A Question of Behavior: Foreign Sovereign Debt Restructuring Before US Courts

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The impact of Argentina's prolonged dispute with the holdouts of its defaulted debt continues to reverberate in the context of foreign sovereign debt restructuring. What has been called the "trial of the century" because of its potential impact on sovereign debt issuances — a clash between the U.S. courts and a foreign sovereign — began in 2001 with Argentina's default. Although Argentina eventually restructured more than 90 percent of its $80 billion in defaulted bonds (through steep haircuts on payments totaling up to 70 percent of some bonds' face value), certain creditors refused to accept the terms of repayment, igniting a long-running dispute in the U.S. District Court for the Southern District of New York.

Suing initially (and successfully) in 2003 to obtain judgments on their defaulted debt, the holdouts who resisted Argentina's restructuring deals in 2005 and 2010 have searched, mostly in vain, for attachable assets to satisfy their judgments. Unable to find any significant number of such assets, in 2010 the holdouts also began in earnest to enjoin Argentina's payments of any of its restructured debt to other creditors as a means of forcing a settlement.[1] The holdouts' efforts focused on a novel interpretation of a boilerplate *pari passu* clause present in the credit agreement governing the defaulted bonds. Holdouts argued that the *pari passu* clause required more than the equal ranking of creditors — the most common interpretation of the clause — it also required the equal payment of creditors, a less common but cognizable interpretation.[2] Judge Thomas P. Griesa of the Southern District accepted this "ratable payment" interpretation of *pari passu* and issued an injunction in 2012, requiring full payment of the holdouts' judgments in tandem with any further payment on the restructured debt — an order widely "credited" as having caused Argentina's second massive default in 2014 when it failed (or refused) to comply.[3]

The verdict's precedential value remains unclear, as the circumstances of the holdouts' decade-long litigation and Argentina's decade-long defiance of court orders to repay holdouts may ultimately serve to distinguish Argentina as a "uniquely recalcitrant debtor" and narrow the case's application.[4] Yet, this is the first instance in which a district court order triggered a sovereign default by barring a sovereign from paying on debt obligations — in this instance, payments to bondholders other than the holdouts — it was willing and financially able to meet. The decision already has had a significant effect on conventional thinking about the ability of holdout creditors to pursue full recovery on defaulted debt, and, consequently, on the drafting of sovereign bond documents.[5] Further, it has spawned at least one "copycat" litigation in which a sovereign's creditors have sought the same "ratable payment" interpretation and remedy on the basis of the sovereign's "course of conduct." That case, *Export-Import Bank of Republic of China v. Grenada*, is set to proceed to trial this year.[6]

The narrative about the Argentine dispute has largely focused on the Southern District's interpretation of *pari passu* to require a "ratable payment" of both defaulted and restructured debt, and how this interpretation may work to incentivize creditors to disrupt restructurings in pursuing full recovery.[7] But another interesting aspect of the case has been the court's expectation that Argentina comply with its orders and how this has perhaps affected the equitable remedies thus far ordered.

The court's "ratable payment" formula requires Argentina to pay the same percentage of the

holdouts' total outstanding debt as the percentage it pays of each interval interest payment owed on its restructured debt, *i.e.*, if 100 percent of a semiannual interest payment is made on the restructured debt, 100 percent of the holdouts' total outstanding debt must be paid as well.[8] This formula, derived as an equitable remedy on pain of contempt, seems to stem principally from the court's view that Argentina had failed to honor its debt as a "good" debtor would. As Judge Griesa noted, "[i]t is the view of the District Court that these threats of defiance [by Argentina in refusing to pay what the court ordered it to pay] cannot go by unheeded, and that action is called for."[9] The court ruled in this case, likely as it would have had any other commercial debtor been before it: Argentina was held responsible "[n]o less than any other entity entering into a commercial transaction."[10] But sovereigns are unlike "any other entity," commercial debtor or market participant, and to treat them as such often yields perverse consequences for everyone but the sovereign.

In the Argentine dispute, several third parties have borne significant costs in the court's attempt to corral Argentina's behavior. This includes a multitude of banks and financial institutions involved in the payment process that have been compelled to litigate the applicability of the injunction to them (or threats of contempt sanctions against them) when they received payments from Argentina,[11] many millions of Argentines who are feeling the economic consequences of the country's second default and, most obviously, the bondholders on whose restructured securities Argentina has been enjoined from paying and now again defaulted.[12] Worse, despite the exacting costs to these third parties, Argentina has continued to resist the court's orders, even following a second default and contempt proceedings.

That Argentina would choose to enter into as extreme a situation as default, and later contempt proceedings, rather than abide the court's orders and expectations suggests that sovereigns will not (and perhaps cannot) comply with the fiction of the "good" or ordinary commercial debtor when they lack the resources, in the sovereign's view, to meet both court judgments and the social or economic needs of their populations. To base a remedy on the failure of Argentina or any sovereign to comply with the court's expectations of ordinary commercial debtors ignores the unique circumstances and obligations of sovereigns. There is no doubt that Argentina or any sovereign should be held responsible for its debts and that the "rule of law" cannot go unheeded, but no one — not even courts or the "rule of law," which may be necessarily flouted — is served by the fiction that a sovereign will (or can) comply with the expectation of being an ordinary commercial debtor.

The "trial of the century" raises the question of how to develop effective remedies or compulsion in sovereign cases without holding third parties hostage. This dilemma may transcend the judicial sphere and lie with other branches of government — or intergovernmental spaces.[13] U.S. courts have historically recognized that the executive branch takes the lead in handling affairs involving sovereigns,[14] despite judicial authority to review sovereign acts and their import to the U.S.[15]

Today however, sovereigns may continue to find themselves before courts and possibly under scrutiny for their compliance with court orders. Given this situation, when negotiating the governing laws for an international bond issuance, sovereigns and their creditors should

consider the expectations of certain U.S. courts that sovereigns behave like ordinary commercial debtors when brought before a court. Sovereigns also should note that this view may not be universal. Other judicial authorities, such as those of the U.K., may charter a different course on these issues that better aligns with the realpolitik of sovereignty.[16]

The fallout from the Argentine bond litigation is far from clear — it may in fact take years to become apparent. In the meantime, markets, sovereigns[17] and international institutions,[18] including the U.N. General Assembly[19] and the International Monetary Fund,[20] have addressed the specific contract drafting issues of the *pari passu* clause such that, going forward, sovereigns may avoid the "ratable payment" interpretation that landed Argentina in its current predicament. The Argentine case may ultimately prove an outlier, with Argentina's behavior (or the desire to effectuate its orders) informing the court's decision, more than representing any clear precedent or rule.[21] Yet, the rhetoric and expectations that led to Argentina's situation persist — a fact that sovereigns would be wise to remember.

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[1] Memorandum of Law in Support of the Motion by NML Capital, Ltd. for Partial Summary Judgment and for Injunctive Relief Pursuant to the Equal Treatment Provision, *NML Capital, Ltd. v. Argentina*, No. 08 Civ. 6978 (S.D.N.Y. Oct. 20, 2010) (Doc. 230).

[2] *NML Capital, Ltd. v. Argentina*, No. 08 Civ. 6978, 2011 WL 9522565, at *2 (S.D.N.Y. Dec. 7, 2011).

[3] *NML Capital, Ltd. v. Argentina*, No. 08 Civ. 6978, 2012 WL 5895784 (S.D.N.Y. Nov. 21, 2012) (Griesa, J.) (Order), *aff'd*, 727 F.3d 230 (2d Cir. 2013), *cert. denied*, 134 S. Ct. 2819 (Jun. 16, 2014) (hereinafter "Amended *Pari Passu* Injunction").

[4] *NML Capital, Ltd. v. Argentina*, 727 F.3d 230, 247 (2d Cir. 2013); *see also* Int'l Monetary Fund [IMF], Policy Paper, *Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring* ¶ 12 (Sept. 2, 2014) (hereinafter "IMF Policy Paper").

[5] *See* IMF Policy Paper, *supra* note 4; G.A. Res. 68/304, U.N. Doc. A/RES/68/304 (Sept. 9, 2014) (hereinafter "U.N. GAOR Resolution"); Silvia Pavoni, *On the Ropes: Can Argentina Recover?*, The Banker, Oct. 1, 2014.

[6] No. 13 Civ. 1450(HB), 2013 WL 4414875 (S.D.N.Y. Aug. 19, 2013) (order denying parties for judgment on the pleadings in lieu of development of the factual record of Grenada's conduct, through discovery).

[7] IMF Policy Paper, *supra* note 4.

[8] *NML Capital, Ltd. v. Argentina*, No. 08 Civ. 6978, 2012 WL 5896786, at *2 (S.D.N.Y. Nov. 21, 2012) (Opinion).

[9] *Id.*; *see also* Amended *Pari Passu* Injunction, *supra* note 3, at *1.

[10] Amended *Pari Passu* Injunction, *supra* note 3, at *2.

[11] Citibank, N.A., Euroclear Bank SA/NV, Clearstream Banking S.A. and Bank of New York Mellon have filed motions for clarification of the injunction.

[12] *See* Hearing Transcript at 07:11-08:01, *NML Capital, Ltd. v. Argentina*, No. 08 Civ. 6978 (S.D.N.Y. Jul. 22, 2014) (Doc. 619).

[13] *See* U.N. GAOR Resolution, *supra* note 5.

[14] *See Braka v. Bancomer, S.N.C.*, 762 F.2d 222, 224 (2d Cir. 1985).

[15] *Allied Bank Int'l v. Banco Credito Agricola de Cartago*, 757 F.2d 516, 522 (2d Cir. 1985).

[16] *See* Fin. Mkts. Law Comm., *Memorandum on Role, Use and Meaning of Pari Passu Clauses in Sovereign Debt Obligations as a Matter of English Law* (Aug. 2014).

[17] Greece, Ecuador, Honduras, Belize and Kazakhstan have modified the *pari passu* clause to exclude the "ratable payment" interpretation and/or remedy in their respective international bond issuances over 2013 and 2014.

[18] Int'l Capital Mkt. Ass'n (ICMA), *Standard Pari Passu Provision for the Terms and Conditions of Sovereign Notes* (Aug. 2014); ICMA, *Standard Aggregated Collective Action Clauses ("CACS") For the Terms and Conditions of Sovereign Notes* (Aug. 2014).

[19] U.N. GAOR Resolution, *supra* note 4.

[20] IMF Policy Paper, *supra* note 4.

[21] *See* Floyd Norris, *The Muddled Case of Argentine Bonds*, N.Y. Times, July 25, 2014, at B1.