Article Title: ARCHIVE | Criteria | Corporates | General: Relying on Upstream Guarantees: When Are They Valid? Data: When a subsidiary guarantees the debt of its parent, that is commonly referred to as an upstream guarantee. The object of the exercise is to address the structural subordination that would otherwise apply to parent-company debt. But there are legal risks that an upstream guarantee may be voided. Standard & Poor's has formulated the following guidelines, in consultation with its counsel, to clarify when it will rely on such guarantees in rating parent-company debt. Upstream guarantees are considered valid if any of these conditions are met: The proceeds of the guaranteed obligation are provided to ("downstreamed" to) the guarantor, or The legal risk period--ordinarily one or two years from the time of entering into the guarantee--has passed, or There is a specific analytical conclusion that there is little default risk during the period that the guarantee validity is at risk, or The rating of the guarantor is at least 'BB-' in jurisdictions that involve a two-year risk, or at least 'B+' in jurisdictions with a one-year risk, Accordingly, there will be cases where Standard & Poor's declines to recognize the upstream guarantee at the time of issuance--due to legal risk--but would upgrade the issue a year (or two) later. Structural subordination In most legal jurisdictions, in a bankruptcy of an operating company and its parent, the claims of operating company creditors have priority on the assets of the operating company; any residual value would be available for the parent's creditors. The term "structural subordination" refers to this inferiority of holding company debt. Standard & Poor's criteria recognize this structural subordination by rating debt issues of a holding company one or two notches below the debt of the operating subsidiaries. Upstream guarantees, if valid, would eliminate the rating distinction because the operating company becomes directly responsible for the guaranteed parent debt. However, the validity of the guarantee is subject to legal risk. An upstream guarantee may be voided in court, if it is deemed to constitute a fraudulent conveyance. The outcome depends on the specific fact pattern, not legal documentation, so one cannot standardize the determination. Still, by understanding the legal issues, the analyst can decide where the legal risk is acceptable in the context of relying on the upstream guarantee so that the parent's debt can be rated the same as that of the guarantor. Legal factors The guarantee will be voided if the guarantor is deemed insolvent or about to be insolvent (after taking into account the liability of the guarantee itself) and did not receive value in exchange for the guarantee. Put differently, if either the guarantor company received value or was solvent for a sufficiently long period of time subsequent to issuing the guarantee, the upstream guarantee should be valid. Accordingly, Standard & Poor's accepts an upstream guarantee whenever the guarantor obtained value. As long as the guarantor is the recipient of the funds, it meets this test. It matters not whether the issuer downstreams the money as an equity infusion or as a loan. Either way, the financing benefits the operations of the subsidiary, which justifies the guarantee. Determining the solvency of the guaranteeing subsidiary is more ticklish. Solvency is not clearly defined. It can be based on balance-sheet accounting values, or it can be a function of whether the company is meeting all its obligations, or something in between. Nonetheless, Standard & Poor's has concluded, upon advice of counsel, that a reasonable standard for solvency is met if a company were to continue operations and meet all obligations for the period required. Whatever the notion of solvency, it must endure one year, two years, or more, past the issue date, depending on the jurisdiction. In the U.S., the requirement is one year; in the U.K. and several continental European countries it is two years. Therefore, if there is confidence, from the analytical perspective, that no insolvency will occur within that time frame, one can rely on the guarantee. Corporate ratings can normally be used as a proxy for the likelihood of near-term insolvency. Even though ratings address the likelihood of default over the life of the obligation--and not necessarily the timing of such a default--there is a general expectation that a company rated 'B+' would not default within a year. Similarly, a company with a rating of 'BB-' or better should be sufficiently strong to survive a couple of years.