Pari passu to Gunboats: NML v. Argentina

Vassilis Paliouras
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ABSTRACT

This article provides a detailed overview of the latest litigation saga before the courts of the state of New York between NML Capital, a distressed debt hedge fund owned by Elliott Management Corporation, and Argentina. The two of them arguably constitute the most aggressive players in the area of sovereign debt, and it comes with no surprise that much of the relative law has been framed by disputes to which, either one or both of them, were parties.

At the heart of the present dispute was the interpretation of the pari passu (originally meaning “on equal step/footing”) clause that was part of the Fiscal Agency Agreement, pursuant to which Argentina issued debt back in 1994. District court judge Thomas P. Griesa read in the clause an obligation of Argentina to make ratable payments to NML each time it pays its exchange bondholders, thereby reviving after approximately ten years of judicial and academic stalemate, the debate about the meaning of the cryptic pari passu clause.

It is argued that the broad interpretation that the district court attached to the pari passu clause is misguided. What is more, it may open Pandora’s Box for the consensual sovereign debt restructuring framework currently at place by creating hazardous incentives for creditors and payment system operators.

The article is structured in four parts: the first part describes the different phases of the litigation before the US District Court for the Southern District of New York and the US Court of Appeals for the Second Circuit, and also provides the factual background of Argentina’s 2001 default that gave rise to the litigation. The second and the third part present and evaluate respectively the findings of the second circuit court. To avoid repetition, the analysis is focused on the second circuit decisions that essentially encompass the district court’s rationale and also provide a more comprehensive discussion of the contested issues. The article concludes with a short note on the implications of the litigation for sovereign debt restructuring and also considers possible responses to the challenges ahead.
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I. PROLEGOMENA

On August 23, 2013, the US Court of Appeals for the Second Circuit delivered its long anticipated decision on the injunctions available to NML et al\(^1\) and the payment formula that Argentina is obliged to effectuate, following the partial remand of the case to the US District Court for the Southern District of New York that the circuit court had ordered in a previous decision in October 2012.\(^2\) The Second Circuit court accepted the amended injunctions\(^3\) that US District Judge Thomas P. Griesa issued, ordering Argentina to make ratable payments to NML et al each time it pays any amount due under the exchanged bonds\(^4\) or any other obligation it may occur in the future following a subsequent bond exchange. The court clarified that such ratable payment shall be equal to the amount Argentina has paid or is about to pay to the exchange bondholders, as a percentage of the total amount due to them under the terms of the exchange bonds, multiplied by the amount owed to NML pursuant to the defaulted bonds at issue.\(^5\) Also, although the district court’s injunctions are targeted to and bind only Argentina, their effects extend to third parties that could assist Argentina in evading them by participating in the process of paying the exchange bonds.\(^6\) Importantly, Argentina is also barred from establishing an alternative payments scheme through which it could

\(^{1}\) NML CAPITAL, LTD., AURELIUS CAPITAL MASTER, LTD., ACP MASTER, LTD., BLUE ANGEL CAPITAL I LLC, AURELIUS OPPORTUNITIES FUND II, LLC, PABLO ALBERTO VARELA, LILA INES BURGUENO, MIRTA SUSANA DIEGUEZ, MARIA EVANGELINA CARBALLO, LEANDRO DANIEL POMILIO, SUSANA AQUERRETA, MARIA ELENA CORRAL, TERESA MUNOZ DE CORRAL, NORMA ELSA LAVORATO, CARMEN IRMA LAVORATO, CESAR RUBEN VAZQUEZ, NORMA HAYDEE GINES, MARTA AZUCENA VAZQUEZ, OLIFANT FUND, LTD.

\(^{2}\) NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 250 (2d Cir. 2012).


\(^{4}\) The bonds that participating creditors received when they tendered their defaulted bonds in the exchange offers that Argentina made in 2005 and 2010. A more detailed analysis of the facts that gave rise to the litigation is provided below.

\(^{5}\) In the words of the circuit court explaining the district court’s payment formula, “...[w]henever Argentina pays a percentage of what is due on the Exchange Bonds, it must pay plaintiffs (NML et al) the same percentage of what is then due on the FAA Bonds”. See Page 7 of the August 23 decision (unreported). If, for example, Argentina owed under the terms of the exchange bonds $1000 and pursuant to the FAA bonds $500 to NML, in case it decided to pay the exchange bondholders in full and handed them a payment of $1000, it is obliged, concurrently or prior to that payment, to pay NML $500.

\(^{6}\) According to the district court, these third parties are: “(1) the indenture trustees and/or registrars under the Exchange Bonds (including but not limited to The Bank of New York Mellon f/k/a The Bank of New York); (2) the registered owners of the Exchange Bonds and nominees of the depositaries for the Exchange Bonds (including but not limited to Cede & Co. and The Bank of New York Depository (Nominees) Limited) and any institutions act as nominees; (3) the clearing corporations and systems, depositaries, operators of clearing systems, and settlement agents for the Exchange Bonds (including but not limited to the Depositary Trust Company, Clearstream Banking S.A., Euroclear Bank S.A./N.V. and the Euroclear System); (4) trustee paying agents and transfer agents for the Exchange Bonds (including but not limited to The Bank of New York (Luxembourg) S.A. and The Bank of New York Mellon (including but not limited to The Bank of New York Mellon (London)); and (5) attorneys and other agents engaged by any of the foregoing or the Republic in connection with their obligations under the Exchange Bonds.” See Pages 5 and 6 in Order, NML Capital, Ltd. v. Republic of Argentina, No.08 Civ. 6978 (TPG) (S.D.N.Y. Feb. 23, 2012) (granting specific performance and permanent injunctions).
service the exchange bonds, thereby rendering ineffective the injunctions, without prior approval by the district court. It should be noted though, that the injunctions issued by the district court and affirmed by the circuit court have been stayed pending a US Supreme Court hearing of a petition for a Writ of Certiorari that Argentina filed against the circuit court’s October 2012 decision, thus preventing an imminent default of the country.

In case that the US Supreme Court does not accept the case for review or it affirms the ruling of the circuit court, the effects of the decisions of the US Court of Appeals for the Second Circuit have the potential to dramatically alter the pattern of international finance, and sovereign lending in particular. Before analyzing in more detail this last wave of litigation before the courts of New York and assessing its broader effects, it is necessary to make a short reference to the events that led to the latest circuit court decision.

In 2001, and during the most severe economic crisis of its modern history, Argentina defaulted on approximately $95 billion in principal and past-due interest of external debt. Post default and in two phases, in 2005 and 2010, the country restructured its defaulted external debt by exchanging its foreign bonds with new ones, achieving to tender approximately 91 per cent of its defaulted instruments, effectuating a nominal value reduction of approximately 70 per cent to the claims of its tendering bondholders. However, as the story typically goes in sovereign debt restructurings, a number of creditors, corresponding to approximately $12 billions in bond claims, decided to hold their bonds, and some of them tried to force Argentina to pay them in full through lawsuits and actions in various jurisdictions and international dispute settlement fora. In February 2005, Argentina demonstrated, in the bluntest way, its intention not to service any non-tendered bond by enacting the so-called Lock Law, effectively prohibiting the country to pay any bondholder that did not participate in the

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8 Argentina’s 2001 default has been recorded as the biggest sovereign default in history. Greece’s debt write down of more than $130 billion is today the biggest debt reduction in economic history, the material difference however is that Greece achieved to reduce its debt on consensual terms with its creditors.
10 Id. Commonly known in the sovereign debt jargon as holdout creditors, or simply holdouts.
12 On February 10, 2005 Argentina passed Law 26,017 pursuant to which “[T]he national State shall be prohibited from conducting any type of in-court, out-of-court or private settlement with respect to bonds that were eligible to participate in the 2005 exchange offer”. In order to reopen the restructuring process, on December 9, 2009, Argentina enacted Law 26,547 that suspended Law 26,017 until the completion of the 2010 exchange offer, providing that “[A]rgentina...is prohibited to offer holders of government bonds who may have initiated judicial, administrative, arbitration or any other type of action, more favorable treatment than what is offered to those who have not done so”. See Order, NML Capital, Ltd. v. Republic of Argentina, No.08 Civ. 6978(TPG)(S.D.N.Y. Dec.7, 2011), 2011 WL 9522565, at *3.
2005 exchange. At the same time, and up until today, Argentina has paid in full all the bondholders that tendered their bonds in 2005 and 2010. In 1994, Argentina issued bonds pursuant to a Fiscal Agency Agreement (FAA), on which it defaulted in 2001. NML et al purchased a number of these instruments post default in the secondary market, and having been frustrated from previous attempts to collect on money judgments delivered by New York courts, they decided to pursue a different strategy. Thus, instead of bringing acceleration claims, they asked for injunctive relief from the district court on the basis of the pari passu clause contained in the FAA.

II. THE US COURT OF APPEALS FOR THE SECOND CIRCUIT DECISIONS

Because of the fact that the two decisions of the circuit court constitute the subsequent steps of a common legal rationale, they are not dealt with separately. Instead, the presentation of the court’s findings unifies the October 2012 and August 2013 decisions by following the logical flow of the court’s reasoning.

The central point of the litigation at issue between NML et al and Argentina was the interpretation of the so-called pari passu clause, a boilerplate provision in sovereign debt contracts, which was also incorporated in paragraph 1(c) of the FAA. The circuit court upheld the district’s court reading of the pari passu clause, according to which “[A]rgentina violated the Provision when it made payments currently due under the Exchange Bonds while persisting in its refusal to satisfy its payment obligations to plaintiffs and when it enacted the Lock Law and the Lock Law Suspension.”

The circuit court dismissed Argentina’s contention that the pari passu clause has long been understood as a means of creditor protection against solely legal subordination and that such subordination did not occur. On the contrary, the court found that the specific language used in paragraph 1(c) of the FAA in fact protects bondholders not only from formal, but from de facto subordination as well. Thus, Argentina was prohibited to give priority to the payment of the exchange bonds over the payment of the bonds held by NML et al (hereinafter also referred as FAA bonds) that up until today remain in default. Further, the court found that legal subordination of the FAA bonds had occurred too by virtue of a series of executive and legislative actions that the country took since its default in 2001. In this regard, the court made reference to the ongoing moratorium on

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14 According to that paragraph, “[t]he Securities will constitute...direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank pari passu 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...”. Point Appendix (Fiscal Agency Agreement Between the Republic of Argentina and Bankers Trust Co.) at A-157, NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246 (2d. Cir. 2012) (No. 12-105). Available at http://www.shearman.com files/upload/Fiscal-Agency-Agreement.pdf.
15 NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 250 (2d Cir. 2012), at *16.
16 Id at *18.
17 Id.
18 Id.
the country’s outstanding debt, the declarations in the exchange offers prospectuses stating that it will not pay holdouts, relevant SEC filings, and most importantly, the effects of the Lock Law. Indeed, according to the court, the Lock Law posit exchange bondholders at a position of legal advantage vis-à-vis holdouts as, in case of default, the former would not face any obstacle in having their New York judgments enforced by the Argentine courts, whereas the latter would be barred from doing so due to the Lock Law.\textsuperscript{19}

In a particularly important statement, the circuit court clarified that preferential payments to the IMF and other multilateral organizations would not violate the pari passu clause because “[c]ommercial creditors never were nor could be on equal footing with the multilateral organizations”.\textsuperscript{20}

In its latest August decision, the circuit court tried to narrow down the effects of its reading of the pari passu clause, arguing that its present ruling is not authoritative over the interpretation of other pari passu clauses, and, to an important extent, is the result of Argentina’s “extraordinary behavior” of disregarding the judgments of New York courts.\textsuperscript{21}

Furthermore, Argentina advanced the equitable defense of laches and claimed that the failure of NML et al to invoke breach of the pari passu clause in previous proceedings before the district court barred them from doing so in the present litigation. The reason is that reasonable expectations had been created to third parties (the exchange bondholders) that there will be no interference with the regular payment of their bonds. However, the court found that the requirements for establishing the defense of laches had not been met; again, the enactment of the Lock Law appeared to be central in the court’s reasoning.\textsuperscript{22}

Argentina further argued that, even assuming that it violated the pari passu clause, the appropriate remedy should have been acceleration of principal and past-due interest according to the terms of the FAA.\textsuperscript{23} However, in the absence of a provision precluding the remedies of specific performance or injunctive relief in the FAA, the circuit court interpreted New York law as allowing NML et al to benefit from those remedies.\textsuperscript{24} The court also noted that, due to Argentina’s continual disregard of previous judgments, monetary relief would be a futile remedy, and thus specific performance was necessary under the particular circumstances of the case.\textsuperscript{25}

Argentina’s next argument was based on the Foreign Sovereign Immunities Act (FSIA). It claimed that the District court injunctions violate the FSIA because they deprive the country of immune property located outside the US. In dismissing this contention, the court noted that the injunctions “[d]o not attach, arrest, or execute upon any property” and that “[T]hey affect Argentina’s property only incidentally”.\textsuperscript{26} Moreover, the injunctions can be satisfied without the court exercising dominion over sovereign

\textsuperscript{19} Id, at * 19-20.
\textsuperscript{20} Id, at * 21.
\textsuperscript{22} NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 250 (2d Cir. 2012), at *22.
\textsuperscript{23} Id, at *23.
\textsuperscript{24} Id.
\textsuperscript{25} Id, at *24.
\textsuperscript{26} Id, at *25.
property, as “[The injunctions] do not require Argentina to pay any bondholder any amount of money.”

The country’s next line of defense coupled proportionality analysis with equity, policy and public interest considerations. The circuit court addressed this kind of objections in both its October 2012 and August 2013 decisions. To begin with, Argentina argued that the hardship caused to exchange bondholders and to itself by the injunctions far outweighs any prejudice to NML et al, which are sophisticated investors that bought defaulted bonds at deep discounts in the secondary market, fully aware of the difficulties they would face to collect. In addition, the country claimed that it would be inequitable for exchange bondholders to receive 25 to 29 cents on the dollar (compared to the original bonds that they exchanged), if holdouts were to be paid in full. Moreover, Argentina contented that the injunctions effectively force it to default, thereby causing undue hardship to the exchange bondholders.

On the policy side, Argentina referred to the perils caused by the injunctions to push the country to another financial meltdown and unravel the consensual sovereign debt restructuring regime that the US has fostered. Argentina also argued that the public interest would be harmed by virtue of the delays to third parties’ transactions that will occur if payment system participants and financial institutions will be forced to perform due diligence to deter payments to exchange bondholders. However, the circuit court was not convinced by this line of argumentation either. It pointed out that Argentina is not in a position to complain on the grounds of equity since Argentina itself has shown disregard of its legal obligations, and in light of this, any affront to its sovereignty caused by the injunctions was tolerable. Furthermore, since exchange bondholders voluntarily accepted to take “haircuts” on their bonds, there is no inequitable treatment vis-à-vis holdouts, who did not accept the exchange offer and are still entitled to full payment. What is more, with respect to Argentina’s notice that a potential default following the injunctions would cause unreasonable harm to the exchange bondholders, the court argued that “[T]his type of harm-harm threatened to third parties by a party subject to an injunction who avows not to obey it—does not make an otherwise lawful injunction «inequitable».”

The court also found that Argentina did not substantiate its claim that it cannot afford to service FAA bonds without defaulting on the exchange bonds, whereas, as far as broader sovereign debt restructuring considerations are concerned, it was satisfied that the proliferation of collective action clauses (CACs) will virtually eliminate the possibility

27 Id.
28 Id, at *15.
30 Id, at *13.
31 Id.
32 Id, at *21.
35 Id, at *14.
36 In a typical collective action clause, a supermajority vote by creditors could alter the payment terms of a particular bond issuance, thereby binding the totality of creditors holding bonds of the same series to the amended terms. This way, holding out for full payment is not an option, as there would be no cause of action to do so.
for holdout litigation.\textsuperscript{37} Regarding transactional costs and delays caused by the injunctions’ effects on third parties, the court drew parallels with US legislation forbidding participation in various international transactions (such as trade of US persons with Iran and with persons trading with Iran or drug trafficking), and held that scouting for payments to exchange bondholders would not amount to an unreasonable burden for financial institutions and payment systems.\textsuperscript{38}

In its last decision of August 23, 2013, the circuit court addressed in more detail how the injunctions of the district court will affect third parties\textsuperscript{39} that facilitate Argentina in the process of paying its exchange bondholders. In this regard, Bank New York Mellon (BNY) and Euro Bondholders\textsuperscript{40} argued that the district court lacks personal jurisdiction over payment system participants, and thus it erred by trying to enjoin them.\textsuperscript{41} Furthermore, Euro Bondholders and ICE Canyon\textsuperscript{42} asserted that the injunctions are improper or at a minimum violate comity as they apply extraterritorially to payment system participants by enjoining them from paying the exchange bondholders.\textsuperscript{43}

In dealing with the personal jurisdiction contention, the circuit court found that the presumed lack of ratione personae jurisdiction over payment system participants was irrelevant because the injunctions are directed exclusively to Argentina and “[s]imply provide notice to payment system participants that they could become liable through Federal Rule of Civil Procedure 65(d) if they assist Argentina in violating the district court’s orders”.\textsuperscript{44} With regards to the extraterritorial application of the injunctions, the court made once again clear that the only foreign entity that is directly enjoined by them is Argentina, and since the country has submitted to the jurisdiction of the courts of New York, it was necessary for the district court to bind the country’s conduct, irrespective of where that conduct occurs.\textsuperscript{45}

Argentina and Fintech next argued that the injunctions violate the Uniform Commercial Code (U.C.C.), and specifically, Article 4A§§502,503. Section 502 refers to creditor process, defining it as “[a] levy, attachment, garnishment, notice of payment, sequestration, or similar process issued by or on behalf of a creditor or other claimant with respect to an account”.\textsuperscript{46} The court was quick to dismiss the argument on the basis of Section 502, as the case at issue did not involve any levy or attachment. Section 503, on the other hand, was applicable and thus “proper cause” was required for a court in order to restrain an Electronic Funds Transfer (EFT). Importantly, Section 503 prohibits injunctions against intermediary banks.\textsuperscript{47} Accordingly, Fintech Advisory Inc.\textsuperscript{48} argued that BNY, BNY’s paying agents, and Depositary Trust Company (DTC) act as intermediary banks, and thus are improperly bound by the injunctions. The court,

\begin{itemize}
\item \textsuperscript{37} NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 250 (2d Cir. 2012), at *27.
\item \textsuperscript{38} NML Capital, Ltd. v. Republic of Argentina (August, 23, 2012, 2d Cir.). Unreported, at *21.
\item \textsuperscript{39} Supra note 6.
\item \textsuperscript{40} A group of Argentina’s exchange bondholders.
\item \textsuperscript{41} NML Capital, Ltd. v. Republic of Argentina (August, 23, 2012, 2d Cir.). Unreported, at *15.
\item \textsuperscript{42} Another group of Argentina’s exchange bondholders, holding GDP-linked securities.
\item \textsuperscript{43} NML Capital, Ltd. v. Republic of Argentina (August, 23, 2012, 2d Cir.). Unreported, at *16.
\item \textsuperscript{44} Id. Importantly, the court noted that if a case arises where a payment system participant will be held liable for violating Rule 65, issues of personal jurisdiction may be properly raised.
\item \textsuperscript{45} Id at *16-17.
\item \textsuperscript{46} Id at *18.
\item \textsuperscript{47} Thus, the district court’s injunctions explicitly exclude intermediary banks from their scope.
\item \textsuperscript{48} A holder of exchange bonds.
\end{itemize}
however, found that the district court “[h]ad good cause to issue injunctions that cover Argentina as well as the Exchange Bond payment system”; moreover, it did not find it necessary to determine which entities would act as intermediary banks in an EFT to the exchange bondholders, explaining however, that Fintech’s assertions are probably invalid.

III. CRITIQUE

Any assessment of the circuit court judgments has to begin with an analysis of the enigmatic pari passu clause, both in the particular context of the case and, more broadly, as a matter of contract interpretation. From this latter perspective, it should be firstly noted that the so-called “ratable payment” interpretation that the circuit court upheld is not novel, as a number of distressed creditors have advanced identical arguments, and in some instances courts gave effect to that reading.

On the other hand, most commentators have argued that the ratable payment interpretation of the clause is false and should be discharged. What is more, the official sector has repeatedly shown its discontent with this reading of the clause through various amici curiae briefs in ongoing court proceedings and policy statements.

A. Pari Passu and Legal Subordination

The traditional interpretation of the pari passu clause, and that seems to be uncontested, suggests that the provision is designed to protect against legal (or formal) subordination of the creditor. Legal subordination could occur where the ranking of a creditor’s claim is formally downgraded vis-à-vis another creditor’s claim, thereby prioritizing the legal right to payment of the latter creditor in detriment of the former. As Buchheit and Pam note, protection against this type of subordination is most meaningful in the event of bankruptcy or insolvency of a corporate debtor where in the stage of liquidation a senior creditor would have a priority claim over the debtor’s assets and would enjoy preferential treatment over subordinated creditors in debt reorganization proceedings.

50 Id at *19-20.
55 Lee C. Buchheit & Jeremiah S. Pam, supra 53 at *873.
In the sovereign debt context, however, there is no authority that would dictate to a State which creditors should be paid and with which order in case of default. Thus, sovereigns with limited funds are virtually free to choose which creditors they will pay and which not.\textsuperscript{56} Nevertheless, according to Bucheit and Pam, this does not render the pari passu clause superfluous as a means of protection against legal subordination. This is so because the clause can have effects in proceedings outside bankruptcy, where an ordinary creditor that has attached assets could invoke the pari passu clause as a defense to a senior creditor who brings a third party action claiming preferential satisfaction through the sale of the attached assets.\textsuperscript{57} As the authors note, this scenario could occur in jurisdictions where involuntary subordination of a creditor may take place in case that a holder of a credit certifies the authenticity of the underlying instrument through notarization by a Notary Public or by obtaining a final judgment on its claim, thereby obtaining senior status over other creditors.\textsuperscript{58}

The analysis of Bucheit and Pam offers a historical account of how the drafters of syndicated loan agreements in the 1970s (from where the clause “migrated” to sovereign debt bonds) thought that the pari passu clause could protect them against the risk of legal subordination. A creditor could be subordinated either by the actions of other creditors taking advantage of provisions codified in national legislations in some jurisdictions or by the debtor country itself through the enactment of laws that prioritize the payment of a certain creditor group. As it has been noted, the significance of protection against this type of legal risk is very limited, as involuntary subordination through the actions of other creditors would not be possible in most jurisdictions, whereas debtor countries do not usually pass laws to effectuate the subordination of their creditors.\textsuperscript{59}

Going one step further, and possibly offering the most sincere and convincing explanation regarding the relevance of pari passu today, Bucheit has suggested that the clause may have “migrated” from corporate cross-border syndicated loans to sovereign debts issuances through the ignorance or inattention of lawyers performing due diligence.\textsuperscript{60} Coming from arguably the most influential lawyer and academic in the area of sovereign debt, this statement deserves significant attention.

\textsuperscript{56} For an overview, see Anna Gelpern, \textit{Building a Better Seating Chart for Sovereign Restructurings}, 53 EMORY L.J. 1119 (2004).
\textsuperscript{57} Lee C. Buchheit & Jeremiah S. Pam, supra 53 at *904.
\textsuperscript{58} Id, at 903-904 and Rodrigo Olivares-Caminal supra 53 at *85-87.
\textsuperscript{59} In this regard, Gelpern notes that legal subordination would occur when a sovereign passes a law formally subordinating some debt or adding burdensome requirements for its enforcement, and argues that protection from this type of subordination is useless to creditors today. See Anna Gelpern supra 54, at *3.
\textsuperscript{60} The exact words of Bucheit were: “[t]he permanent bedrock upon which rests the activity of the entire legal profession is plagiarism...the mythical fellow who prepared the first loan agreement for a sovereign borrower marked up a loan agreement for a corporate borrower...[t]hen the process was repeated countless thousands of times until some lawyer somewhere was told to go off and draft the first sovereign debt restructuring agreement, and he or she just naturally fulfilled this commission by marking up the last sovereign loan agreement. And that, as they say, was that”. See Rodrigo Olivares-Caminal supra 53 at *93.
B. Pari Passu and De Facto Subordination

It is time to turn though to the really contested, broad or ratable payment interpretation of the pari passu clause. It is reminded that according to this interpretation of a typical pari passu clause, such as the one included in the FAA of Argentina that the circuit court upheld, a sovereign debtor cannot distinguish among its creditors, by paying for instance a group of them in full according to the terms of their contract, while at the same time offering to another creditor group less than 100 per cent of what it owes them pursuant to their contract. Bucheit and Pam see four practical implications of that reading of the clause, out of which the two are directly relevant to the proceedings against Argentina:61

a) “It may provide a legal basis for a creditor to seek specific performance of the covenant; that is, a court order directing the debtor not to pay other debts of equal rank without making a ratable payment under the debt benefiting from the clause”; 

b) “It may provide a legal basis for a court order directing a third party financial intermediary such as a fiscal or a bond clearing system to freeze any nonratable payment received from the debtor and to turn over to the pari passu-protected creditor its ratable share of the money”.

Perhaps the most persuasive argument against the broad interpretation of the pari passu clause comes from rules of contract interpretation under New York law. Accordingly, when it comes to the construction of boilerplate language in financial instruments, what is determinative is the common understanding of market participants regarding the meaning of the terms, even if that meaning is contrary to the parties’ understanding of them.62

In their seminal paper on the pari passu clause, Bucheit and Pam offer comprehensive historical evidence proving that sovereign debt market participants never understood the clause as requiring the sovereign debtor to pay its creditors on a lockstep basis.63 If

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61 Lee C. Buchheit & Jeremiah S. Pam, supra 53 at *880.
62 G. Mitu Gulati & Kenneth N.Klee, supra 53 at *643,647, as the authors note, uniform interpretation of boilerplate contractual language that is consistent with market participants’ understanding of it protects the efficiency of financial markets and the public interest, Lee C. Buchheit & Jeremiah S. Pam, supra 53 at *889-890.
63 Lee C. Buchheit & Jeremiah S. Pam, supra 53 at *884,885. Among other arguments, Bucheit and Pam take note of the fact that, despite the preferential treatment that certain groups of creditors (trade creditors, suppliers and international financial institutions) consistently received in sovereign debt restructurings, there was never an instance where a creditor obtained a court judgment halting the practice of paying de facto preferred creditors while restructuring others on the basis of a pari passu clause. Bucheit and Pam make also reference to contractual provisions such as “sharing clauses” that coexisted with the pari passu clause in syndicated loan agreements. Pursuant to a sharing clause, every creditor receiving a disproportionate payment was obliged to ratably share this payment with other creditors. Therefore, the authors argue that, if the pari passu clause already allowed ratable payments to different creditors, there would be no purpose in drafting a four to five pages long sharing clause to offer creditors the same kind of protection. A similar argument can be made with respect to another boilerplate clause, the “most favored creditor” provision. See Rodrigo Olivares-Caminal supra 53 at *91. Bucheit and Pam further note that if the ratable payment interpretation of the pari passu clause was valid and market participants were aware of its implications, then the fierce reaction of the investor community in 1998 when the official sector proposed the inclusion of sharing clauses in sovereign bonds was unreasonable; if ratable payments to creditors were already dictated by virtue of the pari passu clause, then why vigorously
this is so, the ratable payment interpretation of the pari passu clause is clearly wrong, at least as a matter of New York contract law.

C. NML, Argentina and Pari Passu

Going back to the October 2012 decision of the circuit court, we should bear in mind that the court read Argentina’s pari passu clause as offering protection against legal and de facto subordination. Moreover, the court founded Argentina’s breach of the pari passu clause on the broadest grounds of de facto subordination by virtue of its practice to pay exchange bondholders in full, while paying holdouts nothing. The analysis made above demonstrates that the circuit court erred in taking this position. De facto subordination can be only prohibited if one is ready to adopt the ratable payment interpretation of the pari passu clause, and if this interpretation is mistaken, a sovereign is free to pay in full certain groups of creditors while defaulting on others.

The circuit court also found that Argentina subordinated NML et al not only as a matter of fact, but as a matter of law as well. As mentioned above, it seems unequivocal among commentators that the pari passu clause does protect against legal subordination.

The circuit court based its rationale on a series of acts undertaken by Argentina, most notably the enactment of the Lock Law and Lock Law Suspension Law, and concluded that legal subordination had occurred. In this regard, the comment of Gelpern, referring to the enactment of the Lock Law and its effects, is instructive: “[w]hatever the pari passu means, Argentina is the closest I have seen to breach”. Indeed, the Lock Law appears to be this very rare type of legislation that could breach the pari passu clause, even under the narrow interpretation of the provision that prohibits exclusively legal subordination. The Lock Law effectively bars Argentina from paying the FAA bonds, thereby providing a legal basis for the country’s discrimination between the bondholders that participated in the bond exchange and those that did not. This kind of formal discrimination -or subordination- is exactly what the pari passu clause does not allow for, and thus the circuit court was right in finding Argentina in breach of the clause.

However, a violation of the pari passu clause on the grounds of the Lock Law could not lead the court to order Argentina to make pro rata payments to NML et al each time it pays the exchange bondholders. The injunctions upheld by the circuit court are tailored to address de facto subordination and would not be the appropriate remedy to deal with legislation effectuating formal subordination.

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64 NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 250 (2d Cir. 2012), at *18-19.
66 See also Rodrigo Olivares-Caminal supra 53 at *320.
D. Mitigating Sovereign Damage: An “Argentine Interpretation” of the Pari Passu Clause?

As previously noted, the circuit court, obviously realizing the cataclysmic effects that its decision could have, embarked on an attempt to limit the precedential value of its interpretation of the pari passu clause. Thus, it held that its reading of the clause is limited to the particular facts of the case and that Argentina’s “extraordinary behavior” was critical in reaching its conclusions. This is arguably problematic as well. Apart from the fact that the court’s language has an aura of penalization, it can be interpreted as an implicit warning to recalcitrant sovereigns that stricter scrutiny of their treatment to creditors will be employed in the future, whereas more cooperative ones may be given more leeway. Although this approach could be seen as an effective discipline stick, it raises concerns with respect to the need of cash-strapped countries to reduce their debt burdens through debt exchanges with high rates of participation among creditors. Importantly, states do not usually default as a matter of unwillingness to pay, but rather as a matter of incapacity to do so; thus, systematic defaulters, of the kind the circuit court promises to discipline in the future, are more likely to be in need of flexible arrangements with their creditors in order to achieve sustainable debt levels.

The other justification for the limited precedential value of its interpretation of the pari passu clause that the court implies is that the particular language used in Argentina’s FAA was broad enough to allow for such reading. Of course, it is perfectly sensible for the court to state that different versions of the pari passu clause would yield different interpretations. However, the pari passu clause contained in the FAA is in no way exceptional. Consequently, the court’s radical reading of the clause came not much as a matter of legal considerations, as of political or moral valuations about Argentina’s treatment of its holdout creditors. This fact exacerbates the problem with respect to the significance of the court’s decisions for highly indebted countries described right above.

In another attempt to downplay the importance of its judgment for future sovereign debt restructurings, the court made reference to the effects of the inclusion of CACs in sovereign bonds, arguing that in the future CACs will significantly reduce the possibility for holdout litigation. According to Gelpern, this analysis is completely misguided. She notes that as long as CACs operate on a series by series basis - as opposed to allowing for aggregation of votes among different bond series-, it is not difficult for aspiring holdouts to obtain positions in a bond series and form a blocking minority, thereby jeopardizing the restructuring process and also retaining the right to sue in case of less than full payment. To be sure, that was the case in the March 2012 Greek debt exchange, where the CACs of approximately half of Greece’s foreign law bonds were not activated exactly because a number of creditors acquired positions in specific issuances of these bonds letting the door of holdout litigation open.

67 Anna Gelpern, supra 54, at *7.
69 Importantly, that could happen with little cost as these bond series would be traded at deep discounts in the secondary market.
E. Evaluation of the Injunctions

As already mentioned, in its August decision the circuit court mainly addressed the contentions of Argentina and third parties indirectly affected by the injunctions issued by the district judge Thomas P. Griesa. As a general note, the court’s reasoning in responding to these objections was sound. After having (mistakenly though, as this article argues) adopted the ratable payment interpretation of the pari passu clause, the injunctions seemed as the only way to remedy what the court perceived as a violation of the clause.\(^1\)

By clarifying that the injunctions merely function as a notice to third parties that they may be held liable in the future if they were to assist Argentina in paying the exchange bondholders, the court skillfully avoided entering into the merits of third parties’ objections over the lack of personal jurisdiction over them. These issues were not ripe for adjudication yet, the court noted, and they could be addressed in future proceedings. According to Weidemaier, this was probably the right call.\(^2\) The author further notices, that the court’s maneuver effectively achieves the same results with an order that would reject third parties’ objections over personal jurisdiction on the merits, as it is very unlikely that any member of the payment system chain will take the risk to assist Argentina in paying its exchange bondholders.\(^3\)

What could be perhaps a reasonable criticism to the court’s rulings on the injunctions is the fact that, alongside its repeated statements about the solely indirect effects of them on third parties, there is also language that could suggest a more imminent impact on payment system participants and financial institutions.\(^4\)

A more significant criticism would be that the district court injunctions do not provide an effective means of forcing Argentina to comply with its contractual obligations.\(^5\)

Having already seriously damaged its reputation among the creditor community, the country could very well default on its performing debt without groundbreaking reputational costs, with NML et al still not receiving a dollar of what they are owed. Even if the prospect of default were to be considered as an effective discipline stick for Argentina, the injunctions’ power stem not from their effects to the debtor, but from their reach to third parties (payment system operators and other financial institutions) that are threatened with sanctions. This seems to suggest that, when it comes to sovereign debt enforcement, the end justifies the means, as the collateral damage caused to third parties is considered of only secondary importance.

In close relation to the previous point, comes the parallelism that the court made between Argentina’s behavior in non conforming to judicial orders with illicit activities, such as trade with nations that according to US legislation sponsor terrorism and drug

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\(^{1}\) According to Bucheit and Pam, a court order similar to the injunctions upheld by the circuit court would be an appropriate remedy for a violation of the pari passu clause, if the clause was to be interpreted as prohibiting de facto subordination of creditors. See pages 16-17 above.

\(^{2}\) Mark Weidemaier, Argentina Loses... Big, CREDIT SLIPS: A DISCUSSION ON CREDIT, FINANCE, AND BANKRUPTCY (Sep. 11, 2013, 10:45 PM) http://www.creditslips.org/creditslips/2013/08/argentina-loses-big.html#more

\(^{3}\) Id.

\(^{4}\) See NML Capital, Ltd. v. Republic of Argentina (August, 23, 2012, 2d Cir.). Unreported, at *19, “[t]he district court had good cause to issue injunctions that cover Argentina as well as the Exchange Bond payment system”.

\(^{5}\) Anna Gelpern, supra 54, at *9-10.
trafficking. Such comparisons were deemed necessary by the circuit court in order to justify costs and delays caused by the injunctions to payment system participants and financial institutions by virtue of their duty to scoop the transactions that they process for any payment made by Argentina to its exchange bondholders. As Gelpern points out, while there is consensus in the US political discourse that transactional costs associated with activities that counter terrorism and drug trade do not constitute an undue burden for the society as a whole, it should not go without saying that the same applies to unpaid debts of a sovereign country.76

IV. THE IMPACT OF THE COURT’S RULING AND RELATIVE POLICY CONSIDERATIONS

The circuit court’s broad interpretation of the pari passu clause clearly poses a very significant threat to the established decentralized, market-oriented framework for restructuring sovereign debt. Until the last decisions of the circuit court, holdout litigation had not been conceived as a major risk to the success of sovereign debt workouts. Non participating creditors could relatively easily obtain judgments, but sovereigns could ignore court rulings, as collecting on these judgments had been proved a futile quest. Thus, the business model of not accepting a bond exchange offer and holding out in the prospect of suing for full payment was limited to a small group of sophisticated investors, also known as “vulture funds”.77

The circuit court decisions, however, establish a different set of incentives. Holdout creditors are now told that suing defaulted sovereigns in New York may bring about considerable benefits. Even if Argentina were to default, holdouts would have achieved a pyrrhic victory by establishing a precedent in New York law that could force countries to do side payments to every creditor that decides not to participate in future bond exchanges (much like Greece did in its 2012 bond exchange). What is more, participating bondholders, already having accepted significant reductions on their original claims, are caught in the crossfire between holdouts and sovereigns that are incapable or unwilling to pay them. This could make creditors to think twice before participating in a bond exchange. Payment system operators could also be more hesitant to be part of workout agreements as they now face the risk of being sued from pari passu protected holdouts for aiding and abetting sovereign debtors in paying their exchange bondholders.

With such incentives in place, it is very likely that restructurings as we know them today will face a bigger risk of failure in the future. The final result would be a more chaotic environment for sovereign debt restructuring, with clear negative effects for both creditors and sovereign debtors. US policy purposes could be damaged as well by a “migration” of sovereign debt contracts from New York to other, less holdout-friendly, jurisdictions, a development which, quite ironically, would occur as an unintended consequence of a decision made by one of the branches of the US government.

76 Anna Gelpern, Un-Denouement, CREDIT SLIPS: A DISCUSSION ON CREDIT, FINANCE, AND BANKRUPTCY (Sep. 11, 2013, 10:45 PM) http://www.creditslips.org/creditslips/2013/08/undenouement.html#more
What would appear as a good solution to the deadlock described above would be the elimination of pari passu clauses from sovereign debt contracts, or at least their amendment so as to preclude the ratable payment interpretation.\(^78\) Albeit, given the high proliferation of the clause in existing bonds, this task would face important practical difficulties.\(^79\)

Taking stock of the failures of the status quo for restructuring sovereign debt demonstrated by the recent litigation between NML et al and Argentina before the courts of New York, a “regeneration” of the discourse about the creation of an institutionalized framework for sovereign debt restructuring\(^80\) may be expected sooner rather than later. Apart from mitigating the adverse consequences of extreme interpretations of contractual terms with questionable meaning -something that, arguably, can be dealt with contract reform-, a statutory approach could provide a holistic response to the inherent problems of sovereign debt. These relate to the political legitimacy of workout deals reached behind closed doors, the irrevocability of sovereign obligations, the need of indebted countries to be given a fresh start and the right of creditors to have their contracts respected. Although the necessary consensus towards a treaty-based framework for sovereign debt restructuring remains elusive, the recent circuit court decisions could be the catalysts for a major political shift.

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\(^78\) Indeed, the circuit court made a similar statement. See NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 250 (2d Cir. 2012), at *24.

\(^79\) However, there have been propositions for a private-sector driven reform through market utilities that promises to be quicker and easier, while fostering standardization of contractual terms. See Anna Gelpern, supra 54, at *13.