entities to facilitate an industry-supported private-sector initiative to finance the purchase of eligible assets from eligible investors.[19]

3. Other National SPEs.

I also have been examining the Tennessee Valley Authority (TVA) and other "authorities" and "public benefit corporations," as well as SPEs used to finance military aircraft, including through leasing.

C. Identifying Possible National-SPE Abuses.

National-SPE financing can strike at the very heart of our system of representative government, placing into question the fiscal integrity of public governance. I have been analyzing, both descriptively and normatively, their monitoring, governance, and accountability and the transparency of their debt liabilities.[20] Although the use of national SPEs is not inherently wrongful, SPEs have at least as great, if not greater, potential to be abused in public finance than in corporate finance. Several factors contribute to this.

18 Tobias Adrian, Karin Kimbrough, & Dina Marchioni, *The Federal Reserve's Commercial Paper Funding Facility,* FRBNY ECON. POLICY REV. 423 (June 2010). See also FRB: OTHER LENDING FACILITIES - CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET, http://www.federalreserve.gov/monetarypolicy/bst_lendingother.htm (last visited Apr 24, 2012).
19 FRB: MONEY MARKET INVESTOR FUNDING FACILITY, http://www.federalreserve.gov/monetarypolicy/mmiff.htm (last visited Apr 24, 2012).
20 I have not considered, however, national-SPE debt restructuring questions per se.

Reduced transparency of national SPEs, like corporate SPEs, can undermine financial integrity. Because national-SPE debt is not technically a legal obligation of the federal government, the government does not have to disclose that debt in its financial statements and budget. This lack of disclosure can be misleading; the federal government may have compelling economic and reputational motivations to stand behind that debt, especially if the national SPEs engage in providing critical government services—as occurred when the federal government recently backstopped Fannie Mae and Freddie Mac's obligations—or if the federal government's failure to backstop the debt might cause a downgrading of ratings on federal government debt. Because of these motivations, the federal government effectively is making undisclosed de facto guarantees.

Off-balance-sheet financing can also trigger systemic consequences.[21] Its use by corporate SPEs is seen, for example, as a contributing cause of the 2008 financial crisis.[22] The lack of transparency can also have other serious consequences, such as preventing debt from being priced correctly based on national fiscal risk. Moreover, unlike corporate SPEs, reduced transparency of national SPEs can undermine constitutional and democratic legitimacy.

21 *Cf.* Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349, 1359 (2011) (observing that Enron's use of SPEs could have triggered a systemic financial crisis if Enron's viability had more closely correlated with the viability of other financial institutions).

22 *See, e.g.,* Joint Economic Committee, U.S. Congress, *The U.S. Housing Bubble and the Global Financial Crisis: Vulnerabilities of the Alternative Financial System (2008), available at* http://jec.senate.gov/republicans/public/?a=Files.Serve&File_id=b54b89ff-649e-4e45-93f0-395d1f507762; *What Went Wrong*, ECONOMIST, Mar. 22, 2008, at 79, *available at* http://www.economist.com/node/10881318; Niall Ferguson, *Wall Street Lays Another Egg,* Vanity Fair, Dec. 2008, at 190; Mark Jickling, *CRS Report for Congress: Averting Financial Crisis* (2008), available at http://fpc.state.gov/documents/organization/103688.pdf; Martin Neil Baily et al., *The Origins of the Financial Crisis* (2008), available at http://www.brookings.edu/~/media/research/files/papers/2008/11/origin%20crisis%20baily%20litan/11_origins_crisis_baily_litan

D. Assessing the Propensity for Abuse.

The federal government may have a greater inherent propensity than corporations to want to use SPEs to raise off-balance-sheet and off-budget debt: unlike corporations, the federal government cannot "fail" in the sense of being forced to liquidate, so it lacks that deterrent against non-transparent use of SPEs.

National SPEs are also more likely to be misused than corporate SPEs because, as I explain in my forthcoming publication, public finance is more susceptible than corporate finance to monitoring failures.[23]

E. Restraining National-SPE Abuses.

How should national-SPE abuses be restrained and, whatever the restraints, how should they be implemented? Regarding the first question, regulatory efforts to reform state and corporate SPEs suggest four overarching organizing principles: improving transparency of the SPE debt; improving monitoring of the SPEs; limiting the SPE debt; and improving SPE governance.[24] I elsewhere explain how these principles could, and arguably should, be applied to national SPEs.[25]

Regarding the second question (How should restraints be implemented?), the clearest approach would be for the federal government to enact an oversight law for its own SPEs. But why would the federal government do that if the result is, effectively, to more clearly publicize its financial problems?

23 *See* "Special-Purpose Entities in National Finance," *supra* note 16. In that article, I explain that the federal government is monitored by citizens and creditors whereas corporations are monitored by shareholders and creditors. Creditors monitor only to the limited extent of their negotiated covenants but, unlike corporate debt, there are no covenants in federal debt. Therefore creditor monitoring of national-SPE debt is likely to be de minimis compared to creditor monitoring of corporate SPE debt. The federal government is also monitored by citizens, who have even less incentive to monitor than most creditors because, unlike creditors, few if any citizens are likely to have sufficient amounts at stake to justify the cost of monitoring. In contrast, corporations are also monitored by shareholders, who can have concentrated holdings.

24 *The Use and Abuse of Special-Purpose Entities in Public Finance, supra* note 17.

25 "Special-Purpose Entities in National Finance," *supra* note 16.

One answer is that the federal government would be doing the "right thing."[26] Another answer, perhaps more pragmatic, is that as the problem of national-SPE debt becomes more publicly known, the federal government will face reputation costs. Improving national-SPE accountability might then help the federal government save money.[27]

26 Query whether the federal government, at least under the current Congress, really wants to do the right thing. One wag observed at the conference that politicians might know what is right but they don't seem to know how acting right can get them re-elected.

27 *Cf. The Use and Abuse of Special-Purpose Entities in Public Finance, supra* note 17 (observing a savings resulting from improving state-SPE accountability).