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SPECIAL COMMENT

Moody's Identifies Core Principles of Guarantees for Credit Substitution

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Summary

» A guarantee is a legally enforceable promise in which one party (the guarantor) agrees to fulfill the obligations of another party (the principal obligor) should it fail to pay or perform under the terms of its indenture, debt agreement or other contract with a third party. Guarantees appear in a wide variety of transactions that Moody's rates.

» The intent of a guarantee is to enhance credit by substituting the obligor's credit profile with that of the guarantor, typically a more creditworthy entity. Credit substitution can result from unambiguously worded guarantees in which the guarantor has the unconditional and irrevocable obligation to pay or perform on a full and timely basis without the ability to raise defenses to its liability.

» This report provides a set of core principles addressed by guarantees that achieve full credit substitution of the guarantor for the principal obligor. The list of core principles is not intended to be exhaustive or construed as a methodology. Rating teams may interpret these principles in the context of individual transactions to determine whether adherence to all or some subset of the core principles is necessary or sufficient for credit substitution.

Introduction

Issuers and borrowers often use guarantees as a device for achieving credit substitution, which we define as passing through the guarantor's applicable rating under the expectation that the guarantor will not assert any defenses to payment. Guarantees appear in a variety of transactions that Moody's rates, such as:

» In public finance, guarantees often appear in gas prepayment transactions, tender option bond programs and parent-subsidiary transactions for higher education and health care issuers.

» For corporate and financial institutions, guarantees are used in acquisitions, recapitalizations, the financing of long-term debt or issuance of commercial paper by a subsidiary of a rated company, or where an operating company guarantees the notes of a holding company or vice versa.

» Financial institutions are accorded sovereign guarantees in order to restore confidence in the country's financial system.

» Structured transactions often use guarantees to back payments, servicing, custody and trust arrangements, swap counterparty obligations, and indemnities covering particular risks.

Though extensive, these examples are hardly exhaustive of the situations where guarantees are used. A guarantee can arise in any situation where an obligor needs to enhance its credit for any reason, and has available a more creditworthy entity willing to provide meaningful support.

Moody's recognizes that laws on guarantees vary throughout the world. This special comment identifies certain core principles that are found in guarantees that successfully achieve credit substitution; however, this report does not prescribe the actual solutions that may apply in any particular situation. To the extent that Moody's identifies common elements applicable to a business sector (*e.g.*, insurance), transaction type (*e.g.,* swap transactions), asset class (*e.g.*, CDOs) or type of jurisdiction (*e.g.,* civil code versus common law), Moody's may address these in one or more appendices updating this comment over time.

Guarantee Overview

A guarantee is a legally enforceable promise in which one party (the guarantor) agrees to fulfill the obligations of another (the principal obligor) if the principal obligor fails to pay or perform. Ideally a guarantee covers the principal obligor's failure to perform for any reason, including as a result of bankruptcy or in the event that a court rescinds/recovers a payment the principal obligor previously made. Beneficiaries of the guarantee are best served if, upon a principal obligor's default, they are able to proceed directly against the guarantor for satisfaction in full of the guaranteed contractual promise without needing to first exercise available remedies against the principal obligor.

However, depending on how the guarantee is drafted, the guarantor may be able to legally raise a wide array of defenses to its liability. For example, the courts recognize a number of defenses specific to guarantees, which can allow a guarantor to materially delay or completely evade its guarantee obligation. These defenses may relate directly to the terms of the guarantee (*e.g.,* failure to explicitly waive specific defenses). In addition, the guarantor may assert defenses belonging to the principal obligor. Thus, unless the form of guarantee contains certain features to close such gaps in the guarantor's liability, effective credit substitution may not be achieved.

Moody's has identified a number of core principles addressed by guarantees that achieve full credit substitution of the guarantor for the principal obligor (*i.e.*, rating the guaranteed obligation as if it were a direct obligation of the guarantor). Not all transactions, however, require full credit substitution as a basis for the rating.

For example, a transaction may have a swap, where the swap counterparty is unrated but swap payments are guaranteed by a rated entity. If the swap is an integral component of the transaction but not essential for the principal obligor to be able to pay debt service, the failure of the guarantee to fully address some of the core principles would not necessarily impair a rating. On the other hand, if the swap payments were essential to pay debt service and the parties entered into the guarantee to enable the bonds to benefit from the rating of the guarantor, Moody's, in order to assign such ratings, would look to the guarantee to satisfy the core principles of credit substitution.

Core Principles

The following summarizes the types of provisions in guarantees that would support complete credit substitution. This list is intended to describe the principles-based approach that Moody's will use globally to evaluate credit substitution. It is not intended to be an exhaustive list of industry, transaction type, asset class or jurisdiction-specific features that must be present as a matter of law or market practice for credit substitution. Rating teams will interpret these principles in the context of individual transactions.

1. **The guarantee states that it is irrevocable and unconditional.** In Moody's view, a guarantee that is offered as a substitute of the guarantor's rating for that of an unrated participant (or one with a lower rating than the guarantor) would create an unconditional obligation to pay or perform on the part of the guarantor. In such case, the guarantee functions very much like any other third-party demand instrument, such as a letter of credit or bond insurance policy, where the credit enhancer must simply pay without recourse to any defenses. The guarantee directly benefits the intended beneficiaries of the guaranteed obligation and their fiduciary in the specific transaction – for example, the trustee and the bondholders in a securitization. Unless the agreement states that there is joint and several liability among multiple guarantors, Moody's will look for contractual allocation of this liability.

2. **The guarantee promises full and timely payment of the underlying obligation.** Moody's will analyze the timing of payment specified by the terms of both the underlying obligation and the guarantee to assure that the guarantor must pay no later than when the guaranteed obligation is contractually due. A guarantee that achieves credit substitution also covers the full amount of the principal and interest due on the debt obligation as well as any other amounts that are contractually owed to noteholders, such as a redemption premium or penalty interest. In addition, there should be no additional costs to the noteholder as a result of relying on the guarantee that are not otherwise covered or alleviated by the transaction structure. For example, payments may need to be grossed-up for taxes or other regulatory costs that would not be levied except for the guarantee in order to achieve credit substitution.

3. **The guarantee covers payment -- not merely collection.** Guarantees of collection require that the creditor first exhaust all judicial remedies against the principal obligor before demanding payment from the guarantor. Such guarantees do not provide credit substitution; they merely provide a possible recovery at the end of two litigations (first against the principal obligor, then against the guarantor). Guarantees of payment, in contrast, require the guarantor to pay upon demand from

a beneficiary or automatically pay when payment becomes contractually due according to the terms of the underlying obligation. The beneficiary does not have to first demand payment from the principal obligor, nor does the beneficiary have to take any action against the principal obligor in order for liability to arise on the part of the guarantor. Moody's expects a guarantee offered for credit substitution to explicitly state that the guarantee is one of payment and not of collection, or to contain functionally equivalent language.[1] Moody's will also critically assess any other procedural impediments contained in the guarantee that could have the practical effect of converting the guarantee promise into one of collection, or that could, in any way, delay the payment of the debt obligation when due.

4. **The guarantee covers preference payments, fraudulent conveyance charges, or other payments that have been rescinded, repudiated, or "clawed back."** A guarantee that achieves credit substitution covers any payment from the principal obligor that a court rescinded, or required noteholders to give back (*i.e.,* "disgorge") either as a result of the principal obligor's bankruptcy or otherwise. While claw-back or disgorgement most typically occurs as the result of a judicial order from a bankruptcy court, a regulatory agency will sometimes have similar statutory powers.

   For example, under the U.S. Bankruptcy Code, a "preference" is a payment that a borrower made during a certain period prior to filing bankruptcy that meets certain tests. The Code presumes that if applicable tests are met, the payment was made in contemplation of bankruptcy and the creditor which received payment was preferred over other creditors. A bankruptcy trustee or debtor in possession may have the right to recover any such preference payment. To eliminate this risk, a guarantee should cover any beneficiary payments which may be required to be returned to the principal obligor's bankruptcy estate.

5. **The guarantor waives all defenses.** As mentioned previously, a guarantor can invoke various defenses to payment. In its legal capacity as guarantor under the guarantee contract, the guarantor can raise so-called suretyship defenses. In addition, the guarantor may have the benefit of almost all the defenses available to the principal obligor under the guaranteed debt contract. Unless all these defenses have been expressly waived, collection from the guarantor could require complex fact-based litigation, thus increasing the risk that debt service payments may not be made on a timely basis.

   In general, Moody's views suretyship defenses as inconsistent with the purpose and function of a guarantee offered as credit substitution. It is therefore important that all suretyship defenses be explicitly waived. However, because suretyship defenses are specific to a guarantor, language merely stating that "all suretyship defenses are waived" may not be sufficient; courts have required *specific* waivers of particular suretyship defenses.

   Suretyship defenses include but are not limited to: (i) assertions of amendment, waivers or forbearance affecting the underlying agreement or collateral supporting the original transaction; (ii) the principal obligor's lack of authorization to enter into the underlying guaranteed agreement or the principal obligor's disability or bankruptcy; (iii) incomplete performance of the guaranteed contract; (iv) delay by the beneficiary in making a claim; (v) lack of complete disclosure of matters relevant to the guarantor; and (vii) failure to notify the guarantor. If a guarantor pays a guaranteed obligation, general principles of surety law entitle the guarantor to collect reimbursement from the principal obligor. To achieve credit substitution, the guarantor waives all such "rights of

[1] Certain guarantees include *performance* obligations (such as the delivery of collateral or the provision of other services when required) in addition to payment obligations by the guarantor. These performance obligations should also be due upon demand of the guarantee beneficiary or when contractually due.

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subrogation" until the underlying obligation has been paid in full to avoid coincident lawsuits brought against the principal obligor whereby the guarantor is competing with beneficiaries for payment.

Suretyship defenses do not cover contractual defenses that the principal obligor or guarantor could assert such as set-off, counterclaim, recoupment, fraud, duress, failure of consideration, breach of representations and warranties or other agreements, payment, statute of frauds, statute of limitations, accord and satisfaction, failure to deliver notices, and usury. In addition to satisfactorily waiving all of its suretyship defenses, the guarantees achieving credit substitution expressly waive all contractual and other defenses available to the guarantor or the principal obligor. As with surety defenses, "blanket" waivers of such defenses may not ensure enforceability of the waivers. Ideally, the principal obligor will also separately waive its own defenses, especially those of set-off, recoupment and counterclaim. When a guarantee is silent about any of the defenses that either the guarantor or the principal obligor may raise, a guarantor could conceivably assert these defenses. If successful, the guarantor can delay payment, or at worst, renounce its payment obligations altogether.

Guarantees that achieve credit substitution also state that action or inaction, including any non-performance or failure to satisfy any condition precedent by the guaranteed party (i.e., the principal obligor) does not affect the guarantor's obligations. In addition, guarantees that achieve credit substitution explicitly state that the guarantor remains obligated to pay even if the underlying contract is void, unenforceable, illegal, or has any other defect that prevents the beneficiary from obtaining payment.

6. **The term of the guarantee extends as long as the term of the underlying obligation.** A guarantee that does not remain in force for the entire life of the guaranteed obligation, including any bankruptcy or other regulatory preference periods, or that can be terminated prematurely at the guarantor's sole option, raises the possibility of a downgrade or withdrawal of the rating of the guaranteed bonds, even in the absence of a payment or other default.

   A guarantee that achieves credit substitution remains a continuing obligation even if there is a partial settlement or intermediate payment, and terminates only after the final payment due under the guaranteed obligation has been received, any related liabilities have been satisfied, and any bankruptcy or other regulatory preference periods have expired . Alternatively, if the guarantee terminates before the underlying obligation, Moody's expects the guarantor to remain obligated unless it has provided funds sufficient to pay the guaranteed obligation if the principal obligor defaults.

   Similarly, provisions that allow the guarantor to unilaterally terminate its obligations should include adequate alternate safeguards for beneficiaries, such as a requirement that the guarantor first deliver a satisfactory replacement guarantee. Moody's will therefore carefully assess any contractual "outs" available to the guarantor to ensure that these are consistent with credit substitution.

7. **The guarantee is enforceable against the guarantor.** A guarantee that achieves credit substitution is one that is not only signed by the guarantor, but is enforceable against the guarantor as well. To confirm such enforceability, Moody's will review legal opinions similar to those prepared in connection with other credit enhancement instruments, like letters of credit. Legal opinions

addressing the enforceability of guarantees should adhere to the same standards that apply for opinions on other credit enhancement instruments.

Many transaction structures, including those for which the rights under the guarantee are to serve as collateral for the noteholders, may not achieve credit substitution without the acknowledgment and agreement of the guarantor that the benefit of the guarantee may be assigned or transferred and may be granted as security.

8. **The transfer, assignment or amendment of the guarantee by the guarantor does not result in a deterioration of the credit support provided by the guarantee.** Moody's has also encountered guarantees that allow the guarantor to transfer, assign or delegate its obligations to another party. While Moody's recognizes that assignment in and of itself will not necessarily release the guarantor from its obligations, an assignment preserving credit substitution also provides written confirmation from the guaranteeing assignor at the time of assignment that it retains ultimate liability.

   If assignment can result under any circumstance in the release of the assignor or constitute a novation, significant credit substitution issues may arise. For example, the new guarantor may not be rated or may not be rated as highly as the prior guarantor, or the terms of the new guarantee may vary from those of the original guarantee. Similarly, any subsequent amendment of a guarantee may alter the nature of the guarantor's obligation, possibly weakening the guarantee's effectiveness as a credit substitution mechanism. In such cases, Moody's analysis will evaluate the substantive impact of the assignment to determine if a reduction or withdrawal of the rating on the guaranteed obligation is warranted.

9. **The guarantee is governed by the law of a jurisdiction that is hospitable to the enforcement of guarantees.** For example, some states in the U.S., such as California, give guarantors a wide range of rights and defenses, and interpret guarantors' waivers narrowly. Other U.S. states, such as New York, take a more practical approach and the courts have historically been more willing to read waivers broadly and enforce guarantees in a way that is more likely to be consistent with the expectations of the parties. Moody's believes the latter provides more protection. However, in cases involving pro-guarantor jurisdictions, Moody's will seek to understand, perhaps through discussions or opinions from outside counsel, that the guarantee document includes all waivers and other provisions customarily needed to mitigate the effect of pro-guarantor legal principles of the particular venue.[2]

[2] Similarly, in Moody's opinion, England and Wales is one of the least restrictive environments in Europe for issuing upstream guarantees, which allow a subsidiary company to guarantee its parent's obligations (providing it complies within its proper powers). In France and Germany, and other European jurisdictions, on the other hand, there are often limitations on the effectiveness of such guarantees (e.g., director responsibilities, statutory limitations on amount, restrictions on purpose).

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Related Entities:

The core principles in this publication are applicable to guarantees involving *related entities* as well as to those involving unrelated entities. Corporate issuers commonly guarantee the debt of *related entities*, including guarantees of subsidiaries by parent companies and vice versa.

Where the guarantee of a related party departs from the core principles described in this report, Moody's may consider whether the guarantor's self-interest in maintaining the creditworthiness and business viability of its affiliate is sufficient to mitigate contractual deficiencies in the guarantee. The factors Moody's considers include but are not limited to (a) the degree to which the operations of the companies are interwoven, (b) the degree to which the operations of the guaranteed issuer are integral to the guarantor and (c) the degree of business or financial disruption that would result for the guarantor or its corporate family if payments by the guaranteed affiliate are not made on time.

The outcome of this fundamental analysis can range from no support attributed to the guarantee (in which case the rating is based solely on Moody's assessment of the guaranteed issuer's stand-alone credit quality), to an equalization of the ratings of the guaranteed entity with that of the guarantor (meaning full support may be attributed in some cases despite weaknesses in the support documents or even in the absence of such documents).

The durability of the relationship between the supporting and supported entity will be examined closely where implicit support is incorporated into a rating and the guarantee has significant legal weaknesses or where there is no express guarantee. *Because a supporting entity's self-interest may lessen over time due to changes in the strategic importance or ownership of the supported entity, a legally valid and binding guarantee without any shortcomings always provides the strongest long term assurance that the guarantor will provide timely support.*

Conclusion

If properly drafted, guarantees can be an effective mechanism for credit substitution in rated transactions. Moody's takes a transaction-specific and principle-based approach to evaluating what, if any, credit enhancement the relevant guarantee(s) may provide. Moody's rating will depend on whether the guarantee(s) in question adequately address the credit substitution guidelines contained in this comment, as well as on the relative importance of the guarantee to the overall soundness of the transaction being reviewed.

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Moody's Related Research

Rating Methodologies:

» Moody's Rating Methodology for Municipal Bonds Fully Supported by Corporate Guarantees, September, 2005 (94366)

» Rating Non-Guaranteed Subsidiaries: Credit Considerations in Assigning Subsidiary Ratings in The Absence of Legally Binding Parent Support, December 2003 (80304)

» Financial Guaranty Policies – What is Needed For Credit Substitution? March 2009 (55948)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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