COMPLEXITIES OF ADDRESSING INTEREST ARREARS IN A BRADY TRANSACTION: THE CASE OF THE REPUBLIC OF ARGENTINA 1992 FINANCING PLAN

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I

INTRODUCTION

In early 1992, the Working Committee for Argentina,[1] an advisory committee of eleven commercial banks, commenced negotiations to restructure Argentina's external commercial-bank debt through a "Brady transaction,"[2] which provided for debt reduction and debt-service reduction to enable Argentina to achieve a more sustainable level of debt and to settle past-due interest on that debt. In the years prior to these negotiations, Argentina had undertaken many important structural reforms of its economy, had embarked on a privatization program, and had imposed fiscal discipline by enacting the Convertibility Law,[3] which pegged the Argentine currency to the U.S. dollar. Normalizing Argentina's relationship with the international banking community was critical to Argentina's continued success in restructuring its economy and fostering future foreign investment.

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1. The role of the Working Committee was to negotiate the restructuring transactions with Argentina, recommend the terms of the negotiated transaction to Argentina's commercial bank creditors around the world, and seek the approval of those creditors.

2. The term Brady transaction refers to Nicholas F. Brady, former Secretary of the Treasury under George H.W. Bush, who is considered the architect of the Brady plan. Announced in March 1989, the Brady plan contemplated the commercial banks' exchange of sovereign debt for bonds, either par or discount bonds, collateralized by a special issue of U.S. Treasury thirty-year zero-coupon bonds.

3. The Convertibility Law, which was enacted on March 27, 1991, and became effective April 1, 1991, provided for the exchange of the Argentine austral at the rate of 10,000 australes to 1 U.S. dollar and the subsequent replacement of the austral by the peso at the rate of 1 peso to 10,000 australes. Law No. 23928, Mar. 27, 1991, [27104] B.O. 1. The peso remained pegged to the U.S. dollar at the rate of 1 to 1, until January 6, 2002, when the Argentine Congress passed the Emergency Act, which revoked the convertibility regime. Law No. 25561, Jan. 6, 2002, [29810] B.O. 1.

The first Brady transaction had been concluded by Mexico in 1989, so the principal bond-exchange mechanics and documentation had been developed and successfully implemented. The massive interest arrears on Argentina's external commercial-bank debt, though, presented novel issues to be addressed in the context of Argentina's Brady transaction. Further complicating these issues, Argentine sovereign debt in the form of commercial-bank loans had been traded heavily in the market during the years of Argentina's default on interest payments. Determining which banks were entitled to interest payments proved to be a difficult and time-consuming task that necessitated changes in the timing and approach to closing the Brady transaction for Argentina. This article describes the challenges and the solutions to the many practical and legal issues that stemmed from Argentina's interest arrears.

II

NEGOTIATIONS OF THE MEMORANDUM OF UNDERSTANDING

From the end of January 1992 through early April 1992, Argentine officials and the Working Committee met in New York to discuss and exchange proposals on the key aspects of a possible Brady transaction. Not surprisingly, discussions of the terms of the discount bond (a bond issued at less than the principal amount of the debt exchanged) focused on the appropriate percentage of the principal discount and the interest spread; and discussions of the par bond (a bond issued at the same principal amount as the debt exchanged) focused on the applicable initial interest rate and the later step-up of the interest rate. Consistent with the characteristic Brady bond, the principal of both the discount and par bonds was to be collateralized by U.S. Treasury thirty-year, zero-coupon bonds. Of particular focus was the amount of interest-collateral coverage that would be required for each of these bonds.

Although the negotiations of the key terms of the discount and par bonds were difficult, the interest-arrears negotiations proved to be particularly so, given Argentina's limited resources. Argentina's interest arrears exceeded $8 billion—an amount that had been reduced from about $10 billion as a result of the cancellation of external debt in privatization transactions. The negotiations centered on the need to resume monthly interest payments and the amount of the cash payment to be made at closing.

Even though a number of significant issues were still not agreed upon, Argentina and the Working Committee decided to reconvene negotiations in the Dominican Republic, where the Inter-American Development Bank (IDB) meetings were then being held. With the international press covering the IDB meetings, it was critical that the parties either reach agreement that weekend or risk publicly failing. After two days of continuous negotiations, an agreement in principle was reached in the early hours of the morning on April 7, 1992, and a press conference followed several hours later.

The agreement in principle[4] reached between Argentina and the Working Committee contemplated the exchange of the external-debt principal for either discount or par bonds, as follows:

> 1. A thirty-year, collateralized discount bond, with a 35% discount on principal of the existing claims, bearing interest at a floating rate of LIBOR (London Interbank Offered Rate) plus 0.8125% per annum, with interest payments collateralized in an amount equal to twelve months; and
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> 2. A thirty-year, collateralized par bond, exchangeable for 100% of existing claims, bearing an initial interest rate of 4% per annum and increasing annually, capped at a fixed rate of 6% in the seventh year, with interest payments collateralized in an amount equal to twelve months.

The agreement in principle also provided for monthly interest payments of $70 million until closing, a $400 million cash payment at closing, past-due interest (PDI) notes aggregating $300 million, and PDI bonds for the remaining interest arrears.

Although an agreement in principle was reached on key terms of the financing plan, the practical and legal challenges of developing this ten-page document into a more-comprehensive term sheet still lay ahead.

III

NEGOTIATIONS OF THE REPUBLIC OF ARGENTINA: THE 1992 FINANCING PLAN

Over the course of the next two and one-half months, Argentina and the Working Committee negotiated the terms of the 1992 Financing Plan.[5] In developing the procedures for the Argentine bond exchanges, the parties were able to build upon the structure of the par bonds and discount bonds created under the Mexican Brady-bond transaction. What proved more challenging, however, was developing procedures to address the practical and legal issues within the Financing Plan for dealing with the substantial amount of past-due interest.

One of the first issues to be addressed in these negotiations was to determine what would constitute "eligible interest" and "eligible debt." These definitions were important because, preceding the 1992 negotiations, there had been a tremendous volume of trading in Argentine debt, including potentially trades made either directly or indirectly by or for the benefit of Argentina and its various public-sector borrowers. Given the scarce resources available to

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4. *See generally* REPUBLIC OF ARGENTINA SUMMARY PROPOSAL FOR A NEW FINANCING PACKAGE (1992) (on file with *Law and Contemporary Problems*).

5. *See generally* THE REPUBLIC OF ARGENTINA 1992 FINANCING PLAN (1992) [hereinafter 1992 FINANCING PLAN] (on file with *Law and Contemporary Problems*).

purchase collateral for the bond exchange and to make cash payments on the interest arrears, Argentina and the Working Committee specifically agreed that the definition of eligible debt would exclude external debt held by or on behalf of any Argentine governmental agency (other than an Argentine bank). External debt held by or on behalf of an Argentine bank for its own account would be eligible only to the extent that principal owed to the bank exceeded the principal that the bank owed to others. The definition of eligible interest included similar exceptions. Although any debt-buybacks by Argentina or its various public-sector borrowers proved difficult to confirm, the Financing Plan expressly recognized that collateral security for the newly issued bonds and cash paid on past-due interest should not be for the benefit of these creditors.[6]

The 1992 Financing Plan established detailed interim measures relating to, among other things, the adjustment of fixed-rate loans, interest calculations and the resetting of interest periods, and the application of monthly interest payments.[7] The plan also provided guidance on the reconciliation process itself. Dealing with existing interest arrears and the accrual of interest pending the implementation of the Financing Plan was a sizeable undertaking. Developing detailed procedures for the existing facility agents and the lenders under the various loan agreements evidencing existing debt was thus critical if there was to be any hope of determining, in any reasonable period of time, those of the over-800 participants that were entitled to the interest arrangements.

On June 23, 1992, the Republic of Argentina 1992 Financing Plan was finalized and distributed to the international banking community. Even though the plan—which exceeded 150 pages with its annexes, exhibits, and schedules—was thorough and detailed, no one could have predicted the effect of the market on creditor banks' choices between discount and par bonds. Nor could anyone have known the magnitude of the task of reconciling interest as a consequence of interest accruals over a number of years or the added complexity of the way in which Argentina's defaulted debt traded in the market.

IV

IMPLEMENTATION OF THE FINANCING PLAN

Although the 1992 Financing Plan set forth many of the details of the bond exchange, its implementation presented several practical challenges, among them (1) a disproportionate election of par bonds by the creditor banks, (2) concerns about the application of the sharing provisions of the existing debt agreements, and (3) difficulties with the debt and past-due interest reconciliation process, the attendant delays, and the potential claims of creditors to the escrowed assets.

6. *See* 1992 FINANCING PLAN, s*upra* note 5, at ii– iii.

7. *See* 1992 FINANCING PLAN, s*upra* note 5, pt. IV, at 1–3.

A. Disproportionate Election of Par Bonds by Creditors

When the 1992 Financing Plan agreement was reached, Minister of Economy and Public Works and Services Domingo Cavallo stated,

> Argentina has received indications from official sources as to the financing of the collateral for the 1992 Financing Plan. Such financing will be made available to Argentina only in compliance with the rules and restrictions imposed by such official sources, and Argentina relies upon the ability to access the full amount available if it is to be able to implement the plan. To this end, it is essential that Argentina's creditors make a balanced selection of the Discount and Par Bond options if Argentina is to implement the entire package.[8]

The amount mentioned publicly that Argentina was to obtain from these official sources—entities such as the International Monetary Fund, the World Bank, and the Inter-American Development Bank—was approximately $3 billion for purchasing collateral for the bonds.[9]

In the spirit of the Brady plan's "menu of options" approach, the Financing Plan gave the creditors free election between discount and par bonds. Due to falling interest rates, however, the par bond had become increasingly attractive, and creditors were choosing this option disproportionately. Although the par bonds would reduce Argentina's debt service in future years, they were also considered more expensive to collateralize.[10]

In late September, the Argentine government advised the creditor banks that the Financing Plan could not be implemented without a reallocation of their elections. The government requested that creditors voluntarily rebalance all their elections. Although many creditors responded favorably and did so, the targeted balance was still not achieved.

Later that November, the Argentine government informed its creditor banks that, although many of them had agreed to rebalance their elections, many others had conditioned their agreement to rebalance on other creditors doing likewise.[11] Thus, it became imperative that all creditors accept a rebalancing to enable Argentina to reach an overall election of not more than sixty-five percent par bonds. Although negotiations for documentation implementing the Financing Plan were already far along, additional provisions had to be added to the Financial Plan implementation documents to ensure the proper election result.[12]

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8. Memorandum from Domingo F. Cavallo, Minister of Econ. and Pub. Works and Serv., to the Int'l Banking Cmty. 3 (June 23, 1992) (on file with *Law and Contemporary Problems*).

9. James R. Kraus, *Argentina's Debt Pact Hits Snag on Collateral*, AM. BANKER, Aug. 3, 1992, at 1.

10. *Id.* at 7. *See also Argentina Closes Pact with Banks on Brady Debt Restructuring*, REUTERS (Buenos Aires), Nov. 10, 1992.

11. Memorandum from Domingo F. Cavallo, Minister of Econ. and Pub. Works and Serv., to the Int'l Fin. Cmty. (Nov. 10, 1992) (on file with *Law and Contemporary Problems*).

12. Section 2.07 of the Collateralized Discount and Par Bond Exchange Agreement, entitled "Percentage Allocations Among Par Bonds and Discount Bonds: Adjustment of Percentage Allocations," and dated December 6, 1992, sets forth the rules that would be applicable to the

B. Application of Sharing Provisions Under Existing Debt Agreements

Under the existing Argentine syndicated-loan agreements, each lender had an obligation under the applicable sharing provision to share with the other lenders any disproportionate interest payment it received respecting the amounts owed to it and other creditors. Amending the sharing provision would have required one hundred percent of the lenders' consent under the relevant debt agreement. At the time of the 1992 Financing Plan, however, a number of non-bank creditors refused to commit to the plan.

Even those creditors not participating in the Financing Plan still had the benefit of the sharing provisions of the existing agreements. Although sharing interest payments with non-participating creditors was difficult for participating creditors to accept, the $700 million in cash interest payments[13] was distributed to all creditors holding eligible interest for both legal and practical reasons. The legal reason was that each creditor had a contractual commitment to share; the practical reason was that a non-participant creditor could invoke the sharing provisions with respect to the cash payments and could pursue any other available remedies.

C. Reconciliation Process Complexities and Escrow Arrangements

The 1992 Financing Plan contemplated a simultaneous closing of the bond exchange and the implementation of the interest arrangements. Because Argentine external debt had traded heavily during the many years Argentina had been in default on paying interest, the process of identifying the creditors entitled to participate in the interest arrangements and determining the amount of interest to which such creditors would be entitled proved to be a long and tedious task. Moreover, debt-to-equity privatizations using external debt continued during the reconciliation process and added another layer of complexity. Originally, it had been thought that the reconciliation process would be substantially completed by the first quarter of 1993, with the closing to occur at that time. It was also thought that at the time of closing, a small amount of cash and bonds, which were to be exchanged for the amounts not yet reconciled, would be placed in escrow with the closing agent, Citibank, N.A.

What became clear by mid-November was that the reconciliation process, particularly the reconciliation of past-due interest, would take considerably more time than had been expected. At this point, Argentina expressed concern that a delay in the closing might impair its ability to acquire the collateral needed to secure the principal bonds. Argentina requested a change in the

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allocations between discount and par bonds. *See* COLLATERALIZED DISCOUNT AND PAR BOND EXCHANGE AGREEMENT § 2.07 (1992) (on file with *Law and Contemporary Problems*).

13. Argentina decided to pay $700 million in cash rather than to pay $400 million and to issue $300 million in zero-coupon bonds, as was originally contemplated in the 1992 Financing Plan. The recital in the Floating Rate Bond Exchange Agreement refers to the $300 million as the "Interest Reduction Cash Payment." *See* FLOATING RATE BOND EXCHANGE AGREEMENT § 3.04 (1992) (on file with *Law and Contemporary Problems*).

Financing Plan to permit the exchange of principal to occur prior to the settlement of the past-due interest.

The Working Committee agreed to provide the flexibility to decouple the settlement of the principal and the past-due interest on the conditions that (1) Argentina issue the bonds and pay the cash amounts respecting past-due interest in escrow for the benefit of the creditors at the same time as the closing for the principal bond exchange and (2) Argentina not retain any interest in such bonds or cash amounts and exercise no control over the release of such bonds and cash to the creditors upon the reconciliation of the past-due interest. The bond-exchange agreements were modified to provide the details of the escrow arrangement in accordance with these conditions. They also provided that the closing agent would appoint the escrow agent and that the escrow agent would act solely on the instructions of the closing agent.[14]

The escrow included the full amount of the cash payment and bonds in the amounts sufficient to cover the remainder of the past-due interest. Given the size of this escrow and its visibility, it became clear that the closing agent could not serve as the escrow agent and that an official-sector institution was needed. Both the Bank of England and the Bank for International Settlements (BIS) were being considered by the Working Committee to act as the escrow agent. On November 18, 1992, Shearman & Sterling sent a letter to the Bank of England, and Cleary Gottlieb sent an identical letter to the BIS to explore each institution's interest in acting as the escrow agent.

The Bank of England was a desirable option. Prejudgment attachment was unavailable in England, so there was little possibility that the escrow would be frozen pending reconciliation. And the risk of a creditor of Argentina successfully instituting and maintaining a Mareva injunction[15]—a court order with a similar legal effect as a prejudgment attachment—was considered remote. Although the official charter of the BIS seemed to indicate that sovereign deposits were immune from prejudgment attachments,[16] the parties were unsure whether this immunity would be available for the escrowed assets in which Argentina retained no interest. The parties were not certain that the BIS would agree to waive such immunity. Because of the limited time available to consider and resolve to everyone's satisfaction the issues concerning the BIS serving as escrow agent, the decision was made to proceed with the Bank of England.

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14. The relevant provisions relating to the escrow arrangements are set forth in section 3.05 of the Collateralized Discount and Par Bond Exchange Agreement dated December 6, 1992, *see supra* note 12, at § 3.05, and in section 3.04 of the Floating Rate Bond Exchange Agreement dated December 6, 1992, *see supra* note 13.

15. Mareva Compania Naviera SA v. Int'l Bulk Carriers SA, (1975) 2 Lloyd's Rep. 509 (A.C.).

16. Convention Respecting the Bank for International Settlements, Constituent Charter for the Bank of International Settlements para. 10, Jan. 20, 1930, 104 L.N.T.S. 441, *available at* http://www.bis.org/about/charter.pdf.

The escrow arrangement proceeded smoothly, and the Bank of England remained the escrow agent for more than two years. During this two-year period, most of the reconciliation and distribution of the escrowed assets were made. The only assets remaining in the escrow were particularly problematic or disputed claims. On April 29, 1994, the Bank of England appointed Citibank, N.A. (London), as successor escrow agent and transferred to it approximately $7 million in floating-rate bonds and less than $1 million in cash.[17]

V

INTERPLEADER ARRANGEMENTS

To address the possibility that two creditors might not agree to settle a dispute as to the entitlement to an amount of eligible debt or eligible interest, provisions had to be included in the bond-exchange documentation to provide for such disputes to be resolved in another forum. Because it would be important to document the procedure for resolving such disputes and to provide protections to the escrow agent and the closing agent, the exchange agreements proposed that any dispute regarding eligible debt or eligible interest be interpleaded if it could not be resolved by the parties. Both the Floating Rate Bond Exchange Agreement and Collateralized Discount and Par Bond Exchange Agreement set forth detailed provisions relating to interpleader actions, including (1) the jurisdiction of the New York state and U.S. federal courts; (2) waiver of forum non conveniens; (3) details regarding service of process; (4) certain procedural aspects of the interpleader action; (5) dismissal of Argentina, the escrow agent, and the closing agent from the action; and (6) reimbursement of the allocable share of the costs incurred by the escrow agent and the closing agent in connection with the interpleader action.[18]

Only one interpleader complaint was filed by Citibank, N.A. (London), as successor escrow agent, and this complaint was filed in the U.S. District Court for the Southern District of New York. The total amount in dispute between the two creditors was less than $3.5 million; pursuant to the interpleader agreement, Citibank deposited $3,157,000 in floating-rate bonds and $421,665.91 in cash.[19]

VI

CONCLUSION

The Argentine Brady transaction presented many novel legal and practical issues in both the negotiation and implementation of the 1992 Financing Plan.

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17. Letter from the Bank of England to Citibank, N.A. (London), Successor Escrow Agent (Apr. 29, 1994) (on file with *Law and Contemporary Problems*).

18. *See* COLLATERALIZED DISCOUNT AND PAR BOND EXCHANGE AGREEMENT, *supra* note 12, at § 3.05; FLOATING RATE BOND EXCHANGE AGREEMENT, *supra* note 13, at § 3.04.

19. Citibank, N.A. v. Banco de la Provincia de Rio Negro, No. 94 Civ. 3705 (S.D.N.Y. filed May 18, 1994).

The transaction's success is a testament to the hard work, tough decisions, and flexibility of Argentina and the Working Committee; to the skills of the closing agent and the facility agents that the process of reconciling over $30 billion ended with only $3.5 million in dispute; and to the cooperation and support of the Bank of England. And for the attorneys representing the various parties, it was a rewarding team effort to solve the complex and challenging legal issues that this unique transaction presented.