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The Gathering Storm: Contingent Liabilities in a Sovereign Debt Restructuring

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Abstract

The contingent liabilities of a sovereign, such as guarantees of the debts of third parties, can normally be kept off the balance sheet of the sovereign guarantor. That is their charm. As the debt to GDP ratios of many developed countries approach red-zone levels, contingent liabilities are increasingly being favored over direct, on-the-balance-sheet, borrowings.

But what happens if a country carrying large contingent liabilities needs to restructure its debt? The borrower dare not leave its contingent claims out of the restructuring. To do so would risk undermining the financial predicates of the sovereign's economic recovery program should the beneficiaries of the guarantees demand payment in full after the restructuring closes.

Attempting to shoehorn sovereign contingent liabilities into a debt restructuring, however, is a particularly challenging task. There are few precedents for how to do so, and no good precedents. The explosion in the size of contingent sovereign obligations since the financial crisis began in 2008 inevitably means that these issues will need to be confronted sooner or later, probably sooner.

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The Gathering Storm:
Contingent Liabilities in
a Sovereign Debt Restructuring

Lee C. Buchheit
G. Mitu Gulati*

It is a truth universally acknowledged, that a sovereign borrower in possession of an uncomfortably large stock of debt must be in want of camouflage. And since the commencement of the financial crisis in 2008, many sovereigns seem to have found it -- in the form of contingent sovereign liabilities.

In every situation where a sovereign lends its credit support to facilitate a borrowing by a third party, the sovereign will have had a choice. The alternative to guaranteeing the debt of the third party is for the sovereign to borrow the money in its own name and on-lend the proceeds to that entity. The difference is that a direct liability appears on a sovereign's own balance sheet; a contingent liability probably will not. In the last five years, as the need to finance Great Recession stimulus measures has swollen the debt-to-GDP ratios of many developed countries, sovereigns have sought to camouflage the true extent of their liabilities by resorting to the issue of contingent, rather than direct, obligations.[1]

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* Partner, Cleary Gottlieb Steen & Hamilton (N.Y.) and Professor, Duke Law School, respectively. For invaluable assistance with the data, we owe thanks to Guangya Liu at the Duke University Law Library.

[1] *See, e.g.*, Landon Thomas Jr., *State Debt Guarantees That are Hidden Add to Worries in Europe*, N.Y. TIMES, Feb. 5, 2013; Christopher Spink, *Contingent Sovereign Liabilities a 'Landmine'*, INT'L FINANCING REV., May 26, 2012; David Reilly, *Time to End the Fiction of 'Frannie'*, WALL ST. J., Aug. 21, 2012. Mr. Reilly, in his piece, writes:

> That [a new requirement that Fannie Mae and Freddie Mac pay all of their profit to the U.S. Government as a dividend] bolsters the argument that Fannie and Freddie should be included on the government's balance sheet. Of course, that is politically unpalatable: The inclusion of their combined $5.3 trillion in liabilities would balloon the nearly $16 trillion in total federal debt outstanding and breach the debt ceiling.

I. Sovereign Comfort

A benignant sovereign may bestow its credit support to a third party in a variety of ways.

(a) Explicit sovereign guarantees

At one end of the spectrum will be an explicit contractual guarantee by the sovereign expressed in words like these:

> The Republic hereby unconditionally and irrevocably guarantees (as primary obligor and not merely as surety) the punctual payment when due, whether at stated maturity, by acceleration or otherwise, of all obligations of the Obligor now or hereafter existing under this Agreement….

Such an explicit guarantee will sometimes come with all the trappings of an independent, separately enforceable, legal obligation on the part of the sovereign guarantor -- representations, covenants, waiver of sovereign immunity, choice of foreign governing law, submission to foreign court jurisdiction and appointment of an agent for service of process abroad.

Explicit sovereign guarantees may also be extended by operation of law. Some (but only some) deposit insurance schemes benefit from the full faith and credit of the host sovereign. In some countries, certain state-owned enterprises will by law carry the full faith and credit of their sovereign in their borrowing activities.

(b) Implicit sovereign assurances

The other side of the spectrum of sovereign credit support consists of nothing more than a background shadow; a figurative -- perhaps even a literal -- wink, nod and reassuring smile to the prospective investor. These are normally situations in which the primary obligor is so closely associated with the sovereign in the mind of the market (such as a political sub-division or an important state-owned enterprise) that lenders to the primary obligor are passively encouraged in the belief that the sovereign could never tolerate a circumstance in which the primary obligor tarnishes the reputation of the sovereign by defaulting on its debts. Nothing is ever said openly about sovereign credit support in these situations, but the perceptive investor is expected to see the warm arm of the sovereign wrapped in a reassuring manner around the shoulder of the debtor.

(c) In between

Between these two extremes of unambiguously explicit sovereign guarantees and gauzily implicit sovereign reassurances are many gradations. These include:

- partial guarantees -- the sovereign agrees to cover only a portion of the amount payable by the primary obligor;

- indemnities -- the sovereign agrees to indemnify the creditor for any residual loss but only after all efforts to recover the debt from the primary obligor have been exhausted;

- keepwells -- the sovereign's promise to the lender is limited to an undertaking that the primary obligor will at all times have a positive net worth (often expressed as a nominal amount), but the sovereign is free to achieve this objective of solvency in any way it wishes (by recapitalizing the primary obligor, assuming or paying some of its debts, lending money to the primary obligor, etc.); and

- comfort letters -- an aptly-named instrument, the comfort letter, in its most innocuous form, merely assures the lender that the sovereign is aware that the primary obligor is borrowing the money, that the sovereign does not object to the transaction and that the obligor continues to enjoy the affections of the sovereign.

The remainder of this paper will deal only with explicit sovereign guarantees. For obvious reasons, it is impossible to identify or quantify implicit guarantees because they exist only in the eye of the beholder.[2]

II. Contingent Charms

The principal charm (for the guarantor) of a contingent obligation lies precisely in its contingent nature; no one can be sure, at the time the debt is incurred, whether it will be paid by the primary obligor without recourse to the guarantor. This feature allows guarantors, with the blessing of the accounting profession, to treat the resulting liabilities as off balance sheet unless and until something happens down the road that makes it probable that the guarantee will in fact be called. For sovereigns already groaning under dangerously bloated debt-to-GDP ratios, this accounting treatment allows the sovereign to continue to raise capital on the strength of the sovereign's credit standing while not visibly increasing the size of the sovereign's own stock of debt. The only catch is that the loans must be directed in the first instance to a third party (the primary obligor) under the cover of the

[2] This vagueness about whether a particular loan does or does not enjoy the credit support of the sovereign carries its own risks. In a distressed debt context, a lender that thinks itself the beneficiary of an implicit sovereign guarantee is apt to howl if the sovereign orphans the primary obligor and allows the loan to go into default. The United Arab Emirates, burnt by just this reaction during the Dubai financial crisis of 2009, subsequently changed its policy to ensure that there would be no future misunderstandings about which loans to state-linked enterprises did, and which did not, enjoy government support. *See* Camilla Hall, *Abu Dhabi Tightens Rules for Debt Issued to State-Linked Businesses*, FIN. TIMES, Oct. 23, 2012 at 15.

sovereign guarantee. That third party may be related to the sovereign (a state-owned enterprise for example), or it may be a private sector entity whose activities the sovereign wishes to encourage. A construction project undertaken by a private sector entity in the tourism industry is a good example.

Accounting standards differ somewhat in how they describe the circumstances which allow a guarantor to keep a contingent liability off of its own balance sheet. For corporate borrowers, the International Accounting Standards Board (IAS 37) directs that if a present obligation "may, but probably will not, require an outflow of resources" from the guarantor, it need not be "recognized" on the balance sheet of the guarantor, but should be disclosed in financial statements as a contingent liability.[3] Where the likelihood of an outflow of resources from the guarantor is "remote", even the need for financial disclosure is omitted.[4]

The general principle established by Eurostat (the statistical office of the European Union) for presenting the accounts of EU member states is broadly similar. As long as a state guarantee is not called by beneficiary, the liability is recorded only on the balance sheet of the primary obligor, not the sovereign.[5] Eurostat recognizes a "special case" exception to this general principle in situations where need for the government to make debt service payments on the loan is open and notorious from the outset. The Eurostat Manual describes the circumstances in these terms:

> Even though the liability is issued by the enterprise itself, it may be right away considered with certainty as an actual government liability if the following conditions are fulfilled:
>
> - the law authorizing issuance of the debt specifies the government's obligation of repayment.
>
> - the budget of the State specifies each year the amount of repayment.
>
> - this debt, issued by the enterprise, is systematically repaid by the State (interest and principal).
>
> The liability must then be recorded directly -- as soon as at issuance -- in the government financial account and balance sheet, and not in the enterprise's. Its amount must be taken into account in the government debt.[6]

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[3] IASB Guidance on implementing IAS 37, Tables, *Provisions and Contingent Liabilities*.

[4] *IAS* 37, para. 28

[5] Eurostat, ESA95 Manual for Government Deficit and Debt (2002 ed.), II.4.3.2(1).

[6] *Id*., II.4.3.2(2)

A Note on the Database

The statistical information in this paper is based on our survey of sovereign guaranteed bonds issued between January 1, 1965 and July 1, 2013, as those bonds appear on three publicly-available databases (Dealogic, Perfect Information, Thomson One Banker).[7] The prospectuses and offering circulars for a total of 885 sovereign guaranteed bonds appearing on these databases were reviewed.

This is not the total universe of sovereign guaranteed bonds. The databases we use are commercial and therefore usually include only those bonds that the database operators believe will be of interest to paying customers. Our information suggests that those customers tend to be foreign rather than local investors (domestic investors are often less concerned with legal terms, having other mechanisms to police and monitor the behavior of their sovereign). In other words, what we report on is probably both a small and biased (towards the interests of foreign investors) subset of the universe of sovereign guaranteed bonds, the exact size of which is entirely a matter of speculation.

We nevertheless believe that our results reveal the general trends in the issuance of these instruments over time, particularly in the areas of greatest relevance to the subject of this paper -- number of issuances (relative to direct sovereign bonds), governing law, submission to court jurisdiction and waiver of sovereign immunity.

[7] We also examined the bonds available from Bloomberg, a fourth data source. However, there were no bonds there that we had not already accessed from one of the other databases.

III. The Explosion of 2008 - 2012

The data we have reviewed suggests that there was literally an explosion in the number of sovereign guaranteed bonds issued after the onset of the financial crisis in 2008, particularly in Europe. Using publicly-available information (see box -- "A Note on the Data Base"), the results are shown on Figure 1:

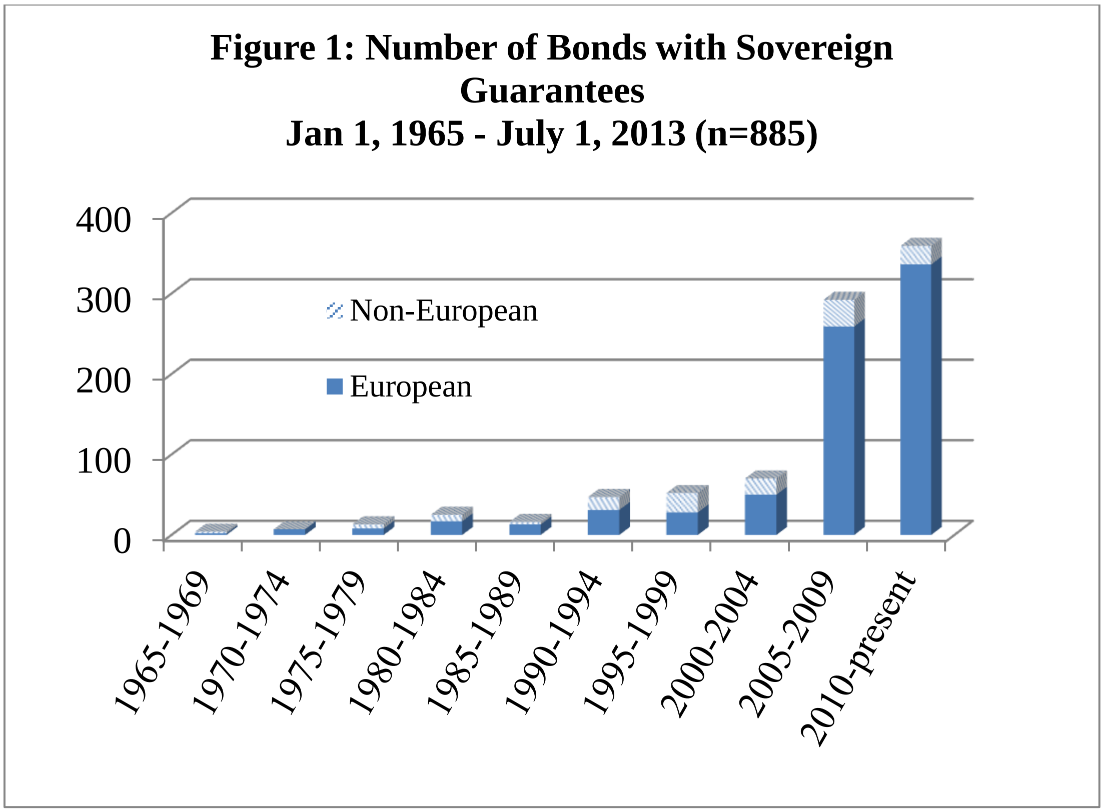
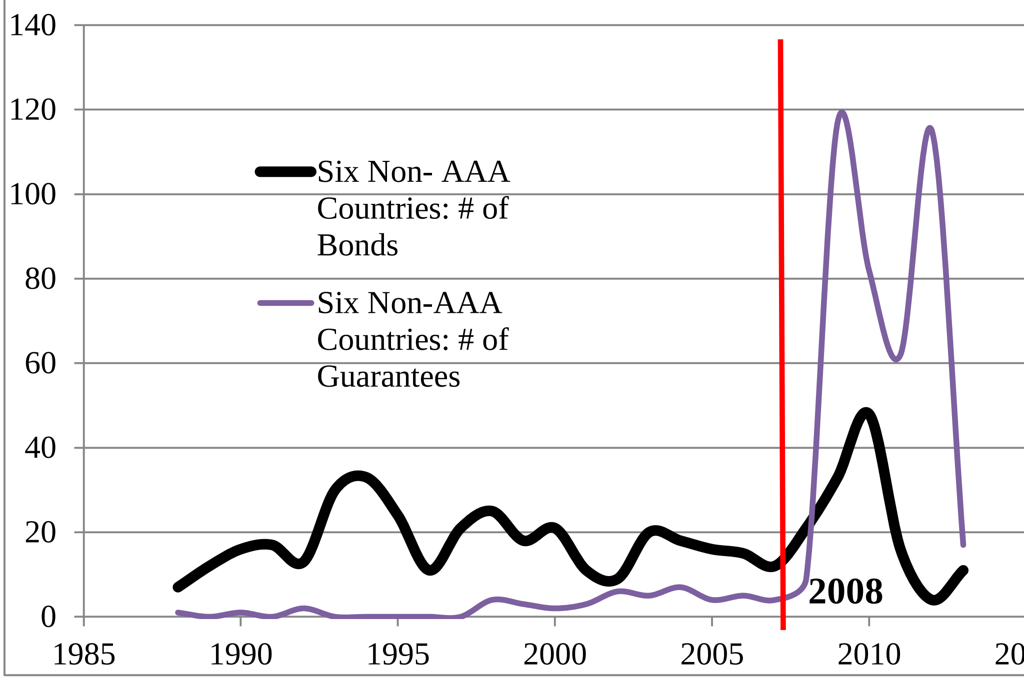


Figure 2 reports a different, but equally striking, perspective -- it focuses on the bonds and guarantees for the six euro area nations that were generally perceived to be at the heart of the crisis starting in late 2009 – Greece, Italy, Ireland, Portugal, Spain and Belgium. These are also the six early entrants to the European Monetary Union who have not traditionally been AAA rated (in contrast to, for example, Germany and France). For these six nations, Figure 2 reports both the numbers of sovereign bonds and guaranteed bonds issued during the quarter century between January 1, 1988 and July 1, 2013. As the European crisis worsens during the 2009-2012 period, the issuance of guaranteed bonds, particularly in comparison to regular sovereign bonds, mushrooms.

Figure 2: Numbers of Bonds versus Guaranteed Bonds for Six Non-AAA Early Euro Area Entrants (Jan 1,1988 - July 1, 2013)



An excellent study released by Houlihan Lokey in May 2012[8] concluded that sovereign loan/bond guarantees in Europe as of end-2010 (a category that did not include other forms of sovereign contingent exposure such as umbrella guarantees or deposit insurance schemes) represented, on a GDP-weighted average, 13.1% of European GDP. In some countries, contingent exposure approached 30 percent of GDP. The trend noted in the Houlihan study was upward; the aggregate size of guarantees outstanding in 2013 is undoubtedly significantly larger than it was in 2010.

[8] Houlihan Lokey, *The Increasing Risks Posed by Contingent Liabilities: How to Measure and Manage Them*, Presentation at the 2012 Meeting of the Private Sector with the Paris Club and with Representatives of Non Paris Club Bilateral Creditors, available at http://www.iif.com/emp/dr/

There are two explanations for this dramatic rise in the popularity of contingent sovereign obligations. The first, as discussed above, is the desire of over-indebted developed countries to minimize further strains on their debt-to-GDP ratios. The off balance sheet accounting treatment of contingent obligations permits this. The second explanation relates to the methods by which the European Central Bank has been prepared to provide liquidity assistance to banks in the Eurozone. A bank in need of liquidity may either borrow money directly from the ECB's discount window by posting eligible collateral for the loan, or the bank may borrow the funds from its own central bank through the Emergency Lending Assistance ("ELA") program. ELA funds, however, are ultimately also sourced from the ECB and the Eurosystem and require the posting of eligible collateral by the borrowing bank.

Peripheral European banks that had exhausted their store of eligible collateral for these programs came up with an ingenious solution -- they manufactured eligible collateral.[9] The bank issues a debt instrument to itself (there is no third party purchaser of the instrument), takes the instrument to its local ministry of finance and obtains a government guarantee, and then uses the instrument as collateral for a new borrowing from ECB's discount window or the ELA.[10]

In July 2012, the ECB is reported to have grown alarmed at the size of the manufactured collateral that it was accepting at its discount window. The ECB accordingly capped the amount of "specially tailored bonds" that could be used for this purpose by Eurozone banks at the level each bank had outstanding at the time the new policy was announced.[11]

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[9] The Cypriot Ministry of Finance charmingly refers to instruments issued for the sole purpose of ECB/ELA discounting as "collateral for liquidity extraction from the European Central Bank." Republic of Cyprus, Ministry of Finance, Public Debt Management Annual Report 2011 (March 2012) at 35.

[10] *See* Sonia Sirletti & Elisa Martinuzzi, *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

[11] *See* Marc Jones, *ECB Caps Use of State-Backed Bonds as Collateral*, REUTERS, July 3, 2012, available at http://uk.reuters.com/assets/print?aid=UKBRE8620V920120703; Joseph Cotterill, *ECB Collateral Shift Du Jour*, FT ALPHAVILLE, July 3, 2012, available at http://ftalphaville.ft.com/2012/07/03/1070271/ecb-collateral-shift-du-jour/.

IV. Precedents

One of the remorseless laws of sovereign debt management is that size brings risk. If a component of a sovereign's debt stock is of negligible size, that component can sometimes escape a debt restructuring. For example, with only a couple of exceptions, sovereign bonds were not restructured in the 1980s debt crisis. The reason? Emerging market sovereign bond issues were rare in the period before the crisis began in 1982 and the cost/benefit analysis weighed heavily in favor of exempting those few bonds from the restructurings that engulfed commercial bank loans and bilateral credits in that decade. But by the late 1990s, bonds had replaced bank loans as the main component of the debt stocks of many emerging market countries. Bond restructurings therefore became inevitable in countries with insupportable debt loads.

If this remorseless law is indeed remorseless, it suggests that any country carrying a significant stock of contingent sovereign obligations will eventually need to address those liabilities if a generalized restructuring of the country's debt becomes necessary. Unfortunately, there are few historical precedents to guide such an exercise.

In the sovereign debt restructurings of the 1980s, the aggregate number of sovereign guarantees was small. This allowed them to be ignored in the debt workouts of that era. The normal approach was to include a contingent liability in the restructuring only if the beneficiary called on the guarantee before the restructuring closed. But no pressure was placed on beneficiaries to call on their guarantees. This set a precedent that has been followed in most sovereign debt restructurings of the last thirty years.[12]

One notable exception was Grenada's restructuring in 2005 where the government's contingent exposure equaled about 10% of its direct liabilities. Grenada warned in the disclosure document for its restructuring that any contingent obligation called by a beneficiary after the restructuring closed would be settled by the delivery of consideration having a net present value equal to what the lender would have received had the guarantee been called in time to be included in the main restructuring.[13]

[12] *See* Lee C. Buchheit & G. Mitu Gulati, *The Treatment of Contingent Liabilities in a Sovereign Debt Restructuring*, in FINANCIAL CRISIS CONTAINMENT AND GOVERNMENT GUARANTEES (J. LaBrosse, R. Olivares-Caminal, & D. Singh eds., 2013).

[13] *See* Lee C. Buchheit & Elizabeth Karpenski, *Grenada's Innovations*, 2006 J. INT'L BANKING AND REG., at 227, 231.

The most recent precedent, Greece in 2012, is mixed. Although the Hellenic Republic had hundreds of outstanding state guarantees at the time it announced its debt restructuring in February of 2012, only 36 of those instruments were made eligible for inclusion in the workout.[14] The distinguishing characteristic of the included instruments was that they fell within Eurostat's "special cases" exception to the general rule of off balance sheet treatment.[15] In effect, Eurostat had already concluded that the liabilities were central government debt and had to be shown as such for Eurostat reporting purposes. Accordingly, they were also made eligible for the restructuring of the central government's direct debt.

Interestingly, although the main Greek debt restructuring was facilitated by Greek legislation which retrofit a collective action mechanism on that portion of the debt stock governed by Greek law (93% of the total), this legislation did not attempt to sweep in the Greek Government guarantees of the guaranteed bonds that were declared eligible for the restructuring, nor did the Greek legislature attempt to pass separate legislation dealing with the Government's local law guarantees. The Greek authorities therefore avoided the legal and operational complications (described below in Part VI of this paper) that would have attended an attempt to restructure sovereign guarantees in a more coercive way.

V. The Restructurer's Dilemma

If a country that is forced to restructure its outstanding (direct) indebtedness also has a significant amount of contingent obligations coming due during the period covered by that restructuring, there are a limited number of options:

(i) hope that the primary obligor will have the resources to pay the debt without a call on the guarantee;

(ii) hope that the beneficiary of the guarantee will voluntarily roll over the debt at maturity;

(iii) honor the guarantee if it is called by paying the debt in full; and

(iv) dishonor the guarantee and attempt to restructure the liability when it matures.

Option (i) is, of course, the sovereign's preferred choice. But a natural selection process is always at work in guarantees. Had the primary obligor been perceived as fully creditworthy on its own, it would not have needed sovereign credit support in order to raise capital at a tolerably low interest rate. The very

[14] Twenty series of these guaranteed bonds (totaling €4.88 billion) were governed by Greek law; the other sixteen series (totaling €4.97 billion) were governed by foreign law.

[15] See text accompanying note 6 above.

presence of a sovereign guarantee is thus a sign that the primary obligor might not be good for the money when it comes due.

Option (ii), a voluntary rollover, is the sovereign's second best choice. Naturally, this requires the cooperation of either an indulgent, or a captive, beneficiary. The "liquidity extraction bonds" (see footnote 9 below) that have been issued by European banks for the purpose of accessing the ECB's discount window or the ELA program presumably fall into the category of "captive beneficiary". Demanding repayment of the loan to the discounting bank on its maturity date would, in most of these situations, be pointless. Demanding payment from the sovereign guarantor of the guaranteed bonds pledged to secure the loan would be inconsistent with the official sector's bailout program for the country. The result is a captive beneficiary that has little choice but to roll over the loan and the accompanying collateral for the loan.

Option (iii), pay up, can have several problems. The first, of course, is money, a commodity that is rarely in abundant supply when a sovereign is compelled to restructure its debts. Even if the cash is available, paying in full the beneficiary of a state guarantee while all of the sovereign's direct creditors have been forced to take losses will naturally delight the former and enrage the latter. Finally, it is unlikely that the financial predicates underlying the restructuring will have assumed payment in full of maturing contingent liabilities during the adjustment period. If those contingent liabilities are of a significant size, a policy of paying them may torpedo the entire program.

Option (iv), attempt an ad hoc restructuring of a contingent liability when it matures, raises the predicable issues of feasibility, cost and intercreditor equity. It would also inevitably prolong the perception that the country remains mired in a debt crisis.

The restructuring of a contingent obligation is more complicated than the same exercise for direct sovereign debt. For one thing, until the guarantee is called by the beneficiary, it remains contingent; the guarantor is rarely in a position to force such a call. This gives the beneficiary the option of attempting to ride out the sovereign's restructuring of its direct obligations in the hope that after that main restructuring closes, the sovereign will be reluctant to plunge back into another debt crisis by dishonoring a call on the guarantee.

Moreover, even if beneficiaries can be persuaded to call upon their guarantees, they are in a fundamentally different position from the sovereign's direct creditors. By definition, the holder of a sovereign guaranteed bond benefits from the credit of both the primary obligor and that of the sovereign guarantor; in the jargon, the creditor is holding "two-name paper". Giving such a creditor the same deal as that offered to direct creditors of the sovereign would effectively attribute no value to the credit of the primary obligor. But any attempt to sweeten the terms of the restructuring for contingent sovereign creditors in order to compensate those holders for the surrender of their claim against the primary obligor requires someone to put a monetary value on that second credit risk. This could be a delicate and politically sensitive task when the primary obligor is a state-owned or controlled enterprise.

In short, the restructurer's dilemma is that contingent liabilities, if they are of any material size, cannot safely be left *out* of a sovereign debt restructuring, nor can they easily be included *in* a sovereign debt restructuring. This problem wasn't a problem for so long as contingent liabilities represented only a small part of the debt stocks of affected countries. But for many countries, that period ended with the commencement of the financial crisis in 2008. The problem will therefore be unavoidable in at least some of the sovereign debt restructurings yet to come.

In the bankruptcy of a corporate borrower in the United States (let's call it Acme Corporation), the value of any contingent claims against Acme that are not expected to be crystalized before the bankruptcy proceeding ends may be estimated for purposes of allowing the beneficiary's claim to be filed in the insolvency proceeding. (See U.S. Bankruptcy Code § 502(c)(1).) This is done to avoid unduly prolonging the administration of Acme's estate or forcing the administrator to establish a reserve against the claim. If it appears that the primary obligor will be able to pay the debt out of its own resources (without requiring a call on Acme's guarantee), then the beneficiary's claim in Acme's bankruptcy may be estimated at zero or close to it.

VI. Restructuring Sovereign Contingent Obligations

How hard would it be to cast the net of a sovereign debt restructuring wide enough to catch the sovereign's contingent obligations?

(a) Voluntary offers

If the debt restructuring is conducted as a purely voluntary exchange (that is, no use of CACs, embedded or retrofit), and involves delivery of new debt instruments of the sovereign in exchange for outstanding sovereign guaranteed bonds, the holders of contingent sovereign paper can be expected to ask for a sweeter deal than that offered to the direct creditors. The justification will be that this additional consideration is needed to compensate for the creditors' surrender of a claim against the first name (the primary obligor) of their two-name paper. Apart from the politically delicate job of deciding whether the incremental credit risk of a parastatal on a debt instrument is worth a nickel or a dime or something more, different values would logically need to be assigned for each of the primary obligors, a tedious and possibly controversial task.

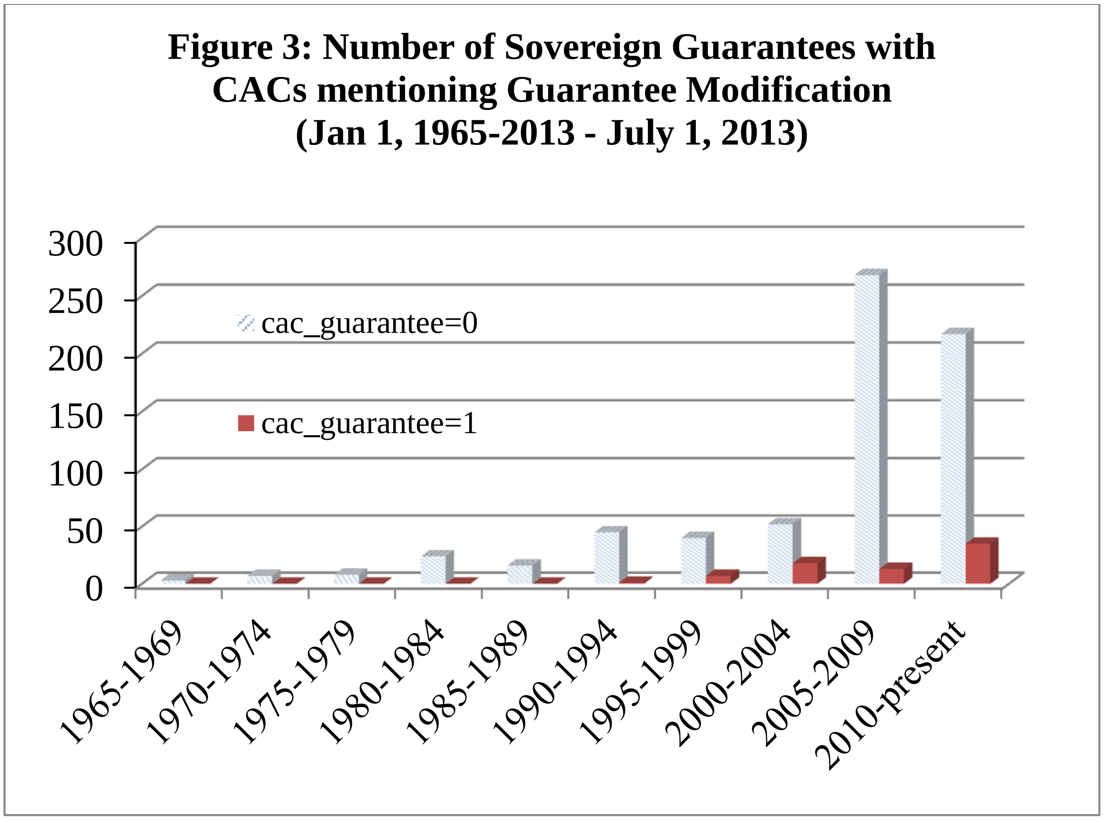
The alternative would involve restructuring each guaranteed bond in a manner that maintains the primary obligor as the first name on the paper. This could be done either by exchanging each old guaranteed bond for a new guaranteed bond with the same parties, or else attempting to modify the terms of that old bond within its four corners (no exchange). This approach would address the concern about the loss of the creditor's claim against the primary obligor, but it could significantly complicate the mechanics of the restructuring. For one thing, it would be tantamount to a separate restructuring for each guaranteed bond. Because the primary obligors would continue as a credit risk on the restructured debt instruments, the securities laws in many jurisdictions would require separate disclosure for each of those primary obligors in the exchange offer. Instead of issuing a single series of sovereign bonds for exchange with existing debtholders, the restructuring would involve the issuance, listing and administration of multiple series of bonds, each corresponding to an underlying guaranteed debt instrument.

(b) Less-than-voluntary offers

A debt restructuring that does not rely exclusively on persuasion to bring creditors into the deal will face its own set of problems with contingent sovereign obligations.

Collective action clauses (CACs). One immediate question will be whether the terms of the guarantee will need to be amended separately from, or in parallel with, a modification of the terms of the underlying debt instrument. If the underlying instrument does not include a collective action clause of some kind, its amendment -- and the corresponding amendment of the related guarantee -- would presumably require the unanimous consent of each debtholder. Even where the underlying debt instrument contains a CAC, however, the related sovereign guarantee almost certainly will not. Our research suggests that CACs are almost never incorporated in sovereign guarantees.

Somewhat more common, but still quite rare, is for the CAC appearing in the underlying bond to permit changes to the accompanying sovereign guarantee. As Figure 2 shows, of the guaranteed bonds with CACs in our database, fewer than 10% permitted modifications by a supermajority vote of creditors to both the underlying bond and the accompanying guarantee.



Why should contract drafters who were cautious enough to put CACs in their bonds have felt it unnecessary to incorporate a similar feature in the accompanying guarantees? The most plausible explanation is that the drafters simply didn't see the need to do so. The guarantee promises payment of the bond on the dates and in the amounts due. If the creditors agree to amend the terms of the bond, this argument goes, the terms of the guarantee will automatically wrap around those modified terms.

This assumption may be a bit too facile. For one thing, the wording of the guarantee could be crucial. For example, a Republic of Turkey sovereign guarantee in our database recites that:

> The intention and purpose of this Guarantee is to ensure that the Bondholders . . . shall receive the amounts payable as interest and principal as and when due and payable <u>according to the Issue Terms</u> . . .[16]

[16] The Central Bank of the Republic of Turkey, DM200,000,000 7% Deutsche Mark Bearer Bonds of 1987/1992, irrevocably and unconditionally guaranteed by the Republic of Turkey, (emphasis added).

No mention is made of a possible modification to the original Issue Terms. It is therefore not clear whether an amendment to the terms of the underlying bond would automatically result in a corresponding amendment to the accompanying guarantee.

More importantly, the amendment of a sovereign guaranteed bond through the use of a collective action clause is still an unusual event and would raise novel legal issues.

If a supermajority of bondholders can alter the terms of an underlying bond through a collective action clause, but no similar contractual flexibility exits to modify the terms of the related sovereign guarantee, can a disaffected minority of bondholders insist on payment by the guarantor of the amounts originally due under the bond? The argument against permitting such a claim focuses on the words of the guarantee promising payment "when due" of the primary obligor's obligations under the bond. If those obligations are extended or reduced in a manner permitted by the terms of the bond (through the exercise of the CAC), the argument goes, the guarantee should automatically wrap around the amended terms.

The argument in favor of allowing those disgruntled creditors to insist on strict performance of the guarantee has several components. First, these guarantees are often deliberately set up to be free standing, separately enforceable instruments; the guarantor is frequently described as being liable as a "primary obligor and not merely as surety" of the underlying obligation. If a supermajority of bondholders wish to modify the terms of the underlying obligation, the presence of a CAC may allow them to sweep along a disaffected minority at that level. But absent a CAC in the guarantee, the consent of each beneficiary of the guarantee would appear to be required to effect a parallel amendment of that instrument. Second, had the drafter of the guarantee wanted to permit its terms to be modified with less than the unanimous consent of the beneficiaries, this would have been easy to do. Under normal principles of contract interpretation a court would not read such a modification clause into the document. Finally, many guarantees contain language similar to the following:

> The liability of the Guarantor hereunder shall be absolute and unconditional irrespective of any change in the time, manner or place of payment, or any other term of, the [underlying obligation].[17]

[17] This language is included in a guarantee to ensure that the guarantor is not released if the lender agrees to vary the terms of the underlying obligation. *See* Raymer McQuiston, *Drafting an Enforceable Guaranty in an International Financing Transaction: A Lender's Perspective*, 10 INT'L TAX AND BUS. LAWYER 138, 156 (1993) ("Common law courts have ruled consistently that a variation or change in the terms of the underlying loan agreement without the guarantor's consent … justifies a release of the guarantor from its obligations.") That said, a bondholder might argue that the language could equally be seen as preserving a bondholder's claim against the guarantor to perform the unamended terms of the underlying instrument unless that lender has also agreed to amend the guarantee.

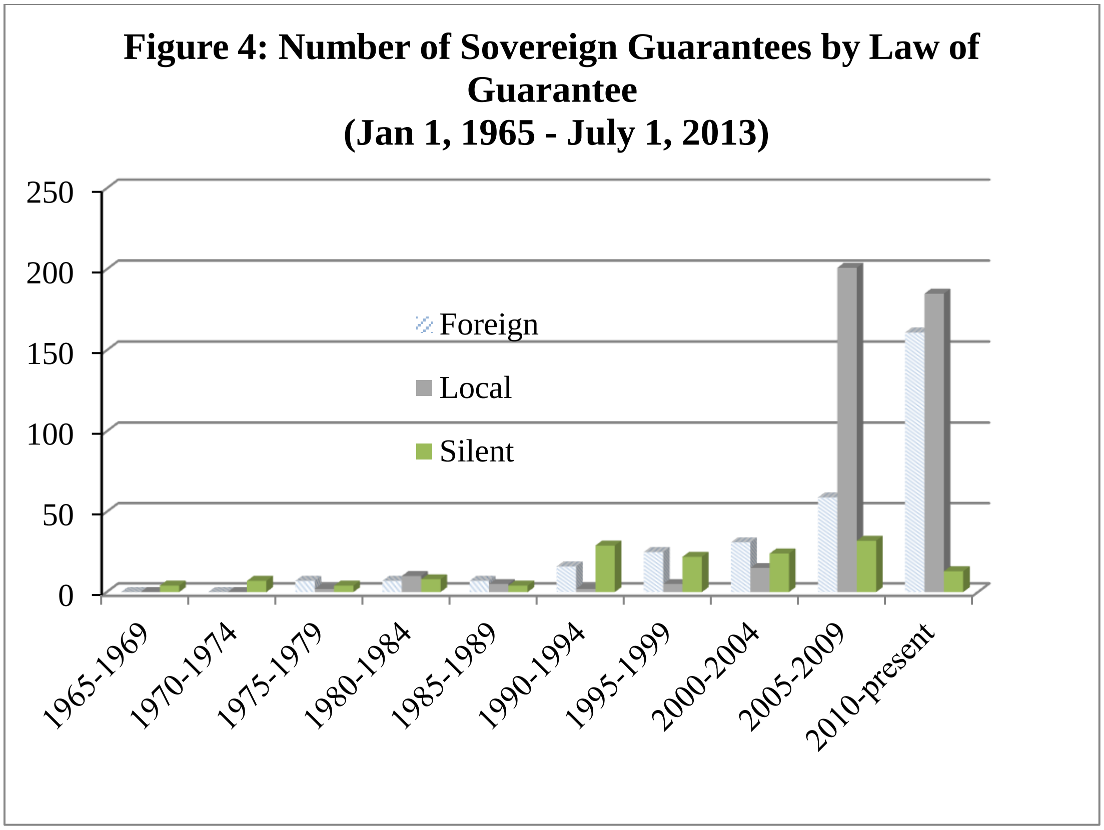
This situation (a conflict between a "collective action" amendment of an underlying obligation and the modification of an accompanying guarantee) is not well developed in U.S. law for the simple reason that collective action modification clauses fell out of favor in corporate debt instruments in the United States in the 1930s, and have only recently (since 2003) begun to appear in sovereign debt instruments governed by the law of a U.S. jurisdiction. In a traditional U.S. amendment clause requiring the unanimous consent of all creditors for a change to payment terms, the issue does not arise; by definition, every holder will have consented to the change.

<u>Governing law</u>. A sovereign fortunate enough to have its guarantees governed by its own law may (subject to constitutional constraints) be able to encourage holders of its contingent obligations to accept a restructuring by threatening to pass domestic legislation containing a sentence along these lines:

> All guarantees issued by the Republic of Ruritania in respect of debt obligations of third parties that are eligible to participate in the [Ruritanian restructuring] shall, if called by the beneficiary at any time after the closing of the [Ruritanian restructuring], be satisfied and discharged in full by delivery to the creditor of consideration equivalent to that offered in the [Ruritanian restructuring].

The effect of such a provision would be to remove any incentive on the part of the beneficiary of a state guarantee to refrain from calling on the guarantee at the time of the main restructuring. It is thus a statutory expression of the warning that Grenada gave in 2005 to the holders of its contingent obligations (see text accompanying footnote 13 above). In a debt restructuring, a local law guarantee thus provides the sovereign with considerable leverage.

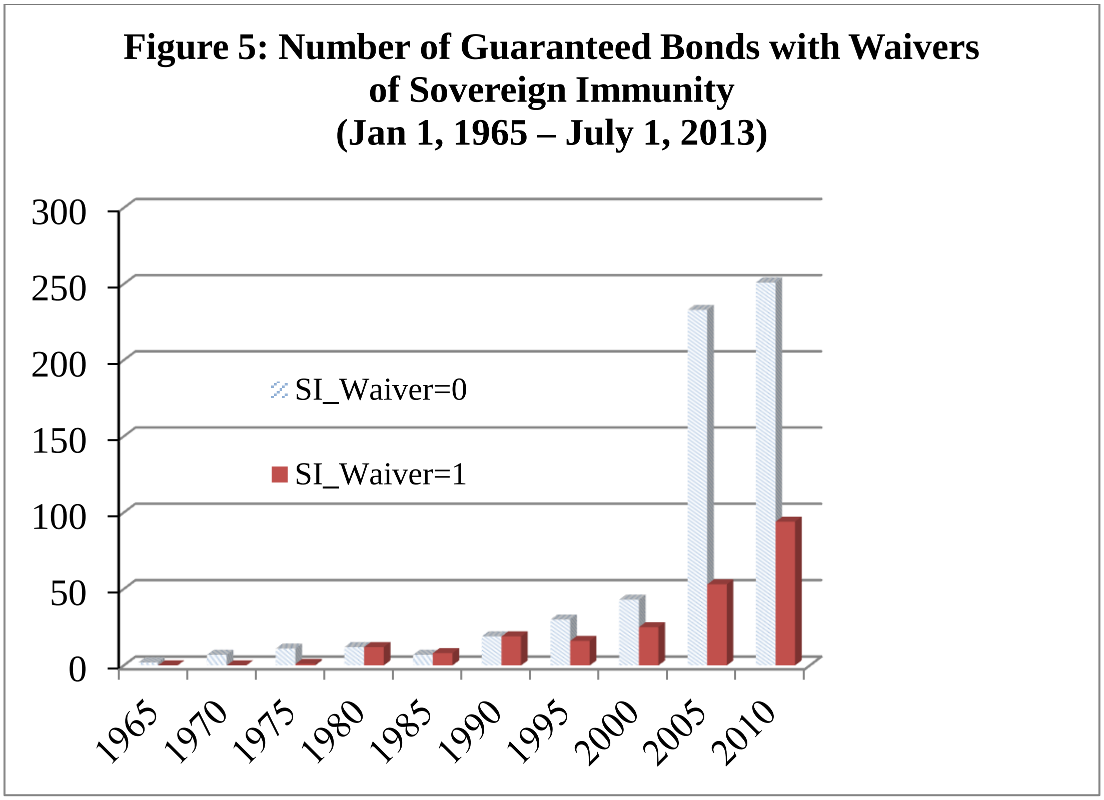
One of the most startling conclusions of our empirical research has been the split between the law chosen to govern underlying debt instruments and the governing law of the related sovereign guarantee. Figure 3 suggests that until 2010, a significant number of sovereign guarantees were governed by local law (the law of the sovereign's jurisdiction), even where the underlying bond was governed by foreign law.



This practice shifted abruptly starting in 2010, probably because the Greek crisis highlighted the added risks for the holders of debt instruments governed by local law.[18] Post Greece, bondholders were no longer as willing to allow their guarantees to be governed by the sovereign's own law. This is, we believe, a particularly vivid example of documentation practices in cross-border debt instruments responding almost immediately to the market's perception of a new -- or in this case, an overlooked – legal risk.

Waiver of immunity. All creditors of sovereigns face the daunting challenge of enforcing their claims against a recalcitrant debtor, but most benefit from an express waiver by the sovereign of any entitlement that the sovereign (or its property) may enjoy based on sovereign immunity. Figure 5 suggests, however, that such express waivers of immunity are far less common in sovereign guarantees than one might have thought.

[18] The Greek Parliament retrofit a collective action mechanism on its local law debt stock in early 2012 in order to facilitate a restructuring of those obligations. *See* Jeromin Zettelmeyer, Christoph Trebesch & Mitu Gulati, *The Greek Debt Exchange: An Autopsy*, Duke Law School Working Paper (Sept. 11, 2012 draft), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2144932



The absence of an express waiver of immunity does not make it impossible to enforce a guarantee against a defaulting sovereign, but it will make the enforcement process more difficult. Sovereigns can be expected to remind the beneficiaries of their guarantees of this likely difficulty as a means of encouraging those beneficiaries to join a general restructuring.

VII. Conclusion

Our conclusions are --

- In a number of important countries, sovereign guarantees have become so prevalent that they cannot be ignored in any future debt workouts that may be needed for those countries.
- Exactly how the contingent portion of a sovereign's debt stock is to be addressed in such a restructuring remains a mystery. There are very few precedents and no good precedents.
- For a while at least (until existing bonds mature and are replaced by new issues with more pro-creditor provisions), some sovereigns will benefit in a debt restructuring from the prelapsarian innocence shown in the contract drafting patterns that

prevailed before 2010 in areas such as governing law and waiver of immunities.

- One thing seems certain: the presence of a significant number of contingent liabilities in a sovereign's debt stock will present major complications for the architects of a debt restructuring for that country. Not the least of these will be psychological. The need to address contingent liabilities will force everyone -- creditors, official sector sponsors and citizens -- to watch with alarm as heretofore off balance sheet liabilities come rushing on to the sovereign's balance sheet, just in time to be restructured.

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