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FINANCIAL RESTRUCTURE FOR BUSINESSES AND GOVERNMENTS

## GOVERNMENT DEBT RESTRUCTURE PRINCIPLES

Presented at the Duke University School of Law Symposium  
*“Modern Municipal Restructurings: Puerto Rico and Beyond”*

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NOVEMBER 10, 2015

## Preface

Many U.S. cities and states have built infrastructure and provided for the welfare of their citizens by borrowing massively from the capital markets and promising benefits to their employees that they have not funded out of their tax base. Now they cannot realistically afford to pay all of this debt.

Likewise, many democratic, capitalist nations around the world have accumulated massive debt to the capital markets while providing for the defense and welfare of their people that they now cannot realistically afford to repay.

Wise government leaders will find ways to solve these problems by obtaining fair contributions from labor, capital and taxpayers.

Here is a way to process government insolvency so that, after reasonable austerity and use of taxation, capital creditors are paid all they can reasonably expect under the circumstances, but more than they would receive by exercising their legal remedies against governments which have only partially waived sovereign immunity. To use terms of art, this would be a debt restructuring that is fair and equitable, and in the best interests of creditors.

While difficult to do, it is easy to outline how to approach such a debt restructure. Rigorously assess what governmental services need to be provided and what labor costs can be afforded, for both current and retired employees. Make a judgment about the appropriate level of taxation. Based on reasonable judgments about “austerity” and “tax levels,” make a preliminary judgment about how much bond debt is sustainable.

Armed with this understanding, initiate negotiations concerning austerity and bond debt levels. The possibility of a payment moratorium can provide substantial leverage. Since creditor remedies against governments are often weak, the possibility of a moratorium alone might be enough to encourage agreement to a reasonable debt restructure plan.

A moratorium will likely provoke collection actions by creditors which must be defended. However, if a government defendant can broaden the scope of the issues and join necessary parties, it can use the judicial proceeding to propose a reasonable plan to restructure debt.

When considering actions against an insolvent government, the ultimate question before the court is not simply whether sovereign immunity has been sufficiently waived to permit one bond creditor to collect its debt. Rather, the issue should be how much can the government debtor reasonably afford to pay to all of its bond creditors. The possibility of a trial about this issue will provide additional power to lead to a fair debt restructure.

Cities in the U.S. already have an available judicial forum where a determination can be made that their debt restructure plan is fair and equitable and in the best interests of creditors and, thus, can be forced on holdout creditors who refuse to negotiate a reasonable deal. If so authorized by

its state government, a municipality can have a trial about this in a plan confirmation hearing in a Chapter 9 case under the federal Bankruptcy Code.

Sovereign governments like Greece, Ukraine or Puerto Rico can improvise ways to have a similar trial, either by broadening the parties and issues in a collection lawsuit, or by agreeing with creditors to have an arbitration about what is a fair and equitable payment.

Democratic governments will not survive if, in an effort to repay debt obligations substantially in full, they impose unreasonable taxation and austerity measures that primarily burden middle and lower class citizens. Such a transfer of wealth away from middle and lower classes will put at risk the survival of many U.S. cities, states and territories, and many sovereign states. Ultimately it will put democracy at risk.

The better approach, described below and in **Leading a Government to Solvency**, provides a way to establish a sustainable balance between, labor, capital and taxpayers.

**A. Given the amount of debt accumulated by democracies around the world since WWII and the extent of government insolvency, it is important for elected officials to understand how to lead their governments to solvency.**

1. There are two models for leading to solvency: either (a) elected government officials lead to a debt restructure based on their judgment of a reasonable amount of austerity, taxation and debt discharge, or (b) the capital community dictates its views on those issues.
2. Failure of elected officials to identify insolvency and lead to resolving it results in significant problems.
  - a. Leaving unaffordable government debt in place stagnates the growth of the economy it governs through a drawn out deterioration of services and pressure to increase taxes that drive away economic vitality.
  - b. Delay by government officials in dealing with insolvency abdicates leadership to special interests.

**B. It is good public policy to use Core Restructure Principles to overcome government insolvency.**

1. Government insolvency has been around for a long time in human history, and a number of bad ways have been developed to try to deal with it.
2. One bad way is to ignore it, pretend it does not exist, and leave it to the next administration. Politicians call this kicking the can down the road to the next administration. Detroit, Puerto Rico, Greece, and many other countries in Europe are showing that this method is not viable.

3. A number of other ways have been tried to deal with unaffordable government debt that either do not work, or, if used in isolation, create substantial problems.
    - a. One way is to try to put the solution entirely on the backs of citizens and labor through what is now called austerity, by cutting government services, jobs, wages and pensions. This reduces middle class jobs and incomes, causes recession, leads to strikes by policemen and firemen, and tears societies apart. Greece is showing the perils of this approach.
    - b. Another way is through unreasonable taxation. This primarily impacts the middle class, encourages those who are able to pay taxes to leave, and tears societies apart.
    - c. Another way is to devalue currency. This effectively taxes the middle class and pensioners and, if used to excess, tears societies apart.
    - d. The idea that governments all over the world can grow their way out of debt that they cannot reasonably afford to pay is limited by scarce resources and a climate that is already stressed by our current level of economic activity.
  4. A better approach is to apply the three core restructure principles that are used in Chapter 9 of the U.S. Bankruptcy Code to craft a debt restructuring plan that is: (a) fair and equitable, (b) in the best interests of creditors, and (c) feasible (**“Core Restructure Principles”**).
  5. **Core Restructure Principles** deal with: (a) whether the government is proposing to pay all it can reasonably afford, (b) whether creditors will get at least as much as they would by pursuing their remedies against the government and (c) whether the government is likely to be able to make the restructured payments and still provide adequate service to its citizens so that its private economy can thrive.
  6. Applying **Core Restructure Principles** essentially asks for a fair contribution from labor, capital and taxpayers to place them into a sustainable balance, with unaffordable debt discharged.
- C. Core Restructure Principles are a common-sense response to the practical issues that are presented in a government restructure.**
1. A **“fair and equitable”** plan deals with the following issues:
    - a. How much austerity, meaning less government spending, is reasonable and not counterproductive? Austerity reduces payments to citizens and labor by cutting services, levels of employment, wage levels, pension and

retiree medical payments. At some point, further spending cuts become unreasonable, unfair and even counterproductive.

- b. What is an appropriate level of taxation? How much tax increase, if any, is reasonable and not counterproductive? Too much tax increase can drive away business activity and people able to pay taxes, and actually result in lower tax collection.
  - c. When austerity causes a breach of labor and pension contracts, what is a reasonable replacement contract that will cost less going forward? What will be done with the damage claim generated by the difference between the value of the old breached contract and the new replacement contract?
  - d. What claims are actually secured by a perfected lien on collateral, and what is the value of the collateral taking into account the remedy available and market for the collateral? Secured claims should be paid the value of the collateral over time; any residual amounts owed beyond the value of the collateral are unsecured claims.
  - e. How much can the government reasonably afford to pay out of its future budgets to unsecured claims? Unless there are good reasons to do otherwise, all unsecured claims can be put in a general unsecured claim class that includes: (i) unsecured bond claims, (ii) the under-secured portion of secured bond claims, and (iii) labor-related contract rejection claims. The government's plan will be fair and equitable if it pays these claims all it can reasonably afford after reasonable austerity and use of taxation, with the remainder discharged.
  - f. A proposed fair and equitable debt restructuring plan is then subjected to two additional tests: (i) best interests of creditors and (ii) feasibility; one sets a floor and the other sets a ceiling for what should be paid.
2. The **“best interests of creditors”** test considers whether, under a debt restructuring plan, a creditor is being paid at least as much as it would get by exercising its remedies against the government, which has usually not waived sovereign immunity enough to provide creditors with very good remedies.
  3. **“Feasibility”** analyzes whether the government will be able to pay the debt as restructured, still provide adequate services to its citizens, and create a climate where its economy can thrive.
    - a. Feasibility thus presents the most fundamental issue. Will this debt restructuring plan facilitate a viable, sustainable public/private climate going forward? Will the government likely be able to maintain post-restructure metrics that show fiscal viability?

- b. The restructure process should not be used to reduce government debt just to enable a government debtor to take on new debt at an unsustainable level. One way to avoid this is to write financial metrics into the court order that approves debt discharge. If these metrics are violated, the reorganized government debtor could be required to report that it is acting in a “fiscally irresponsible” fashion. Such a court order would not limit future government action, but it would give the public notice to consider electing new leaders if current ones act fiscally irresponsibly.

**D. Different procedures for dealing with government financial restructure.**

1. Chapter 9 of the U.S. Bankruptcy Code provides a system of substantive law and a procedure to process these issues for insolvent cities openly, promptly and efficiently. In this system, the debtor government leads, publicly proposing a plan for debt restructuring based on what it believes is reasonable austerity, reasonable use of taxation and a reasonable level of debt discharge, and provides evidence to support its plan. Ideally, it spends considerable time and effort trying to sell this plan in negotiations before filing a Chapter 9 case. If certain creditors won't agree to its plan, it can file a Chapter 9 case and ask for a prompt, public trial. A court can decide promptly whether the proposed restructuring plan, including the amount of debt proposed to be discharged, is fair and equitable, in the best interests of creditors and feasible, as it decides whether to confirm this plan or not.
2. Where there is no bankruptcy system to process these issues, representatives of the capital community often approach a government that is insolvent and near default to demand austerity, tax increases and sometimes privatization of government owned assets, as a condition to the extension of additional loans to keep the government out of default. These new loans are often used to refinance existing loans and often provide little additional cash for the operation of the debtor government.
  - a. The demands of the capital community are made in private; but the argument over whether these demands are reasonable and should be accepted ultimately takes place in the public political process. Politicians can lose public support if they are seen to have been too accommodating to capital providers about the levels of austerity and tax increase that are to be imposed on citizens.
  - b. This happened in Greece with George Papandreu who asked for a referendum to approve the deal he had just made with Greece's capital providing creditors. The agreement was approved, but soon thereafter he lost public support and was out of office.
  - c. Alex Tsipras started down this path by asking for and obtaining a referendum vote supporting his “No” to the Eurozone creditors' last

demand for payment in full, with more austerity and taxation. He later accepted all the Eurozone had asked for before the referendum, plus agreed to sell many important Greek assets. So far, he has survived in office, but there are more chapters to come in this Greek drama.

#### **E. Different Leadership Challenges.**

1. Leaders of governments in U.S. cities merely need the courage to take on insolvency and lead to resolve it through the use of **Core Restructure Principles**, proposing a fair and equitable plan for debt restructuring, rather than allowing insolvency to fester and passing it on to the next administration. Chapter 9 provides a forum to resolve issues if negotiations fail.
2. For leaders of U.S. states and territories, and of sovereign countries, the same courage is needed to lead by proposing a fair and equitable plan. The possibility of a payment moratorium gives significant power to encourage acceptance of a such a plan, especially since sovereign immunity has often not been waived sufficiently to provide creditors with very good remedies.
3. These leaders are challenged to find a legal procedure that will provide the functional equivalent of a U.S. Chapter 9 bankruptcy case in which to apply **Core Restructure Principles** through an adjudication binding on holdouts. Equity receiverships and arbitrations could serve this function, as can existing statutes promoting comity in favor of bankruptcy judgments.

#### **F. Additional information:**

1. Appendix A to this paper, **Leading a Government to Solvency**, provides roadmap for leading a government debt restructure process.
2. For more detail about the legal foundation for government debt restructure, and how to do it, please see the additional published material described below which is available online at [www.zackclement.com](http://www.zackclement.com) or by request to Zack A. Clement, 3753 Drummond St., Houston, TX 77025, [zack.clement@icloud.com](mailto:zack.clement@icloud.com), 832-274-7629.

#### **G. Published Articles Concerning Government Debt Restructure**

1. **How City Finances Can Be Restructured in the Shadow of a Chapter 9 Case**, published by **Bloomberg** in October 2013, describes how a U.S. city can lead its financial restructure by proposing a fair and equitable plan of reorganization based on all it can reasonably afford to pay, restoring a sustainable balance between labor, capital and taxpayers. *BNA Bankruptcy Law Reporter*, Vol. 25, No. 39, October 10, 2013

2. **How City Finances Can Be Restructured**, published in the **American Bankruptcy Law Journal** in April 2014, describes in greater detail how government debt restructuring can be done (i) under US state law which must stop short of contract impairment, (ii) under US federal bankruptcy law which permits contract impairment and the fair and equitable payment of what the government can reasonably afford, with an order discharging unsustainable debt, and (iii) in federal equity receiverships pursued by US related entities that are not currently authorized to file a chapter 9 case. This article describes the meaning of three **Core Restructure Principles**: (i) fair and equitable, (ii) best interests of creditors and (iii) feasible. *Am. Bankr. Law Jour.*, Vol. 88, Issue I, pp. 41-84 (April 2014)
3. **What Can Puerto Rico Do?** Published in the **Puerto Rico Federal Bar Association's From the Bar**, Issue No. 52, May 2014, describes how Puerto Rico could lead its financial restructure by proposing a fair and equitable plan of reorganization, seeking to confirm that plan through a federal equity receivership, if necessary. There is substantial support for such an approach in U.S. Supreme Court and Circuit Court opinions. US states could also use this approach.
4. **Executive Summary -- Restructuring Government Debt Through a Federal Equity Receivership**, describing how the issue of how much a government can reasonably afford to pay can be litigated among the necessary parties in connection with a U.S. federal court lawsuit. Duke Law Symposium, Modern Municipal Restructurings: Puerto Rico and Beyond, November 10, 2015. This Executive summary summarizes a legal memorandum that describes substantial authority for this approach.
5. **A Revised Proposal for Arbitration of Sovereign Financial Restructure**, published at the June 2014 **International Insolvency Institute Annual Conference**, describes how a sovereign state can lead its financial restructuring by proposing a fair and equitable plan of reorganization, with questions about the fairness of its plan to be decided by an arbitral panel, and that arbitration supported by action from the UN, EU or other such organization to protect the sovereign's assets from creditors that holdout from the arbitration.
6. **Restructuring Sovereign Government Finances - in Public and in Less Than a Year**, published by **Westlaw, Insolvency Intelligence** in August 2013, describes how questions of reasonable austerity and reasonable use of taxation could be quantified by opposing parties so they could be tried and adjudicated in an arbitration of the fairness of a sovereign's plan of reorganization. 26 *Insolvency Intelligence*, Issue 6, pp. 91-83 (August 2013).