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Sovereign debt after *NML v Argentina*

W. M. C. Weidemaier*

Key points

- This article examines the recent case of *NML v Argentina*, in which the US Court of Appeals for the Second Circuit approved a potent form of injunctive relief to creditors holding defaulted Argentine bonds.
- The injunction forbids Argentina to pay holders of its restructured debt unless it pays restructuring holdouts. Such a remedy, if made available to other creditors, would increase incentives to hold out from a sovereign restructuring.
- The case turns on the meaning of the *pari passu* clause. The version of the clause used by Argentina promised to maintain the equal ranking of the country's 'payment obligations'.
- This article explains how, in practical terms, the Second Circuit interpreted this language as a promise not to employ standard restructuring techniques that sovereigns have used for centuries. The court's interpretation is significant because *pari passu* clauses similar to that used by Argentina are in widespread use.

1. Introduction

Legal enforcement has long been a peripheral concern in the sovereign debt markets. Observers disagree about why sovereigns repay loans, but almost no one thinks they do so to avoid being sued. There are obvious reasons for the scepticism. The usual remedy for failure to repay a loan is a money judgment for the amount due, which must be enforced through seizure of sovereign assets. Despite a handful of creditor successes, sovereigns are very good at keeping assets out of their creditors' hands. As a result, most academic treatments of the subject take for granted that sovereigns repay their debts not because they fear litigation but because they wish to preserve their reputation in the capital markets or because they have some other incentive to repay.¹

The recent case of *NML Capital v Argentina* has the potential to shatter this consensus. Eschewing the usual remedy of a money judgment, a federal district judge in New York has granted a novel form of injunctive relief to creditors who hold bonds that remain unpaid after Argentina's 2001 debt default. The creditors are holdouts who refused to participate in the country's subsequent debt restructurings, and the injunction forbids Argentina to pay other bondholders—those who hold restructured 'exchange bonds'—unless it also pays the holdouts.² A panel of the US Court of Appeals for the Second

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1 For a summary of theories of sovereign debt repayment, see Ugo Panizza, Federico Sturzenegger and Jeromin Zettelmeyer, 'The Economics and Law of Sovereign Debt and Default' (2009) 47 J Econ Lit 651–98.

2 *NML Capital, Ltd v Republic of Argentina* (SDNY 7 December 2011) (No 1:08–cv–06978–TPG), ECF No 353 [herein, District Court Opinion of 7 December].

Circuit has affirmed the injunction,³ although that court must still resolve a number of questions before the injunction will take effect.

The Second Circuit's decision has caused turmoil in the sovereign debt markets, raising fears that Argentina will default on its restructured debt and prompting the US government, the exchange bondholders, and a number of financial intermediaries to ask the court to change course and to overturn or limit the injunction. Remedies of the sort approved in *NML v Argentina* may also have broader systemic consequences for the sovereign debt markets. Most notably, if made broadly available to creditors, injunctions of this sort would increase bondholders' incentives to hold out from a debt restructuring and complicate efforts to provide debt relief to financially distressed sovereigns.

This brief article provides both modern and historical context to highlight the significance of *NML v Argentina*. The case is important both for its interpretation of the *pari passu* clause—some version of which appears in nearly all sovereign bonds—and for the novel injunctive remedy the courts have fashioned. After describing the case, the article explores the Second Circuit's interpretation of the *pari passu* clause, which turns on particular language found in Argentina's version of the clause. That language promises to maintain the *pari passu* ranking of the country's 'payment obligations' to certain defined types of creditor. As will become clear, the court interpreted this language as a promise not to employ standard restructuring techniques that sovereigns have used (seemingly without objection) since the inception of the sovereign bond markets. Next, the article demonstrates that *pari passu* clauses similar to that used by Argentina are in widespread use, a fact that emphasizes the significance of the court's interpretation. The article closes by examining the novel injunctive relief awarded to the plaintiffs and its implications for future sovereign restructurings.

2. *NML Capital v Argentina*—a recap

Proceedings in the district court

The litigation stems from Argentina's 2001 default. The plaintiffs are investors who did not participate in the 2005 and 2010 exchange offers by which Argentina restructured its debt. The lead plaintiff, NML Capital, has obtained money judgments in a number of other lawsuits against Argentina but has so far had little success enforcing them against Argentine assets. In this lawsuit, NML took a different approach, arguing that Argentina was violating the *pari passu* clause in its bonds by paying exchange bondholders—ie holders of restructured Argentine debt—without also paying investors like NML. The district judge accepted this argument and also accepted NML's invitation to remedy the breach with what amounted to an order of specific performance. The court entered an injunction providing that, 'whenever the Republic pays any amount due under the terms

³ *NML Capital Ltd v Republic of Argentina* (2d Cir 26 October 2012) (Nos 12-105(L) etc) [herein, NML, Second Circuit Opinion].

of the [exchange] bonds,' it must also pay plaintiffs 'the same fraction of the amount due them (the "Ratable payment")'.⁴

An injunction of this nature is unprecedented.⁵ Assuming Argentina intends or can be forced to comply, the injunction presents it with a choice. It can surrender in its decade-long fight against holdouts, or it can default on payments to holders of exchange bonds. Both choices would be consistent with the injunction, although of course they would have starkly different consequences.

Into uncharted territory

The district court's decision raises a number of difficult questions. As an initial matter, the appropriateness of the injunction depends on the meaning of the *pari passu* clause—a standard feature in sovereign bond documentation whose meaning has never been clear.⁶ The injunction also raises questions about the scope of a US court's authority to issue an injunction against a foreign sovereign, the scope of its authority (if it has any) to punish the sovereign for non-compliance, and the range of financial and other intermediaries who might be subject to contempt sanctions for acting 'in active concert or participation' with Argentina if it chooses to violate the order.⁷

On 26 October 2012, a panel of the US Court of Appeals for the Second Circuit affirmed the order of injunctive relief. The Second Circuit adopted a sweeping interpretation of the *pari passu* clause, essentially reading the clause as a promise by Argentina to forgo the traditional restructuring techniques that sovereigns have used for nearly a century. Because of its novelty, and because it may have significant implications for future sovereign restructurings, the Second Circuit's decision is worth an extended look.

3. At long last: the (definitive?) meaning of *pari passu*

NML Capital and other plaintiffs hold Argentine bonds that include the following *pari passu* clause:

The Securities . . . shall at all times rank *pari passu* and without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness . . .

As noted, there is a great deal of uncertainty about what clauses like this mean in the context of sovereign debt. In an unsecured corporate bond, the *pari passu* clause ensures

⁴ *ibid* 11.

⁵ The injunction sweeps far more broadly than a similar injunction issued in 2000 by a court in Brussels, which blocked the Euroclear System from processing payments to holders of Peru's Brady Bonds. See Elliott Assocs, LP, General Docket No 2000/QR/92 (Ct App of Brussels, 8th Chamber, 26 September 2000). The Brussels injunction, moreover, was issued *ex parte* and, because issued by a court in Belgium, was not viewed as a definitive interpretation of New York law (which governed in that case).

⁶ For discussion of various meanings attributed to the clause, and evidence calling each into question, see Mark Weidemaier, Robert Scott and Mitu Gulati, 'Origin Myths, Contracts, and the Hunt for *Pari Passu*' Law and Social Inquiry 38 (2013) 72–105.

⁷ Under Federal Rule of Civil Procedure 65(d)(2), an injunction issued by a US federal court binds a range of parties who receive actual notice of the injunction, including the agents, employees, attorneys, and other persons 'in active concert or participation' with any of these people.

that the debt will have the same priority as all of the borrower's other unsecured debt in the event of a liquidation. Of course, there is no sovereign bankruptcy regime, and sovereigns cannot be liquidated. As a result, even experienced sovereign debt lawyers have acknowledged uncertainty about the meaning of the clause.⁸

***Pari passu* as promise not to restructure**

In theory, Argentina might have violated the *pari passu* clause in at least two ways. Many observers interpret the clause narrowly as a promise by the issuing country that it will not formally subordinate bondholders to other, defined categories of unsecured creditor. Under this narrow interpretation, for example, a country that has promised to maintain the *pari passu* ranking of debts may not enact a statute declaring that bondholders will be paid only after equally ranked creditors are paid in full. To pressure bondholders to accept its 2005 exchange offer, however, Argentina passed the so-called Lock Law, which forbade executive-branch officials to re-open the exchange offer or to conduct any settlement with non-participating bondholders.⁹ The Lock Law arguably violates the *pari passu* clause even under this narrow interpretation, for it amounts to a formal, legal declaration that exchange bondholders may be paid while *pari-passu*-ranking holdouts may not.

Yet if Argentina violated the *pari passu* clause by enacting the Lock Law, it is not clear what the remedy should be for its breach. Under this narrow interpretation, the clause forbids only formal (ie legal) subordination; it does not prevent the country from making differential *payments*. Indeed, as will be discussed below, countries have selectively paid bondholders since the inception of the sovereign bond markets, especially in the context of debt restructurings. This makes the district court's injunction poorly tailored as a remedy for Argentina's breach. If the *pari passu* clause only forbids formal subordination, why should passage of the Lock Law result in a court order directing the country to make equal payments to all bondholders? The practical effect of such an order would be to enforce a promise that the country never made.

Only a broader reading of the *pari passu* clause can justify such an injunction. The Second Circuit provided one. According to the appeals court, Argentina's *pari passu* clause protects bondholders from more than just formal subordination. In the court's view, the first sentence of the clause¹⁰ incorporates the narrow reading described above, prohibiting 'Argentina, as bond issuer, from formally subordinating the bonds by issuing superior debt'.¹¹ The second sentence, which promises to maintain the equal ranking of Argentina's 'payment obligations',¹² imposes a broader duty prohibiting Argentina,

8 Philip Wood, *Project Finance, Subordinated Debt and State Loans* (Sweet and Maxwell 1995); Lee C Buchheit, 'The *Pari Passu* Clause sub specie aeternitatis' (1991) 10 *Intl Finan L Rev* 11–12.

9 Argentina temporarily suspended the Lock Law to enable its second exchange offer in 2010.

10 'The Securities. . . shall at all times rank *pari passu* and without any preference among themselves.'

11 NML, Second Circuit Opinion (n 3) 18.

12 'The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness.'

‘as bond *payor*, from paying on other bonds without paying on the [holdouts’] bonds’.¹³ If the court’s reading is correct, then Argentina, in this one sentence, agreed to forgo at least a century’s worth of sovereign restructuring practices.

Historical context for the meaning of *pari passu*

For as long as there have been sovereign bond markets, sovereign restructuring has involved (i) a cessation of payments, (ii) an offer to resume payment on terms more favourable to the issuing country, and (iii) a resumption of payments to those (but only those) bondholders who agreed to reduce their claims. Sovereigns did not win many friends with these practices. As a historical matter, however, market participants did not treat this routine restructuring process as a violation of any bond covenant. The sovereign’s default consisted of its failure to pay bondholders the amount they were due, not its selective payment of restructuring participants.¹⁴

In the first decades of the twentieth century, for example, sovereigns routinely issued bonds in international capital markets. Given the ensuing economic and political turmoil, many of these bonds went into default and were later restructured. These restructurings followed some common patterns. Sovereigns employed a variety of techniques to encourage bondholders to assent to a restructuring proposal. For example, the disclosure documents that accompanied restructuring offers typically included threats not to pay non-participating bondholders. In some (but, surprisingly, not all) cases, the sovereign also promised restructuring participants that holdouts would never be given a better deal. Yet sovereigns rarely conditioned restructuring offers on the participation of any particular number of bondholders. Nor did they attempt to conduct restructurings in a manner that would bind dissenters.¹⁵ As a result, even a successful restructuring left in its wake a large group of unpaid holdouts.

These restructuring proposals typically resulted from negotiations between the borrower and a standing committee representing bondholder interests, such as the Corporation of Foreign Bondholders (CFB) in the UK and the Foreign Bondholders Protective Council (FBPC) in the USA.¹⁶ The committees could not commit bondholders to the restructuring, but their recommendations in favour of a settlement held a great deal of weight. More importantly, the CFB and FBPC had extensive experience interpreting sovereign bonds and likely did so in ways that were both consistent over time and advantageous to bondholders. It is plausible to assume that at least some of the bonds restructured with the participation of these committees included the *pari passu*

13 NML, Second Circuit Opinion (n 3) 18.

14 For discussion of these practices, see W Mark C Weidemaier and Mitu Gulati, ‘A People’s History of Collective Action Clauses’ (draft dated 7 November 2012) available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2172302> accessed 6 March 2013.

15 In at least one case, a sovereign conducted a voluntary restructuring despite the fact that the relevant bonds (issued by Czechoslovakia in 1922) included a collective action clause that might have allowed the restructuring to bind dissenters. See Weidemaier and Gulati, *ibid*.

16 See Barry Eichengreen and Richard Portes, ‘After the Deluge: Default, Negotiation, and Readjustment During the Interwar Years’ in Barry Eichengreen and Peter H Lindert (eds), *The International Debt Crisis in Historical Perspective* (MIT Press 1989); Barry Eichengreen, ‘Historical Research on International Lending and Debt’ (1991) 5 *J Econ Persp* 149–69.

clause. This is because, although the clause often is thought to be a modern phenomenon, it made rare appearances in sovereign bonds in the first half of the twentieth century.¹⁷ There is no direct evidence about how (or even whether) the CFB and FBPC interpreted the *pari passu* clause during restructuring negotiations. It is clear, however, that the CFB and FBPC routinely negotiated restructuring proposals in which participants got paid, and holdouts did not, without any suggestion that this practice might violate the terms of the underlying bonds.

This historical evidence highlights the significance of the Second Circuit's ruling. As noted, the court focused on Argentina's promise to maintain the equal ranking of its 'payment obligations' under the bonds, which the court interpreted to prohibit the country, 'as bond *payor*, from paying on [restructured] bonds without paying' holdouts. Language of this sort first began to appear in sovereign bonds in the 1980s and 1990s.¹⁸ (Prior to that, most *pari passu* clauses referred only to the ranking of the sovereign's debt.) If the court's interpretation is correct, then sovereigns who adopted this broader formulation were promising to forgo these common restructuring practices. No longer would these countries make any payments to restructuring participants unless they also paid holdouts in full.

A brief diversion to collective action clauses

In an amicus brief filed in support of Argentina's appeal, the US government argued that the district court's order might complicate future sovereign restructurings by encouraging holdout litigation. The Second Circuit acknowledged this concern but gave it little weight. The court noted that Argentina had failed to include a collective action clause (CAC) in its bonds but that CACs are now prevalent in bonds governed by New York law. According to the court, these clauses 'effectively eliminate the possibility of "holdout" litigation'.¹⁹ As many readers know, CACs are contract terms that allow a super-majority of bondholders to approve a restructuring proposal in a vote that will bind dissenters. Structured properly, such clauses can significantly reduce the incidence of holdout litigation. For at least two reasons, however, CACs as currently drafted do not accomplish this result.

First, CACs are usually structured so that the vote binds only holders of a particular bond issue. Because most countries have multiple bond issues outstanding, and because some of these issues are relatively small, an investor can easily buy a large enough stake in a particular issue (for example, 25.1 per cent) to block a restructuring vote.²⁰ Other contract terms, often called aggregation clauses, mitigate this concern by allowing a restructuring vote to be aggregated across all of a country's bond issues. These clauses,

17 See Weidemaier, Scott and Gulati (n 6).

18 Although *pari passu* clauses made rare appearances in early-twentieth century bonds, the clauses did not include this 'payment' language. See *ibid*.

19 NML Second Circuit opinion (n 3) 27.

20 See Anna Gelper, 'Sovereign Restructuring After NML v. Argentina: CACs Don't Make *Pari Passu* Go Away' (3 May 2012) available at <<http://www.creditslips.org/creditslips/2012/05/sovereign-restructuring-after-nml-v-argentina-cacs-dont-make-pari-passu-go-away.html>> accessed 6 March 2013.

however, appear in only a handful of post-2003 issuances governed by New York law, and not at all in bonds issued before then.²¹

Secondly, even those bonds that include both CACs and aggregation clauses allow holders to block the restructuring of a particular bond issue by buying a somewhat larger stake in that issue. Often this stake is one-third of the aggregate principal amount.²² At distressed prices, it is easy to imagine holdouts buying a sufficiently large stake to block a proposed restructuring. Contrary to the Second Circuit's suggestion, then, modern bond contracts are not structured in a way that will put an end to holdout litigation.

Argentina's formulation of the *pari passu* clause is widespread

Until the 1990s, most sovereign bonds used a version of the *pari passu* clause that read something like this: 'The bonds rank, and will rank, *pari passu* with all other present and future unsecured and unsubordinated External Indebtedness.' This formulation arguably corresponds to the first sentence in the clause used by Argentina.²³ As noted, however, Argentina also added a second sentence promising that its 'payment obligations . . . under the [bonds] shall at all times rank at least equally with . . . [other] unsecured and unsubordinated External Indebtedness'. Because the Second Circuit's broad interpretation rested on this second sentence, bonds that use the traditional formulation of the *pari passu* clause may be less vulnerable to holdout litigation.

Argentina, however, is not alone in using language that extends *pari passu* treatment to the issuer's 'payment obligations'. As Figure 1 details, this or functionally similar language has become more common over time, beginning in the 1990s. The figure draws from a sample of bonds issued in foreign capital markets and governed by foreign law.²⁴ The figure divides *pari passu* clauses into three categories: (1) those that seem only to promise that the issuer will maintain the equal *ranking* of its bonds; (2) those, like Argentina's, that arguably imply an equal *payment* obligation; and (3) those that contain what amounts to an explicit promise of equal payment (eg the bonds 'rank *pari passu* in right of payment and shall be paid as such').

As Figure 1 indicates, the second version of the *pari passu* clause has increased in frequency since the 1990s, to the point that nearly one-half of bonds issued after 2000 included language that is functionally similar or identical to that used by Argentina. The widespread use of such language highlights the potential significance of the *NML v Argentina* litigation for other issuers.

21 See Michael Bradley and Mitu Gulati, 'Collective Action Clauses for the Eurozone' at 21 (draft dated 7 May 2011) available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948534> accessed 6 March 2013.

22 *ibid.*

23 I use the term 'arguably', because the first sentence in Argentina's *pari passu* clause refers only to the equal ranking of '[t]he Securities'. The most literal interpretation of this sentence is that it represents only a promise to maintain equal ranking among the bondholders themselves. In that case, it is possible to read the second sentence as a promise to maintain the equal ranking of bondholders with *other* unsecured creditors. Under this reading—which admittedly gives little effect to the reference to 'payment obligations'—the clause does not prohibit selective payments.

24 For more information on the data set, see Weidemaier, Scott and Gulati (n 6); Mitu Gulati and Robert E Scott, *The Three and a Half Minute Transaction: Boilerplate and the Limits of Contract Design* (University of Chicago Press 2012).

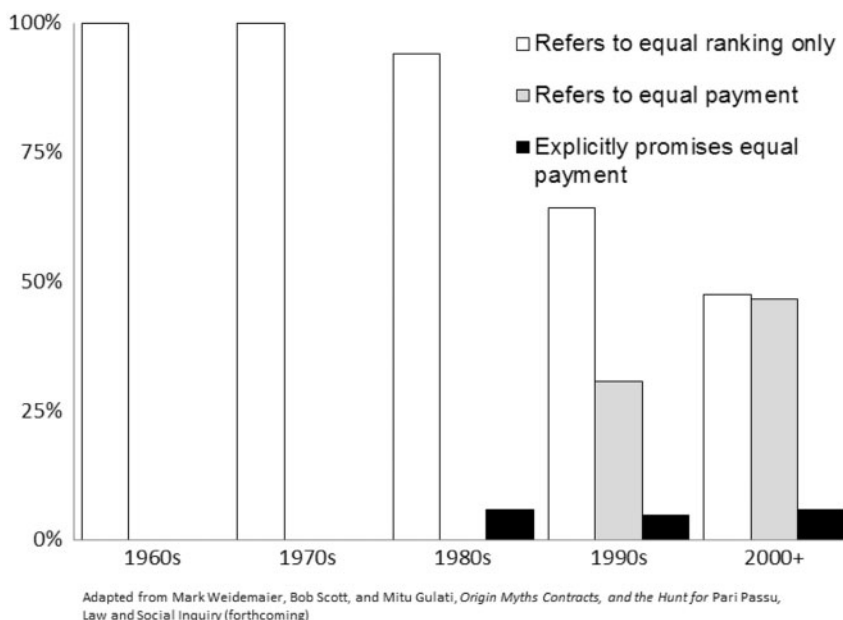


Figure 1. Different versions of *pari passu* over time.

4. Conclusion: *pari passu* as promise not to restructure?

It will be difficult to assess the long-term implications of *NML v Argentina* until the dust settles. As matters now stand, the district court has entered an injunction forbidding the country to pay exchange bondholders unless it also pays the full amount (approximately \$1.3 billion) owed to holdouts. Argentine public officials have repeatedly stated that the country will not pay holdouts but also will not default on its exchange bonds. These statements may signal the country's intent to circumvent the court's order—for example, by attempting to make payments to exchange bondholders outside of the USA.

Normally, wilful violation of a court's order results in a contempt sanction. Section 1606 of the Foreign Sovereign Immunities Act of 1976 provides that '[a]s to any claim for relief with respect to which a foreign state is not entitled to immunity' under the Act, 'the foreign state shall be liable in the same manner and to the same extent as a private individual under like circumstances'.²⁵ This language may authorize US courts to issue injunctions against a foreign sovereign, but it is doubtful that courts can impose meaningful (or perhaps any) penalties if the sovereign chooses not to comply.²⁶ The

25 28 USC § 1606. See also House Report (Judiciary Committee) No 94-1487 at 22 (9 September 1976) (noting that 'a court could, when circumstances were clearly appropriate, order an injunction or specific performance').

26 If the sovereign has waived its immunity from execution—which is often but not always the case in sovereign bond transactions—then the court may be able to impose a monetary fine. See House Report (Judiciary Committee) No 94-1487 at 22 (noting that a fine might be unenforceable if the sovereign's assets were immune from execution). On the other hand, in previous litigation the US government has suggested that courts may not impose monetary sanctions for a sovereign's violation of a court order. See Brief of the United States as *Amicus Curiae* in *Belize Telecom Ltd. v Government of Belize*, No 05-12641-CC (2 September 2005). In any event, even if it can impose a fine as a contempt sanction, the court would have difficulty collecting the fine, and it is doubtful that the prospect of a monetary fine would deter a sovereign that was determined not to comply.

injunction in *NML v Argentina*, however, also purports to bind a wide range of third parties, including Bank of New York Mellon (the trustee for the exchange bondholders), the registered owners of the exchange bonds, and clearing systems such as the Depository Trust Company and Euroclear.²⁷ Under Federal Rule of Civil Procedure 65(d)(2), the injunction extends to these and other parties to the extent they act as agents for, or ‘in active concert or participation with’, Argentina. Because many of these third parties are potentially subject to contempt sanctions, Argentina may find it difficult to route payments to exchange bondholders even if it wishes to violate the court’s order.

At present, the Second Circuit has stayed the injunction pending further review. That review, however, is primarily designed to resolve questions concerning the amount of the payment due to holdouts and the range of third parties subject to the injunction. Argentina has also petitioned for both panel and *en banc* rehearings, and it remains possible that the decision to grant the injunction will be reversed or modified. If not, the injunction represents the first truly potent remedy that courts have devised for aggrieved bondholders.

Perhaps too potent. When enforced by injunction, the Second Circuit’s interpretation of the *pari passu* clause may significantly alter sovereign restructuring dynamics, particularly for sovereigns that have issued New York-law bonds with a *pari passu* clause equivalent to that used by Argentina. Because there is no bankruptcy regime, sovereigns must persuade bondholders to reduce their claims voluntarily. The court’s decision effectively imposes a condition—full payment to holdouts—on the sovereign’s ability to make restructuring payments. If bondholders expect the sovereign to obey such an injunction, then they have little incentive to reduce their claims voluntarily. Who would agree to take 30 cents on the dollar (roughly the amount accepted by exchange bondholders) on condition that holdouts are paid in full?

For at least 20 years, the official sector has responded to debt crisis by promoting ‘private sector involvement’ in restructurings. These policy initiatives have a simple and widely accepted theoretical basis: If sovereign borrowing results in default, the cost should be borne by lenders rather than transferred to taxpayers in the form of government-sponsored bailouts. Viewed against this policy backdrop, the Second Circuit’s interpretation of the *pari passu* clause is especially striking. Its practical import is to treat the *pari passu* clause as a mechanism for limiting bondholder participation in a restructuring. Perhaps some investors would prefer bonds that include such a mechanism. But one has to wonder whether public officials—including judges—should go out of their way to create one from ambiguous contract language.

27 See Amended 23 February 2012 Order para 2(f), *NML Capital, Ltd v Republic of Argentina* (SDNY 21 November 2012) (No 1:08-cv-06978-TPG).