Sovereign Damage Control

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Introduction[2]

A string of US court rulings against Argentina is reverberating around the world: Italy changed its debt contracts, Taiwan sued Grenada, Belize passed a special law, and the International Monetary Fund (IMF) and some of its largest members are revisiting their policies on sovereign debt restructuring. The case, *NML Capital Ltd. et al. v. Republic of Argentina*, has breathed new life into initiatives ranging from sovereign bankruptcy to market-wide contract reform. If upheld, recent rulings threaten collateral damage to other countries and parts of the financial system. The impact may be felt sooner and farther afield, even compared with Argentina's record-breaking 2001 default, because court action is unfolding against the background of public debt distress in Europe, new emerging-market restructurings, and a regulatory focus on clearing and payment systems.

Argentina exchanged nearly USD 100 billion in principal and past-due interest on its defaulted foreign bonds in two waves, in 2005 and 2010. Both times some creditors refused to take the deal and insisted on full payment. Among them, NML Capital Ltd., an affiliate of Elliott Associates, has been chasing Argentina in courts around the globe for years. Its efforts to collect have largely failed so far. If Elliott prevails this time, creditors will gain a potent new tool against sovereign debtors. The power shift would come courtesy of one obscure debt contract term that has gained destructive power in a case where the government and its creditors are uniquely willing to test the limits of the law.

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[2] This essay is updated and adapted from Gelpern (2013).

Cat and mouse forever

Sovereign debt is a paradox: it is mostly unenforceable, but it never goes away. Foreign government bonds routinely contain expansive sovereign immunity waivers and clauses submitting the debtor to the jurisdiction of a court in New York, London, or another place the creditors find reassuring. But when the debtor runs out of funds, creditors discover that enforcement requires skill, commitment, and resources beyond the reach of all but a few specialists. Facing default, most either agree to exchange their bonds for new ones worth a fraction of the old, or sell their old bonds to the specialists at a deep discount. The specialists may go on to test the legal system to secure full repayment from the funds freed up by the original creditors' concessions. Sometimes they succeed. There is no bankruptcy discharge and, despite decades of innovation, no contractual device to force a committed creditor to modify its claim in line with the rest. The cat-and mouse game can go on forever.

The vast majority of cases do not go on forever; most never even go to court. Lawsuits were a factor in 29 out of 180 sovereign debt restructuring episodes involving private creditors between 1976 and 2010 (Schumacher, Trebesch and Enderlein 2012). Governments that successfully restructure most of their debt usually settle with the remaining creditors under the table, to avoid perennial litigation. For an extreme example, Greece continues to make scheduled payments to the holders of its foreign-law bonds that stayed out of its 2012 restructuring (Zettelmeyer, Trebesch and Gulati 2013). Participating creditors rarely mind, since they themselves have no stomach for a long court battle and might even appreciate the holdouts' disciplining effect on the sovereign (Fisch and Gentile 2004).

The tension between lack of enforcement and lack of discharge – and most debtors' and creditors' shared aversion to spending the rest of their days in court – paves the way for relatively smooth restructurings. The battle between Argentina and Elliott Associates is different. It features worthy adversaries, which have, together and apart, made some of the most important case law in sovereign debt. They are perhaps

the most determined debtor-creditor pairing in modern memory, which almost by definition puts their dispute on the cutting edge.

Equality as a collection tactic

The provision at the heart of the case is part of the *pari passu* clause, which has roots going back to the nineteenth century (Gulati and Scott 2012). All versions of the clause promise that the debt contract that contains it will be on equal footing with some subset of others – except that lawyers cannot agree on what equal footing means or what to do when it becomes unequal (Weidemaier, Scott and Gulati 2013). Argentina's formulation, which has become popular in recent years and is shared by the likes of Cyprus, promised to rank the debtor's payment obligations equally. In one sense, the case is about the relative significance of the words "rank" and "payment". If *pari passu* only promised legal rank, it would be useless to modern-day creditors of sovereign governments. The only practical way for a debtor to breach would be to pass a domestic law effectively subordinating the debt (Buchheit and Pam 2004). But for most countries, simply stopping the payments to some creditors does the job. Passing a law to sanction this adds nothing.

In 1997, Elliott Associates gave *pari passu* a more capacious meaning. In lawsuits against Nicaragua and Peru, Elliott claimed that the clause required a debtor unable to pay all its creditors in full to pay each creditor proportionately or "ratably" – and that payments on its performing obligations could be blocked until the debt covered by the clause was paid.

In 2000, a Belgian court endorsed this view, and enjoined Euroclear from distributing payments on Peru's restructured bonds until Elliott was paid.[3] Peru settled on terms very favorable to Elliott. Belgium responded with a law shielding Euroclear from similar injunctions – even as its higher courts later rejected Elliott's argument.[4]

Overnight, the meaning of *pari passu* went from marginal and forgotten to all-important and hotly contested. Since the clause was ubiquitous, it offered the first replicable path for collecting sovereign debt, one that did not rely on finding one-off commercial assets left outside the debtor's borders.

The "ratable payment" interpretation of *pari passu* also opened a host of operational questions. What should count as "ratable" was anybody's guess without bankruptcy, a single moment of reckoning, or a fund to divvy up among a fixed group of claimants. A government's general revenue flows might suffice to pay its debts due on Monday, but not on Tuesday – or next week or next month. Would paying everything until the coffers ran dry mean subordination, or just bad luck, for the debts that came due later? Would creditors receiving the early payments have to share with others? Would creditors such as NML, if they recovered on the ratable payment theory, have to share with those who might sue later? Would payments to the World Bank, the IMF, and others excluded from restructuring by custom, count as super-senior for *pari passu* purposes? How might aratable payment scheme be administered across different instruments held by dispersed creditors – would it be up to every creditor to trace and block payments to every other? Most such questions had no good answers.

***Pari passu* returns**

When creditors tried to block a debt exchange by one of its provinces using the *pari passu* clause in 2004, Argentina asked US District Court Judge Thomas P. Griesa to declare that the clause could not be used to support a ratable payment order under New York law. The US government and the Federal Reserve Bank of New York sided with Argentina; the Fed called the enforcement strategy "terrorism of payments and settlement systems."[5] The court agreed with the plaintiffs that issue did not need to be decided, since they had not brought a *pari passu* claim against Argentina itself.

NML waited until late 2011 to raise *pari passu*. Since 2004, Argentina had steadfastly refused to settle with the holdouts, and even enacted a "Lock Law" raising additional barriers to side payments. Intended to reassure those participating in the 2005 exchange, the Lock Law was the rare bit of domestic legislation that could be read as violating even the narrow "ranking" interpretation of *pari passu*.

[3] Elliott Associates, L.P., General Docket No. 2000/QR/92 (Ct. App. of Brussels, 8th Chamber, September 26, 2000).
[4] *Republic of Nicaragua v. LNC Investments LLC*, General Docket No. 2003/ KR/334 (Ct. App. Brussels, 9th Chamber, March 19, 2004).

[5] Letter from Thomas C. Baxter, Federal Reserve Bank of New York, to the Honorable Thomas P. Griesa, dated January 12, 2004, re: *Macrotecnic Int'l v. Argentina and EM Ltd. v. Argentina*.

In February 2012, Judge Griesa ruled that Argentina was in breach and ordered it to stop paying the new bonds unless it paid NML. The order was stayed while the government appealed. The US Court of Appeals for the Second Circuit stunned observers when it upheld the lower court ruling in October 2012, rejecting every contract, policy, and statutory argument mounted by the Republic, and the US State and Treasury Departments. It held that (1) Argentina's contracts support ratable payment to holdouts, (2) Argentina violated its contracts by some combination of protracted default, public statements that it would never pay holdouts, and the Lock Law, and that (3) NML and its fellow plaintiffs were entitled to an injunction telling Argentina to pay them and the new bondholders in equal step.

Though it ruled for NML, the appeals panel sent the case back to the Judge Griesa to clarify what he meant by ratable payment and how the injunction would affect third parties, such as the banks processing payments from Argentina to its bondholders.[6] The judge's response was stunningly broad: "ratable" meant that the plaintiffs should get full principal and past due interest whenever performing bond holders get an interest coupon. Trustees, clearing houses, and payment systems were all exposed to sanctions for sending money to the bondholders while NML went unpaid.

Throughout 2013, the case has taken one crazy turn after another. The Second Circuit panel had committed to review Judge Griesa's response. It faced an avalanche of briefs from old and new bond holders, market utilities, trade groups, and academics of all stripes.

On February 27, 2013 more than 250 lawyers, investors, analysts, journalists, and gawkers packed into two overflowing court rooms to hear celebrity lawyers try to convince three thoroughly exasperated judges. While everyone agreed that Argentina had lost, many puzzled over the court's apparent willingness to sanction a wide range of third parties and simultaneously entertain repayment alternatives. Two days later, the panel ordered Argentina to propose a formula. This was big: allowing debt contract modification over creditor objections would be akin to sovereign bankruptcy, achieved here outside the statutory framework using the judges' equitable discretion and the debtor's immunity. Argentina's response showed that it was either unwilling or politically unable to seize the opportunity. It offered a menu of securities along the lines of its 2010 exchange, which the plaintiffs had rejected long ago – and promptly rejected again this time.[7]

The next two months passed in tense anticipation of the appellate ruling. Creditors holding bonds denominated in euros and Argentine pesos asked courts in New York and Brussels to rule that their payments outside the United States were beyond the reach of the injunctions. Potentially facing a deadline for an appeal to the US Supreme Court, Argentina filed a petition on June 25. The filing was narrowly limited to the Foreign Sovereign Immunities Act and did not challenge the interpretation of the *pari passu* clause. No doubt Argentina decided to maximize its chances of Supreme Court review by focusing on a federal statute, rather than on state-law contract interpretation issues of the sort the Supreme Court tends to avoid.

A month later, France filed an amicus brief asking the Supreme Court to take the case, making all the contract and policy arguments sidestepped by Argentina. This would have been a bizarre side note had the United States not pulled back its own brief at the last minute and blocked a filing by the IMF – perhaps yielding to political pressure. France's appearance raised the likelihood of the Supreme Court requesting the US government's views, and with it, the likelihood that the court will hear the case.

On August 23, the Second Circuit issued its second ruling, another decisive victory for NML: Judge Griesa's draconian injunctions were upheld in full, and third parties were put on notice that helping Argentina service its restructured debt was risky business. At this writing, petitions in the *pari passu* battle are pending at every level in the US federal court system. It seems unimaginable that the tide of decisions against Argentina could reverse. Another round of Supreme Court appeals is virtually certain.

[6] See *NML Capital Ltd. v. Argentina*, 699 F.3d 246, 244–255 (2d Cir. 2012) ("[The ratable payment formula] could be read to mean that if, for example, Argentina owed the holders of restructured debt USD 100,000 in interest and paid 100 percent of that amount then it would be required to pay the plaintiffs 100 percent of the accelerated principal and all accrued interest. Or it could be read to mean that, if such a USD 100,000 payment to the exchange bondholders represented one percent of the principal and interest outstanding on the restructured debt, then Argentina must pay plaintiffs one percent of the amount owed to them. We cannot tell precisely what result the district court intended.").

[7] The plaintiffs' filing also dismissed Argentina's forecast of more lawsuits to come. As if on cue, a group of individual investors tried to join the fray two days later, demanding that Argentina pay *all* its holdouts, not just the plaintiffs in NML's lawsuit. The court rejected the new *amicus* brief on April 25, 2013.

The fallout

NML v. Argentina may or may not change the world of sovereign debt restructuring as we know it. Whatever happens to the parties in this case, the market will adapt. The more urgent question is whether the *pari passu* remedy as it stands today makes for bad law and creates a policy problem – even assuming the market adapts in the end. I suggest that it does for three reasons.

First, the *pari passu* remedy is premised entirely on maximizing collateral damage, without reaching the debtor.[8] A fundamental problem with ratable payment orders is their inability to compel Argentina to do as it promised. If Argentina is determined not to pay NML, it can continue stonewalling it. Ignoring the court will not land officials in jail or damage Argentina's reputation any more than it is already damaged. In contrast, the various market actors heretofore on the sidelines in the fight between Argentina and NML have suddenly become the holdouts' principal levers and opponents. The court orders operate like a secondary boycott: If Argentina defies court orders, parties who are within the court's reach risk punishment for dealing with it. The country remains sovereign and immune, if increasingly isolated.

Second, as proposed by NML, the *pari passu* remedy is partial, arbitrary, and inequitable. It gives a single enterprising credit or a large windfall payment, not shared with the other defaulted bondholders – as the late-coming holdouts discovered in their failed attempt to get a ratable share of this case. Even those who welcome the recent court orders as a long-overdue check on sovereign impunity might be troubled by the arbitrary incidence of the check: Some of the debtor's assets are blocked for the benefit of a small group of creditors, while everyone else suffers deep losses. It stands in contrast to the bankruptcy ideal, where the debtor's estate is distributed among all its creditors.

Third, the *pari passu* remedy is bad for debt management and debt restructuring incentives. The Second Circuit opinion does not differentiate between an ordinary debtor that runs out of cash and what some have termed a "rogue debtor" (Porzecanski 2005). Future courts will need to flesh out when a good apple turns bad or when default becomes subordination. Until the standards are clear, creditors may attach the same litigation risk premium to both, lending the good apple too little and the bad apple too much. In distress, fear of lawsuits may delay the debtor's decision to restructure and reduce the creditor's willingness to participate. Though the magnitude of this effect is unclear, it is likely to be more pronounced for smaller, poorer, less stable countries that cannot afford to battle its creditors for over a decade on Argentina's model.

[8] This concern was "determinative" for the English court that denied a ratable payment injunction against Congo in 2003, rejecting a remedy "directed towards the coercion of third parties rather than securing immediate compliance by the defendant" (*Kensington International Ltd. v. Republic of Congo*, [2003] EWHC 2331).

Those who argue that the outcome in Argentina will have no impact on future debtors and creditors point to the successful debt exchange in Belize, completed in March 2013 against the background of Second Circuit proceedings.[9] It is too early to tell whether Belize is a sign of things to come: It might have succeeded thanks to factors unique to Belize, continued uncertainty about Argentina, or Argentina's ultimate irrelevance. Reflecting uncertainty, countries' reactions to the New York proceedings have ranged from expressions of concern in US Securities and Exchange Commission (SEC) filings by Mexico, Paraguay and others, to radical contract surgery eliminating the ratable payment promise in Italian bonds, and a new *pari passu* lawsuit by Taiwan against Grenada, complete with its own rush of third-party briefs. The IMF cited litigation against Argentina in a policy paper made public in May 2013, launching a new work stream to reform sovereign debt restructuring.

Ways out

Three solutions would solve all three problems.

A statutory sovereign bankruptcy regime is the most obvious response, and the least likely to happen. Depending on how it is designed, treaty-based bankruptcy could offer countries the prospect of a fresh start, or debt discharge, in exchange for paying all their creditors on an equitable basis. Statutory bankruptcy would also have the advantage of greater political legitimacy and public accountability for its distribution choices.

The failure of the IMF's Sovereign Debt Restructuring Mechanism (SDRM) in 2003 for lack of support from key stakeholders (Setser 2010) suggests that even a modest treaty scheme may be doomed. There is no evidence of wholesale conversion among those that blocked it a decade ago. But if debtors become a little

[9] "Belize Debt Offer Exchange Successful," Reuters, March 8, 2013.

more hesitant to launch a restructuring, and if creditors become a little more reluctant to participate, it would bolster the case for sovereign bankruptcy. The tipping point is hard to tell.

Contract reform to overcome creditor coordination problems is the presumptive alternative to statutory bankruptcy. Collective action clauses (CACs), which have proliferated in sovereign bonds since 2003, allow a supermajority of creditors to bind would-be holdouts in a restructuring. If CACs could eliminate all holdouts, there would be no *pari passu* lawsuits – the meaning of the clause would be irrelevant. But CACs cannot and should not guarantee the success of every restructuring operation.

For the most part, CACs operate on an issue-by-issue basis. This allows creditors to buy blocking stakes in small issues trading at a deep discount and keep them out of the restructuring. For example, more than half of Greece's foreign-law issues with CACs failed to get enough votes, held out, and continue to be serviced on time. This made little difference for the overall outcome of the debt exchange because over 90 percent of the Greek debt stock had been governed by Greek law and was amended across multiple issues, leaving no holdouts (Zettelmeyer, Trebesch and Gulati 2013).

A small subset of sovereign bond contracts allow votes across multiple bond issues. The device is known as aggregation or cross-series modification. In most cases, aggregation procedures require a double-majority vote (conducted across the debt stock and for each issue) and let single bond issues drop out of the restructuring. Aggregated CACs that provide for a single vote and do not allow any issues to drop out would blur the line between contract and bankruptcy, and remain controversial. The IMF and some of its largest members have begun to advocate just such a solution, which has become more politically palatable as a result of *NML v. Argentina*.

Some outstanding bonds (no one quite knows how many) still do not have CACs because they were issued under New York law before 2003, where the custom was to require unanimous bondholder consent to modify the financial terms. A few post-2003 issues have resisted CACs. Moreover, not all sovereign debt instruments with *pari passu* clauses are in the form of bonds susceptible to the inclusion of CACs. For example, syndicated and bilateral loan contracts with *pari passu* clauses may present a distinct source of vulnerability.

The third solution is limited and direct: change or eliminate *pari passu* clauses that give rise to ratable payment injunctions. Unlike the first two solutions, which try to reform the overall regime for debt restructuring, the third focuses on collateral damage control.

Because the *pari passu* remedy targets trustees, clearing houses, and operators of payment systems, it is in their interest to shield themselves. Private-sector initiative would be particularly appropriate in this area, dominated by a small cohort of large regulated institutions that serve as gatekeepers for the securities market. Stock exchanges and clearing houses have a history of driving contract change through listing and membership requirements (Flandreau 2013; Buchheit and Gulati 2003). Clearing and payment systems and trustees already seek commitments from participants to protect themselves from risks associated with particular counterparties and contracts.

After *NML v. Argentina,* market utilities could require sovereign debtors to represent that none of their outstanding debt contracts contain ratable payment terms that would expose the utility to injunctions. A debtor that refuses either would not get the service or would have to pay more for it. Additional sanctions could apply if the representation is discovered to be false after the fact. The requirement could also take the form of clearing eligibility criteria, covenants, indemnity provisions, or some combination of all these.

Although the precise formulation should be up to the market utility, any such requirement would have three benefits. First, it would force governments to discover and disclose information about their debt contracts (not just bonds) that could impose costs on third parties. Second, it would prompt governments to eliminate particularly risky formulations of *pari passu* for fear of paying more or losing market liquidity. Third, it would preserve any given government's ability to promise ratable payment to its creditors up front in clear and unambiguous terms. Even if the value of this promise as a collection device would be dubious, some creditors might want it as extra protection against "rogue debtors." They would pay more or lose liquidity – and so they should. The requirement would force debtors and creditors that present the highest risk to the system to internalize their costs.

Like any contract reform, this one would entail transition challenges. It would be burdensome and expensive for countries to change all their debt contracts over-

night.[10] However, having market utilities drive *pari passu* reform should be quicker, easier, and more likely to produce a standardized outcome than the CAC campaigns of the 1990s and 2000s.[11] The utilities are motivated to protect themselves and provide essential services across the sovereign debt market. This should help overcome the network and agency problems that seem to keep governments and their lawyers from changing suboptimal contracts (Gulati and Scott 2012).

Even if it were wildly successful, the third solution would not do much to advance a comprehensive sovereign debt restructuring regime. It is all about damage control. A new regime would require a new political bargain, in which countries agree to cede some sovereignty and immunity protections, while creditors agree to join in a comprehensive collective proceeding. For as long as such a bargain remains out of reach, sovereign debt will remain unenforceable, inescapable, and deeply dysfunctional.

[10] Amending *pari passu* in bond contracts now generally requires the highest supermajority vote. The advantage of a successful vote is that it binds dissenters. Governments can also change their debt contracts as part of liability management operations, issuing new debt and retiring the old.

[11] Back then, each borrower had to struggle with the question whether adopting CACs would raise its borrowing costs (Gelpern and Gulati 2006). Securities regulators could not decide whether CACs were good or bad for investors and ultimately forced them to be disclosed as "Risk Factors" in offering documents.

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