Grenada's Innovations

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Grenada's Innovations

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Authors' note

The legal techniques used to restructure the debt of sovereign borrowers have evolved considerably over the last 25 years. At times this evolution has been painfully slow. A technique, if used successfully in the restructuring of the debt of one country, tended to be applied mechanically in other cases. At other times, however, the evolutionary process accelerated in rapid spurts in response to changes in the nature of the affected creditors (commercial banks, bondholders, trade creditors, and so forth), the debt instruments being restructured (loans, bonds, trade paper, suppliers' credits, interbank lines, derivatives), or a perceived shift in the delicate balance between creditors and their legal remedies on the one side, and sovereign borrowers and their tactical advantages on the other.

This process has always been organic and incremental. It is thus not possible, merely by looking at a snapshot of a single country's debt restructuring, to discern where that country and its advisers applied techniques they inherited from prior deals, and where they had struck off boldly into the unmapped territory of structural innovation. Future historians of this period will no doubt be frustrated by this aspect of sovereign debt restructuring. But of more immediate concern, the current practitioners of these arts sometimes lack the historical perspective that allows them to predict—and often to guide—the future direction of sovereign debt management.

Perhaps the day will come when the international financial community will apply a standard set of remedies to deal quickly with sovereign debt crises, in much the way that the medical profession now prescribes antibiotics as the treatment for many types of infections that, 70 years ago, would have called forth a bewildering array of nostrums. But that day has not yet arrived. At least for a while longer, sovereign debt restructurings will limp along case by case. The individuals who manage these episodes will employ legal techniques, conventional or innovative, in an effort to achieve the needed debt relief. Regrettably, they may not always know on which side of the line a technique falls.

This is the second in a series of short articles in this journal intended to provide a contemporaneous record of the evolution of the legal techniques used to restructure sovereign debt obligations. The first article, "Uruguay's Innovations", appeared in 2004.[1] That article reported on the legal innovations incorporated into the Republic of Uruguay's successful bond exchange offer of May 2003. This article discusses Grenada's debt restructuring in 2005.

The wrath of Ivan

Grenada consists of three islands located in the southern part of the Caribbean Sea. On September 7, 2004, Grenada was struck head-on by a massive hurricane, Hurricane Ivan. The damage to the country and its economy was appalling. Nearly 90 per cent of the houses in the country were destroyed or severely damaged, as were many of the hotels that support Grenada's tourist industry (70 per cent of the hotel rooms in Grenada were rendered inoperable). Ivan also devastated Grenada's agricultural industry, particularly the trees producing its largest export commodity, nutmeg. Ivan's damage to Grenada amounted to more than 200 per cent of the country's nominal gross domestic product ("GDP") for the prior year.

At the time of Ivan's unwelcome visit, Grenada's total debt stock equalled approximately US$550 million, including approximately US$100 million of government guarantees. Although this was high when expressed as a percentage of GDP (over 130 per cent),[2] the debt was being serviced normally and Grenada's one large US dollar bond issue—launched just 26 months before Ivan struck—was then trading above par in the international markets.

* *Cleary Gottlieb acted as legal adviser to Grenada in the transaction described in this article.*

1. Lee C. Buchheit and Jeremiah S. Pam, "Uruguay's Innovations" [2004] J.I.B.L.R. 28.
2. Grenada's guarantees (nearly one-fifth of the total debt stock), although contingent obligations, were nevertheless scored for purposes of debt stock figures as actual liabilities, significantly inflating the reported debt-to-GDP figure.

Approximately 70 per cent of Grenada's debt stock was in the hands of commercial creditors, 10 per cent was held by bilateral (government) creditors, and the remaining 20 per cent was owed to multilateral creditors such as the Caribbean Development Bank and the World Bank.

Grenada's commercial debt took many forms: five bond issues denominated in Eastern Caribbean dollars; another five bond issues denominated in US dollars; commercial bank loans and overdraft lines; obligations to the local social security system; treasury bills of differing tenors; and government guarantees of construction projects in various states of completion. Unlike Ecuador in 2000, Uruguay in 2003, Argentina in 2005, or any of the other large sovereign debt restructurings of the last six years (the Republic of Iraq and the Commonwealth of Dominica excepted), all of which dealt exclusively with a single type of debt instrument (bonds), Grenada would have to face the practical and inter-creditor issues raised by the need to restructure a heterogeneous debt stock.

Grenada is also one of the rare examples of a country whose debt crisis was precipitated, in a matter of only a few hours, by a random external shock—a severe hurricane. The ensuing debt restructuring therefore did not bear the usual marks of tactical prepositioning on the part of either the sovereign debtor or the affected creditors. Specifically, the market was spared the predictable drama of a country mismanaging its economy for years or decades before the actual default, punctuated by occasional promises of reform, short-lived IMF programmes and the agonising endgame of deciding when, exactly, to admit that a debt restructuring is unavoidable.

On the creditors' side, the lack of advance warning of a crisis meant that the secondary market for the country's debt obligations did not, through a remorseless hammering down of the trading price, sound the alarm that trouble was in the offing. Nor was there time for "dedicated high-yield" investors, sometimes called vultures, to settle on the country's moribund debt stock during a downward spiral. For the debt restructuring team that arrived in Grenada post-Ivan, the country was therefore a financial Pompeii—both the debtor and its creditors frozen in the positions they occupied on that dreadful morning of September 7, 2004.

The planning

Within four months of Ivan's visit, Grenada had retained both legal advisers and financial advisers (Bear Stearns & Co. Inc.) to assist in planning and executing a restructuring of the country's debt stock. The threshold task was, as it usually is, to identify the categories of outstanding indebtedness that would be subject to the eventual restructuring. Because Ivan's devastation had been so thorough, this more accurately could be described as identifying which categories of the country's debt stock would *not* be invited to the restructuring party.

The answer? Short-term Grenadian Treasury bills, certain compensation claims against the Government, and obligations owed to multilateral creditors such as the World Bank, the IMF and the Caribbean Development Bank, were excluded from the restructuring (although these institutions provided emergency financing as lenders of last resort). Most of the rest of Grenada's debt stock—bonds, loans, guarantees of private sector obligations, bank overdrafts and bilateral credits—were deemed eligible (savour, gentle reader, the euphemism) to participate in the forthcoming debt restructuring.

A second threshold issue involved a determination of the country's sustainable debt servicing capacity. This judgment, reached in consultation with the IMF, required projections concerning the debtor's future earnings, expenditures and economic policies. What made this task unusually difficult in the case of Grenada was the extent of Ivan's destruction. Grenada's prior economic performance could not readily be used as a baseline for projections going forward. Ivan had destroyed too much of the country's economic infrastructure.

Debt servicing ceased on most categories of the debt that would be subject to restructuring as of December 2004. Even if the financial resources had been available to Grenada to continue normal servicing after this date (and they were not), a policy of paying the principal of debts that mature during the period before a restructuring proposal can be launched will only aggravate concerns about inter-creditor equity. If the sovereign debtor adopts such a policy, those lenders whose credits serendipitously mature before a restructuring offer can be made are paid in full, while all other creditors must face even more stringent financial terms because these principal payments will have depleted the pool of resources available for general debt service.

The transaction

It took Grenada exactly one year and two days after Ivan's passage over the island to make an offer to its commercial creditors to settle outstanding claims. In part, this delay reflected the fact that yet another serious hurricane, Hurricane Emily, hit Grenada on July 14, 2005, exacerbating the damage inflicted by Ivan and forcing yet another reassessment of the country's economic projections. The restructuring offer to the holders of eligible commercial debt (equal to about US$275 million), when it eventually arrived on the commercial creditors' desks on September 9, 2005, proposed an exchange of all eligible debt (including the accrued but unpaid interest on those debts over the prior 10 months) in return for US dollar denominated bonds (in the case of eligible debt originally denominated in US dollars) or Eastern Caribbean denominated bonds (in the case of eligible debt denominated in Eastern Caribbean dollars). Bilateral creditors were approached separately with a request for equivalent debt relief.

In every project of this kind, the threshold decision about the country's future debt servicing capacity implies an aggregate level of debt relief that the sovereign will need to seek from its existing creditors. It will not, however, suggest how that relief is to be obtained or how it is to be apportioned over the existing debt stock. Sovereign debt restructurers have in their toolbox only three instruments with which to fashion a transaction that will provide the country with a targeted amount of debt relief: (i) a simple deferment of principal or interest payments on the old debt (a "rescheduling"), (ii) a reduction in the rate of interest payable on the old debt (a "coupon reduction"), or (iii) a reduction in the outstanding principal amount of the old claims (a "principal haircut"). The choice of instruments in a given case will reflect both the extent of the needed debt relief and the preferences of the affected creditors.

Creditors naturally find *all* of these techniques distasteful but, if forced to choose, some techniques are thought to be more palatable than others. It is much like medical patients facing hypodermic needles: after first satisfying themselves that there is utterly no alternative in the matter, most patients will elect—for reasons related to personal dignity and short-term seating comfort—to receive the shot in the upper arm as opposed to another part of the anatomy.

In Grenada's case, the inescapable debt restructuring affected only the coupon structure and the maturity dates of the old debts; no haircuts were inflicted on the principal amount of the claims apart from the capitalisation of about 10 months of accrued but unpaid interest. This comported with the preferences expressed to Grenada's advisers by a majority of the institutions holding the claims. Each of the two new series of bonds offered in the exchange matured 20 years after issuance. Each contained an identical, graduated coupon structure as follows:

Year after issuance	*Coupon (per annum)*
1–3	1.00%
4–6	2.50%
7–8	4.50%
9–10	6.00%
11–12	8.00%
13	8.50%
14–20	9.00%

When the exchange offer tender period expired on October 14, 2005, holders of more than 85 per cent of the universe of eligible claims had accepted Grenada's offer. Most of the untendered claims comprised commercial bank overdraft lines and commercial loans. These creditors subsequently agreed to reduce the interest rate and extend the maturity date of their exposure, but they declined to swap the exposure outright for new bonds.

Innovations

Grenada's debt restructuring contained the following innovative features.

Treatment of non-participating creditors

One of the most critical decisions that a sovereign debtor must make early in the debt restructuring process is how it will treat creditors that elect not to participate in the restructuring. This decision cannot be put off until after the closing of the offer. Conventional wisdom dictates that the sovereign's intentions regarding non-participants ("holdouts", to use the unflattering term) should be disclosed in the offering document itself. There are several reasons for this:

- The legal duty to disclose all information material to a creditor's decision about whether to participate in the exchange requires that the creditor also be warned of its fate if it elects *not* to participate.
- Sovereign debt exchanges undertaken to address a serious debt sustainability problem are "voluntary" in a rather special sense of that word. If enough creditors decline the exchange offer, the transaction fails and the old debts remain non-performing. If most creditors go along but a significant minority of them balk at the offer, that holdout minority is unlikely to see its old debts serviced normally. Alerting prospective holdouts of this policy tends to dampen yeasty optimism about getting paid in full and on time after the debt exchange closes.
- Under the guise of doing one's legal duty by way of full disclosure, of course, the sovereign debtor hopes to encourage participation in the offer by warning potential holdouts that their path to a preferential recovery (preferential, that is, when compared to the restructuring terms) will be long, rocky and expensive.

Practice differs widely, however, on how to approach this issue. Some sovereigns limit themselves to vague mutterings about their constrained debt servicing capacity for years to come. Others say "no further offers to settle claims will be made or entertained", and leave creditors to draw for themselves the logical inference. Other sovereigns announce—solemnly, publicly and repeatedly—that holdout creditors will be consigned to the outer darkness. These debtors do not actually use the word repudiate, but a lexicographer would be hard-pressed to parse out the difference.

Grenada decided that it did not wish to repudiate the debts held by non-participating creditors. But, by the same token, Grenada did not have the resources to pay untendered eligible claims on their original terms and could not promise when those resources might become available. Borrowing from language used by its neighbouring island of Dominica in that country's debt restructuring of 2004, this was the operative text in Grenada's Offering Memorandum for the exchange:

> "Grenada does not intend to pay any non-tendered Eligible Claims unless resources become available to do so. In addition, Grenada does not intend to pay any amount in respect of a non-tendered Eligible Claim if, at the time such payment is due, a payment default then exists under any [new bond issued in the exchange]."[3]

Historians of sovereign debt restructurings may recall that this was precisely the approach taken by the United States of America in its own debt exchange offer of 1790. On September 1, 1790, the Secretary of the Treasury, Alexander Hamilton, assured holders of the public debt of the United States that the exchange offer—designed to reduce the debt servicing burden on the new Republic—was entirely voluntarily. "[W]hether you will accept the terms offered to you," he assured them, "is certainly left in your own choice."[4] That said, Hamilton was quick to remind the holders that their old claims were legally inferior to the new instruments being offered in the exchange; new instruments that benefited from an explicit pledge of excise tax revenues and a permanent appropriation of the funds required to service the new instruments. Speaking to what we would today call prospective holdout creditors, Hamilton said that ". . . the faith of the government remains pledged to you to fulfill its engagements [under the old debts], which must be performed, *as fast as its resources can be brought into action for the purpose*".[5]

This will perhaps someday be dubbed the "Caribbean Approach" to the treatment of holdout creditors in a sovereign debt exchange. Grenada and Dominica both used it, and Alexander Hamilton was, after all, born on the Caribbean island of Nevis circa 1755.

Individual enforcement rights

There are only three or four significant differences in the operation of English-style trust deeds and US-style trust indentures. The most significant difference is in the extent of the trustee's power to enforce the debt on behalf of all holders.

English-style trust deeds vest the enforcement power exclusively in the hands of the trustee. The trustee can decline to enforce the instrument (in which case the bondholders recover a right of direct enforcement), but for so long as an English trustee is prepared to enforce the debt, it alone has the legal power to do so. Under an English trust deed, the debt is actually owed to the trustee who receives payments in trust for the ultimate holders of the bonds, so centralising enforcement power in the hands of the trustee follows logically.

American-style trust indentures are similar, but only up to a point. An American trustee typically has the exclusive right (which it may decline in practice) to enforce the debt for the rateable benefit of the bondholders except in one situation. Under a conventional trust indenture, the right of each holder to commence a legal action to recover its share of an amount of principal or interest that was not paid on its regularly scheduled due date is inviolable. This feature of trust indentures for offerings of debt securities by corporate issuers is commanded by s.316(b) of the Trust Indenture Act of 1939.

The Trust Indenture Act is not applicable, however, to indentures used in connection with debt securities of sovereign issuers. Sovereigns have thus always been legally free to deny bondholders individual enforcement rights in their trust indentures; they have just never done so. Drafting momentum, coupled with the universal tendency of bond underwriters never to risk tampering with their own gauzy notions of "market expectations", has kept a provision for individual enforcement in US trust indentures for sovereign issues in the absence of any legal requirement for its inclusion.

The practical consequences of this difference between English trust deeds and US trust indentures can be significant. When a trustee enforces a debt instrument, it does so for the rateable benefit of *all* holders. No bondholder need fear that it may be disadvantaged by a fellow holder forcing a preferential recovery through the threat, or through the reality, of litigation.

But if individual holders are free to bring their own lawsuits to recover their share of missed payments, then a Hobbesian state of nature is created among the bondholders. The larger holders, the more litigious holders, and the holders located in jurisdictions where such lawsuits are easy to bring and easy to win, will have an advantage over their smaller, meeker or ill-positioned colleagues. If an individual holder sues and recovers in reliance on such a provision, it is under no obligation to share the proceeds of its recovery with its less fortunate, or more indulgent, fellow bondholders. Moreover, a precipitous lunge toward litigation by a few holders may preclude a negotiated workout with the issuer, making a bad situation irreversibly worse for all the other holders. As Hobbes would say, it is the war of each against each.

Grenada's trust indenture for its US dollar bonds, although governed by New York law and otherwise in a standard form for sovereign debt issued under New York law, omits any reference to individual bondholder enforcement rights. As in an English-style trust deed, all enforcement powers are centralised with the trustee and may only be

3. Grenada Offer to Exchange, Offering Memorandum dated September 9, 2005. p.18. The disclosure goes on to reserve the Government's ability to service non-tendered commercial bank credits or domestic bonds if a failure to do so would destabilise the domestic financial system.

4. Alexander Hamilton, "Address to the Public Creditors" in H.C. Lodge, ed., *The Works of Alexander Hamilton* (Federal Edn. 1904), Vol.II, p.475.

5. *ibid.*, p.476 (emphasis added).

exercised for the rateable benefit of all holders. In this important respect, Grenada's indenture reflects a convergence between English and New York documentation practices for sovereign bonds. To the authors' knowledge, it is the first of its kind.

Treatment of guarantees

Approximately 10 per cent of the stock of the debt eligible for the exchange offer consisted of government guarantees of certain private sector projects, mostly in the tourism sector. Few other sovereign debtors have confronted the question of how to address contingent liabilities such as guarantees in a generalised debt restructuring programme and none, to the authors' knowledge, has done so in circumstances where the contingent liabilities represented a significant part of the overall debt subject to restructuring.

What makes contingent liabilities tricky in the hands of a sovereign debt restructurer is the fact that they *are* contingent. Unless a guarantee has been called by the beneficiary prior to, or immediately upon, the announcement of the restructuring, the sovereign guarantor cannot know whether the liability will ever move out of the category of contingent and into the category of actual. There is always a chance that the primary (private sector) obligor will be able to service the debt on its own, in which case the sovereign guarantor will be permanently off the hook.

The risk, if the sovereign forces a premature call on a guarantee, is that this may self-inflict an unnecessary wound. But leave a guarantee out of the restructuring altogether and the liability may, if called later, undermine the financial predicates on which the debt restructuring programme was designed and was sold to the other creditors.

Grenada's solution to this dilemma had three elements:

- Beneficiaries of all government guarantees were given the option to call upon their guarantees at any time prior to the expiration date of the 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[6] 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).

This last condition was obviously designed to discourage beneficiaries from attempting to ride out the restructuring without calling their guarantees in the hope that the guarantees could be called, and would be fully paid, after the exchange offer closed. It was also intended to achieve a parity of treatment among creditors.

In the event, the beneficiaries of four government guarantees (out of a total of five eligible guarantees) elected to call their guarantees during the restructuring programme and receive bonds in discharge of the guarantees.

6. See Offering Memorandum, fn.3 above, p.16.