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Sovereign pari passu clauses: NML Capital 2, Argentina 0

The US Supreme Court has declined to hear Argentina's appeal against a lower court's judgment on the effect of a pari passu clause in Argentina's bonds. This leaves in place the decision that if Argentina pays current interest on its restructured bonds, it must also pay its holdout creditors in full. This points the spotlight directly at Argentina. Argentina has so far flatly refused to pay the holdouts. Will it now default on the restructured bonds, try to negotiate a settlement with holdouts or does it have a plan to circumvent the US courts? The decision also has wider implications for other sovereign borrowers. The US court rulings make sovereign payment default even more unattractive than it would otherwise be, but careful drafting of sovereign bonds could mitigate the risk of a similar fate for other sovereign borrowers.

The US Supreme Court's refusal to hear Argentina's appeal in *NML Capital Ltd v Argentina* leaves Argentina seemingly with nowhere to go in the legal system. The decision by the United States Court of Appeals for the Second Circuit in August 2013 is now final. Argentina really is prohibited under New York law from paying current interest to the more than 90% of its creditors who accepted its restructuring terms unless it also pays in full the holdouts, who rejected those terms. As news of the Supreme Court's decision spread, the price of Argentina's bonds lurched lower, its stock market slumped, its currency crashed on the black market and its credit rating collapsed.

The next payment on Argentina's restructured bonds is due on 30 June 2014, subject to a 30-day grace period. Argentina's President Fernandez de Kirchner said that Argentina will not submit to "extortion" from the holdouts but will honour its obligations to its other creditors. However, subsequent statements, such as those from Argentina's legal counsel, may suggest that the position has softened, and the court has appointed a "special master" to facilitate settlement negotiations and instructed Argentina and the holdouts to cooperate. How Argentina will square this circle is not yet clear, though Argentina has had over 20 months since the lower court's decision to put in place contingency plans for this eventuality. Other sovereign debtors will also be looking on anxiously to see what transpires.

Reprise

The background to the *NML Capital* case, as well as the Court of Appeals' decision, is set out in our briefing entitled *Sovereign pari passu clauses: don't cry for Argentina - yet* (December 2012). In summary, in 2001 Argentina defaulted on well over $80 billion of its bonds. Through exchange offers in 2005 and 2010, Argentina compromised with 93% of

Key issues

- US courts order Argentina to pay its holdout creditors in full when it pays interest on its restructured bonds.
- There are practical and legal obstacles to Argentina's paying the holdouts.
- Argentina must find a way to compromise with the holdouts or adhere to the court order. It may otherwise look to find a way to pay on its restructured bonds outside the US, or default – again.
- The decision gives holdout creditors in general a powerful weapon, making restructuring sovereign debt more difficult.
- The decision will focus the attention of sovereigns and their creditors on the drafting of pari passu clauses, as well as on how sovereign debts can be restructured more effectively.

the bondholders, who exchanged their bonds for new, less favourable, bonds. The 7% who refused to compromise, including NML Capital Ltd, have been pursuing Argentina through courts around the world ever since but have had little success in finding Argentine assets against which to enforce their rights.

The strategy that led to the Supreme Court was NML's latching on to the pari passu clause lurking in the boilerplate of the defaulted bonds. The pari passu clause provides that Argentina's payment obligations on the defaulted bonds rank equally with its other external indebtedness. NML persuaded US District Court Judge Thomas Griesa at first instance, and then on appeal, the US Court of Appeals for the Second Circuit that pari passu means that if Argentina makes any payment on its restructured bonds, it must at the same time pay all outstanding sums on its defaulted bonds.

The beauty of this argument, as far as NML is concerned, is not the direct effect on Argentina. Argentina has been ignoring its payment obligations for more than a decade; one more court order to add to the pile is of no consequence. The significance of NML's success is the effect on third parties, such as payment agents, trustees and other banks, involved in the payment flow on Argentina's restructured bonds. They have been served with the court order and so cannot do anything that might help Argentina evade the pari passu ruling. Judge Griesa said that these parties are "in active concert or participation" with Argentina within the meaning of applicable US law, and must make sure that they do not violate the rulings he laid down in his decision. He added after the Supreme Court's decision that "if anyone undertakes to make a payment to the exchanges, without making sure of a payment to NML, they are in violation of this court order".

The immediate future

Having failed to attract the attention of the Supreme Court, *NML Capital Ltd v Argentina* goes back down the court hierarchy. The immediate legal issue is what would happen if Argentina sought to pay on its restructured bonds through New York in the usual way. If the trustee received funds on behalf of the restructured bondholders, what would it be obliged to do? No trustee would want to take the risk of violating a court order, so the issue could go back to Judge Griesa to decide whether the holdouts can stop payments being made on the restructured bonds or can claim all or some part of the payment for themselves.

Alternatively, Argentina may have devised a scheme to avoid payments on the restructured bonds going through the institutions served with and bound by the US court orders (some press reports suggest an exchange for new bonds payable in Argentina). It is, however, hard for dollar payments to circumnavigate the US entirely, nor does Argentina have long to implement any plan before the next payment is due. Another default will not help Argentina's cause.

Argentina must decide whether to risk normal payments through New York, to attempt a different means of payment, or to default on its restructured bonds. The alternative would be to settle with the holdouts. But Argentina has persistently refused to do that - at least on terms acceptable to the holdouts. Immediately after the judgment, President Fernandez de Kirchner offered to negotiate with the holdouts (causing bond prices to rebound), but the cabinet chief later ruled out a mission to New York (causing prices to fall).

There are legal and practical difficulties in the way of settlement with the holdouts. For example, Argentina's own "lock law" prohibits this (though laws can always be changed even if there is a political price to pay), and the restructured bonds contain rights-upon-future-offerings clauses ("RUFO") that, until the end of 2014, require Argentina to offer the same terms to the holders of the restructured bonds as are voluntarily offered to holdouts.

A clearing house for information?

Although the Supreme Court did not accept Argentina's principal appeal, it did rule on another appeal in the same case - also against Argentina.

In *Republic of Argentina v NML Capital Ltd* (16 June 2014), the Supreme Court ruled (7-1) that there is nothing in the US Foreign Sovereign Immunities Act to prevent a US court from ordering banks in the US to disclose details of Argentine payments, account balances and other assets that might be recoverable outside the US. This may offer NML an additional means to find and enforce against Argentine assets, though any enforcement measures will have to be taken in the courts of the location of any assets.

For more details, see our briefing entitled *U.S. Supreme Court Rules that Sovereign States Are Not Immune from U.S. Court Discovery into their Worldwide Assets* (June 2014).

Argentina's wallet also may not hold sufficient to make it prudent to pay the holdouts, especially since NML and the other plaintiffs in the current litigation represent only a portion of the defaulted bonds still outstanding. Estimates put the total defaulted bonds outstanding as high as $15 billion.

In the meantime, Judge Griesa appointed a special master to "conduct and preside over settlement negotiations." It is not clear from the court record whether one or more of the parties requested this appointment or if Judge Griesa made the appointment on his own initiative after hearing overtures of settlement from Argentina's lawyers. Argentina has also asked Judge Griesa to stay his injunction to allow settlement discussions to proceed without the pressure of the upcoming payment date under the restructured bonds and while the RUFO provisions are in effect. A ruling on that request is pending at the time of this publication.

It seems unlikely that we have seen the last of Argentina in the US courts.

The US is not the only venue of legal proceedings involving Argentina's defaulted debt. Less on the public radar, but still significant, are the final hearings in an arbitration brought against Argentina by Italian retail investors holding nearly £1.4 billion in defaulted bonds. The arbitration is taking place at the World Bank's International Centre for Settlement of Investor Disputes (ICSID) and is scheduled to end by 27 June 2014, with a final award some time after that.

The wider future

If other sovereign debtors have issued bonds that include pari passu clauses to the same effect - and the effect of a pari passu clause will always depend heavily on its drafting (such as whether it includes a rateable payment element) as well as the governing law – the ruling in *NML Capital Ltd* will have made restructuring those bonds more difficult. Those who choose not to go along with the restructuring have a potentially powerful weapon to ensure that they are paid in full. This could discourage those otherwise inclined to agree to a restructuring from doing so.

A simple route round this may be to ensure that any restructured bonds have no contact with the US; but where US dollar payments are involved there is likely to be at least a correspondent bank in the US, making this a difficult proposition. Payment within the sovereign issuer's own territory may be unattractive to bondholders. Payment elsewhere, coupled with a non-New York governing law, begs the questions of whether other courts will follow the US courts' view of the meaning of the clause and, if they do, whether they can or will grant the same remedies affecting third parties as the US courts appear inclined to do. It is the remedy for failing to honour a pari passu clause that is the key: it is generally only if a court can grant a remedy that impedes payment to a third party that pari passu clauses matter to sovereign debtors.

Others involved in any restructuring process must ensure that they are not acting in contempt of a court to which they are subject (if, as in *NML Capital Ltd*, there are already court orders in place) or committing a tort, delict or other wrong by helping a sovereign evade its obligations under a pari passu clause.

Then there are future bond issues. Sovereigns will naturally be keen to avoid pari passu clauses like Argentina's but, even if that is not possible, collective action clauses (CACs) can reduce the risk of holdouts impeding a restructuring. CACs allow a majority of the bondholders to bind the dissident minority to a restructuring. CACs are currently much under discussion at the IMF, the ICMA and elsewhere, but, even if they were to be universally accepted, it would take a long time before all extant bonds contained them.

There are many issues surrounding the broader adoption of CACs - for example, should they apply across several or all issues (aggregation), what should the aggregation mechanism be, should an overall majority of bondholders in all aggregated bonds be sufficient or should there also be majority requirements for each series being aggregated, and what should the majorities be. However, CACs may ultimately offer a more satisfactory solution for distressed sovereigns than a bankruptcy regime, all discussions on which have so far foundered.

Interestingly in this regard, the euro area has already implemented its own model CAC to facilitate sovereign restructurings. Some want to go further, however, and eliminate the current requirement in the euro area CAC to obtain a majority in each series of instruments to be restructured in order to reduce even further the risk to a restructuring posed by holdouts.

Conclusion

The Supreme Court's rejection of the appeal in *NML Capital Ltd* may in itself not be a huge surprise, but it came rather sooner than most had expected. The prevalent view was

that the Supreme Court would seek the US Solicitor-General's opinion before reaching its decision. As it turned out, the Supreme Court did not find that necessary. This has turned the immediate spotlight on Argentina: what will it do regarding payments on its restructured bonds, which it has pledged to honour? In the longer term, the case will cause those involved in sovereign bond issuances to consider the boilerplate more carefully, and will cause those involved in trying to make sovereign bond restructurings work more effectively to accelerate their deliberations.

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