

**The Argentine case: the U.S. District Court for the Southern District of New York interpretation of the *pari passu* clause and the recent U.S. Supreme Court opinion, *Argentine vs NML Capital, ltd*, no. 12-842 (*i.e.* the discovery case).**

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**I. Facts**

In 2001, Argentina suffered the worst economic social crisis in its modern history, causing poverty and unemployment to reach unprecedented levels. Unable to pay its debts, and provide basic government services, Argentina declared a payment moratorium on more than 80 billion dollars of its public external debt. Republic of Argentina restructured approximately 93% of that debt by offering creditors new securities to swap out the defaulted ones.

While most of Argentina's bondholders agreed to voluntary debt restructuring in 2005 and 2010, others, including NML Capital ltd (NML), did not and started lawsuits against Republic of Argentina.

It should be specified that the defaulted bond are governed pursuant to the 1994 Fiscal Agency Agreement (FAA), upon that Argentina agreed to waive its immunity. Moreover, in

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the indenture of the issuance agreement, Argentina signed the *pari passu* clause: “*the security will constitute direct, unconditional, unsecured and unsubordinated obligation of the Republic and shall at all times rank pari passu and without any preference among themselves*”. In a wider interpretation of that clause, if Argentina pays the holder of the new bond (the bonds issued upon the restructuring plan), it has to pay the ratable amount to the holder of old bond (i.e. equal treatment provision).

However, in that indenture was not included the collective action clause (Cac), whereby in the case of debt restructuring plan the majority of the creditors compels the dissenting minority to enter into the agreement.

Therefore, no creditor was obliged to participate in the debt restructuring plan and approximately 7% of them did not participate in the 2005 and 2010 debt restructuring agreement.

So far, Argentina refused to pay the holders of old bonds. In 2005, Argentina's government passed a law known as Lock Law, declaring that Argentina was prohibited from paying these holdouts of old bonds. The Lock Law was intended to encourage holdouts to participate in the exchange since otherwise holdouts would not be paid.

However, some of them, who rejected the 2005 and 2010 offers to exchange their defaulted bonds, resorted instead to lawsuits to block payments to other bondholders and attempted to seize Argentine government assets abroad (e.g. notably Central Bank deposits in the Federal Reserve Bank of New York, the presidential airplane, the ARA Libertad, an Argentine Navy training frigate, and recently satellite launch contracts).

Particularly, a hedge fund creditor, NML Capital Ltd, sued Argentina in the Southern District Court of New York to collect on its debt of approximately 1.3 billion dollars.

## **II. The sovereign debt restructuring: an overview.**

Sovereign debt restructuring is a process that allows a sovereign state facing cash flow problems and financial distress to reduce and renegotiate its delinquent debt in order to improve or restore liquidity so it can continue its operations.

Since this process is not governed by any international treaty and there is no bankruptcy regime for sovereign nations, the States have to negotiate with the creditors (i.e. the bondholders) in order to agree to the conditions and terms of a voluntary debt restructuring agreement.

Besides, occasionally creditors do not agree to participate in that agreement. Instead, they file lawsuits in order to recover the money they invested into sovereign debt bonds.

Moreover, nothing obliges bondholders to stipulate the restructuring agreement, except the collective action clause. Indeed, with that clause the dissenting minority of creditor is compelled to accept the restructuring plan if the majority of them agrees with the debtor. In the Fiscal Agency Agreement (*i.e.* the agreement that governs the issuance of Argentinian bonds), this clause lacks. Therefore, nothing could compel Argentina's creditors to participate in the restructuring of its debt.

The Argentine case provides an extreme example of the negative consequences to the absence of a binding international treaty that would assist sovereigns in the coordination of debt restructuring with all holders of governmental debt.

In 2002, Deputy Director of the International Monetary Fund, Anne Krueger, proposed the adoption of a Sovereign Debt Restructuring Mechanism (SDRM) by states, anticipating that:

*“The absence of a predictable, orderly, and rapid process for restructuring the debts of sovereigns that are implementing appropriate policies has a number of costs. It can lead a sovereign with unsustainable debts to delay seeking a restructuring, draining its reserves and leaving the debtor and the majority of its creditors worse off. Perhaps most crucially, the absence of a mechanism for majority voting on restructuring terms can complicate the process of working out an equitable debt restructuring that returns the country to sustainability. The risk that some creditors will be able to hold out for full payment may prolong the restructuring process, and even inhibit agreement on a needed restructuring. The absence of a predictable process creates additional uncertainty about recovery value.”*

The key features of the proposed Sovereign Debt Restructuring Mechanism would be: 1) majority restructuring binding on any dissenting minority (*i.e.* collective action clause); 2) a stay on creditor enforcement litigation before reaching agreement on the restructuring; 3) safeguards for creditor protection during the period of the stay; 4) priority financing during the stay period.

Argentina's debt saga renewed calls in 2013 for an international sovereign bankruptcy regime featuring the Sovereign Debt Restructuring Mechanism, which remained at a standstill since 2002 when the United States expressed its opposition to the proposal.

In 2013, the International Monetary Fund issued its paper<sup>2</sup> to revisit sovereign debt restructuring in light of the Fund’s mandate (*i.e.* reducing the external debt burdens of the most heavily indebted poor countries), including surveying recent practices in overcoming the collective action problem for other sovereign bond issuances that did not include a “*collective action clause*”.

There is certainly nothing that compels countries to enter into an international treaty on sovereign restructuring since treaty-making is a State’s sovereign decision. On the opposite, an argument for pressuring States to sign an international treaty on sovereign restructuring would also put in practice their duties as States Parties to the International Covenant on Economic, Social and Cultural Rights (ICESCR). Under the ICESCR, States have duties of international cooperation “*to take steps...with a view to achieving progressively the full realization of the rights recognized in the present Covenant by all appropriate means, including particularly the adoption of legislative measures.*” [Article 2(1), ICESCR].

Since 1990, the Committee on Economic, Social and Cultural Rights has stressed that “**international measures to deal with the debt crisis should take full account of the need protect economic, social and cultural rights through, inter alia, international cooperation.**”

Had the States adopted an international treaty for the debt sovereign restructuring upon the SDRM, the dissenting minority of creditors would not have speculated on the sovereign bonds as they did in the past and in the Argentine case.

An international treaty establishing a sovereign debt restructuring mechanism would ensure that the risk of a sovereign debt default (and the counterpart incentive to engage in sovereign debt restructuring) is justifiably and equitably supported by all parties, without privileging one set of creditors against others.

In addition, an internationally-binding procedure would also ensure that the debtor state’s development program does not have to grind to a halt – with critical resources having to be marshaled towards a global litigation and arbitration defense against a dissenting minority of creditors (e.g. creditors who purchase bonds at a lower price and then bring actions to the courts to collect the face values of them, so that they consequently profit off of debtors who are in financial distress) who choose to bolt restructuring negotiations and race to execute their credits against sovereign assets.

### **III. The *pari passu* case and the T.Griesa ruling.**

<sup>2</sup> Sovereign Debt Restructuring—Recent Developments and Implications for the Fund’s Legal and Policy Framework, International Monetary Fund–IMF–(April 26, 2013).

On June 16, 2014, the Supreme Court of United States denied the petition for writ of certiorari (573\_\_\_2014. 13-990) *Republic of Argentina V. NML Capital, ltd., et al., petition for a writ of certiorari to the United States Court of Appeal for the Second Circuit n. 12-4694 - 124865.*

The Supreme Court justices declined to hear Argentina's separate appeal of the decision by the Second Circuit, *699 F.3d 246, Aug. 2013*, that upheld the decision of the United States District Court for the Southern District of New York, Thomas P. Griesa, Senior District Judge, who granted partial summary judgment to defaulted bondholders and permanently enjoined Argentina from making payments on bonds issued pursuant to debt restructurings without making comparable payments on defaulted bonds. *S.D.N.Y., T. Griesa, 2012 WL 5895786, (Nov. 2012).*

Indeed, the District Court pointed out that Argentina must pay plaintiffs NML 100% of that 1.33 billion dollars concurrently with or in advance of the payments on the Exchange Bonds. To give effect to this, Argentina was ordered not to alter the bank payment processes and at the time of the payment Argentina must certify to the court that it has satisfied its obligations.

The Second Circuit simply affirms the District Court's conclusion that Argentina's extraordinary behavior was a violation of the particular *pari passu* clause found in the Fiscal Agency Agreement. In other words, Argentina, upon this clause, could either pay all its bondholders or none, but could not pay only those who cooperated with the 2005 and 2010 restructuring and ignore the rest.

The Second Circuit held that the public interest of enforcing contracts and upholding the rule of law would be served by the issuance of injunctions, particularly when creditors have no recourse to bankruptcy regimes to protect their interests and must rely upon courts to enforce contractual provisions.

Moreover, the Circuit Court upheld the opinion of the District Court which found that Argentina now “*has the financial wherewithal to meet its commitment of providing equal treatment to plaintiffs and Exchange Bondholders.*”

#### **IV. The discovery case and the recent US Supreme Court opinion, Republic of Argentina vs NML Capital, ltd, no. 12-842.**

Since 2003, one creditor, NML, has pursued discovery of Argentina's property, and in 2010, served subpoenas on two non-party banks, Bank of America and Banco de la Nacion Argentina (that has a branch in New York) in order to acquire information, such as documents

relating to accounts maintained by or on behalf of Argentina, current balances, transfers in and out of Argentina's accounts, etc.

Argentina, joined by Bank of America, moved to quash the Bank of America subpoena and NML moved to compel compliance. The District Court denied the motion to quash and granted the motions to compel, stating that extraterritorial asset discovery did not offend Argentina's sovereign immunity.

In supplemental post judgment proceedings instituted by judgment creditor NML Capital Ltd to facilitate the execution of its judgment against Argentina, the United States District Court for the Southern District of New York, *T. Griesa, J., 2011, WL 3897828*, granted NML's motion to compel non-party banks to comply with subpoenas *dues tecum*, and denied Argentina's motion to quash the subpoena issued to one bank.

Argentina appealed, but the Second Circuit held that because District Court ordered only discovery, not the attachment of sovereign property, and because that discovery was directed at third-party banks, Argentina's sovereign immunity was not infringed. *EM ltd NML capital, ltd, vs Republic of Argentina, Bank of America 695 F3d 201, August 2012 (2<sup>d</sup> Cir. 2012)*.

In fact, the Second Circuit stated that post-judgment discovery into a foreign State's property, "*does not implicate immunity from attachment under the FSIA,*" because "*it does not allow [respondent] to attach Argentina's property.*"

The Court pointed out that, once the District Court had subject matter and personal jurisdiction over Argentina, it could exercise its judicial power over Argentina as over any other party, including approving the kind of "*broad post-judgment discovery in aid of execution*" that the Second Circuit identified as "*the norm in federal and New York state courts.*"

Second, the Second Circuit stated that "*the Discovery Order does not infringe on Argentina's sovereign immunity*", because "*the subpoenas at issue were directed at commercial banks that have no claim to sovereign immunity.*" In the court's view, "*the banks' compliance*" will "*cause Argentina no burden and no expense,*" and "*Argentina's sovereign immunity*" is therefore not endangered.

On June 16, 2014, the U.S. Supreme Court granted writ of certiorari 571 U.S.\_\_\_\_2014, to decide the issue of "*whether a court can order post-judgment discovery that will help enforce a judgment against a sovereign nation with respect to all assets, regardless of use or location, or if such discovery limited to assets located in the United*

*States that fall under the Foreign Sovereign Immunities Act of 1976. "Argentina vs NML capital ltd, no. 12-842, 573 U.S.\_\_\_\_2014.*

Justice A. Scalia, who delivered the opinion, first addressed the rules governing discovery, then moved to a brief analysis of Foreign Sovereign Immunities Act of 1976 (FSIA) and the regime it replaced, and finally he faced some considerations relating the international-relations consequences of siding with the lower court.

#### **IV.1 The rules governing discovery**

Federal Rule of Civil Procedure 69 (a)(2) states that, "*in aid of the judgment or execution, the judgment creditor...may obtain discovery from any person – including the judgment debtor – as provided in the rules or by the procedure of the state where the court is located.*" Moreover, New York law entitles judgment creditors to discover all matter relevant to the satisfaction of a judgment.

Argentina argued that the normally broad scope of discovery in aid of execution is limited by principles of sovereign immunity. Therefore, Argentina's petition for writ of certiorari asked to the U.S. Supreme Court only whether the Foreign Sovereign Immunities Act imposes a limit on a United States court's authority to order blanket post-judgment execution discovery on the assets of a foreign state used for any activity anywhere in the world.

#### **IV.2 Foreign Sovereign Immunity Act and the Court's holding**

Foreign sovereign immunity is a matter of grace and comity on the part of the United States, and not a restriction imposed by the Constitution.

Prior to 1976, when the FSIA was adopted, the matter was regulated by the determinations of the Executive. In 1952, the State Department embraced the restrictive theory of sovereign immunity, which holds that immunity shields only a foreign sovereign's public, noncommercial acts.

Since 1976, the issue is governed by the FSIA, as a comprehensive set of legal standards governing claims of immunity in every civil action against a foreign state. Therefore, any kind of immunity defense made by a foreign sovereign in an American Court shall stand on the Act's text. The Act confers two kind of immunities: a) a foreign state shall be immune from the jurisdiction of the courts of the United States; b) the property in the United States of a foreign state shall be immune from attachment, arrest, and execution.

However, there are some exceptions to this rule. The first is stated in §1605 whereby a foreign state may forgo jurisdictional immunity; the second is regulated in §1610, that sets

forth “*the property in United States of a foreign state is subject to attachment, arrest, or execution if it is used for commercial activity in the United States*”.

These provisions, especially the first one, are of no help to Argentina because it waived sovereign immunity in its bond indenture agreement which states “*to the extent that Argentina or any of its revenues assets or properties shall be entitled...to any immunity from suit...from attachment prior to judgment...from execution of a judgment or from any other legal or judicial process or remedy...Argentina has irrevocably agreed not to claim and waived such immunity...*”

Furthermore, nothing forbids or limits discovery in aid of execution against a foreign-sovereign judgment debtor's assets.

Argentina argued that subpoenas meant to uncover assets held abroad were improper if those assets could not be seized under the relevant foreign law. Justice Scalia conceded the point. “*But the reason for these subpoenas,*” he said, “*is that NML does not yet know what property Argentina has and where it is, let alone whether it is executable under the relevant jurisdiction’s law.*”

In conclusion, Justice Scalia stated the prospect that NML’s general request for information about Argentina’s worldwide assets that may turn up information about property that Argentina regards as immune does not mean that NML cannot pursue its discovery.

#### **IV.3. Final Supreme Court considerations**

The Supreme Court of the United States did not address the political point objected to by Argentina and the United States of America. Indeed, the United States filed an *amicus curiae*<sup>3</sup>, stating that, “*at the time the FSIA was passed, the international community viewed execution against a foreign state’s property as a greater affront to its sovereignty than merely permitting jurisdiction over the merits of an action.*”

The General Solicitor in the *amicus curiae* brief also clarified that broader discovery of extraterritorial foreign State assets that are not subject to execution would be irreconcilable with the principles of comity and reciprocity embodied in the statute.

Upon those considerations, the Court agreed with this objection, observing that Argentina and the United States have to consider the worrisome international-relations consequences of siding with the lower court. Indeed, a discovery order may provoke adverse treatment of the United States in foreign courts and might damage United States foreign relations.

<sup>3</sup> Brief for the United States as *amicus curiae* in support of petitioner Republic of Argentina.



However, Justice Scalia wrote that those worries should be addressed by the Congress (i.e. the branch of government with authority to amend the Act), which enacted the Foreign Sovereign Immunities Act in 1976 in an effort to deal with what he called the bedlam of “*the old executive-driven, factor-intensive, loosely common-law-based immunity regime.*” In fact, he specified that those apprehensions “*are better directed to that branch of government with authority to amend the act — which, as it happens, is the same branch that forced our retirement from the immunity-by-factor-balancing business nearly 40 years ago.*”

#### **V. The current scenario in the light of the recent US Supreme Court opinion.**

Argentina, which had to pay the exchange bondholders on June 30, 2014, filed a motion for a stay while negotiating the formula of payment.

On June 26, 2014, in order to pay the U.S. bondholders, Argentina government deposited the \$539 million with Bank of New York Mellon, the bondholders’ trustee.

On June 27, 2014, Judge T.Griesa denied the motion for stay: “*the request is inappropriate. The injunctive relief ordered by this court (dealing with the pari passu clause) does not even come into play unless the Republic makes payments to the exchange bondholders...A special Master has been appointed to assist settlement negotiations. It is the understanding of the Court that such negotiations will include the handling of any further payment due to the exchange bondholders*”. Order, NML Capital Ltd v Republic of Argentina, No. 08 Civ. 6978 (TPG) (S.D.N.Y. June 27, 2014).

He also forbade the bank from transferring the funds to the bondholders. The U.S. federal Judge said that was because it would violate his ruling, upheld on June 16 by the US Supreme Court, that Argentina must pay the holdouts in full at the same time as holders of its performing debt. Besides, the Court appointed a special master to assist in settlement negotiations.

Thus, Argentina had a 30-day grace period, under the term of Exchange Bond, because a non-payment of interest becomes an event of default.

Republic of Argentina pointed out that to negotiate or to make a payment to the holdouts before January 1, 2015, will cause the “Rights on Future Offers” (RUFO) clause written into the restructured bond contracts. That clause, which expires on the last day of this year, says that Argentina cannot “voluntarily” extend a better offer than the one it made during its 2005 and 2010 restructurings without also proffering the same deal to all debt holders.

In other words, if Argentina offered a better deal to the holdouts before that date, each

creditor who participated in the debt restructuring agreement (i.e. the exchange bondholders) would have a right to that deal as well<sup>4</sup>.

On July 22, 2014 Judge T. Griesa held a new hearing to hear various motions by Citibank and creditors whether part of the U.S. dollar denominated bonds are covered by the former injunction or not. The Court clarified that Citibank can make payments in the dollar and peso denominated exchange bonds, but he only referred to those bonds not related with the restructuring agreement<sup>5</sup>. *Order, NML Capital v Republic of Argentina, no 08 Civ. 6968 (TPG) (S.D.N.Y. , July 28)*

Judge T. Griesa also denied the Argentina repeated request for a stay and directed the parties to meet with the court-appointed mediator “*continuously and promptly*” in the attempt to reach a negotiated solution.

However, on July 29 and 30, 2014, the efforts to settle the case by the mediator were fruitless. The holdouts did not accept the stay and the Republic of Argentina did not accept to pay them since that payment could trigger the R.U.F.O. clause. Therefore, on July 30, since the South American country failed to get the \$539 million payment to the exchange bondholders (money that upon Griesa's ruling couldn't be distributed unless the plaintiff holding defaulted debt also got paid), it defaulted for the second time in 13 years on its external debt<sup>6</sup>.

## **VI. Conclusion**

The Argentine case, and, particularly, the mentioned Justice Scalia's opinion gave me the opportunity to pay attention on two different issues.

The first one is the final consideration of the U.S. Supreme Court justices, of not

<sup>4</sup> The Rights Upon Future Offers clause in the bond indenture states that “*If following the expiration of the Invitation until December 31, 2014, Argentina voluntarily makes an offer to purchase or exchange or solicits consents to amend any securities eligible to participate in the 2005 exchange offer and not tendered or accepted pursuant to that offer or the April 2010 exchange offer (other than an offer on terms substantially the same as, or less favorable than, the April 2010 exchange offer), Argentina will take all steps necessary so that each holder of Discounts will have the right, for a period of at least 30 calendar days following the announcement of such offer, to exchange any of such holder's Discounts for the consideration in cash or in kind received in connection with such purchase or exchange offer or securities having terms substantially the same as those resulting from such amendment process, in each case in accordance with the terms and conditions of such offer to purchase, exchange offer or amendment process. The right of tendering holders to participate in any such transaction is subject to certain conditions described under “Description of the New Securities’s Rights Upon Future Offers.”*”

<sup>5</sup> The Republic of Argentina issued bonds pursuant to a settlement with Repsol Y P F,S.A. in an unrelated case (the “Repsol bonds”), which have the same International Securities Identification Number (“ISIN”) as the dollar-denominated exchange bonds paid through Citibank. The Court stated that Citibank may make payment on the interest due on the Repsol bond and on both the peso- and dollar-denominated exchange bonds. However, J. Griesa allowed this one-time payment on the dollar-denominated exchange bonds and directed the parties to distinguish for the future the Repsol bond and the exchange bond.

<sup>6</sup> On July 30, 2014, Standard & Poor's rating Services declared Argentina in default on some of its debt. At this time, the jeopardy is that provisions in bond indentures known as cross default clauses would allow exchange bondholder to demand their money back immediately. It may trigger bondholder claims of as much as \$29 billion, equal to all its foreign-currency reserve. Economists observed that the default would pressure an economy already mired in recession, potentially leading to higher inflation and weaker currency.

addressing the political problem of waiving foreign immunity. Justice Scalia specified this is a Congress issue, *i.e.* the branch of government with the power to amend the Foreign Sovereign Immunity Act. In fact, the Congress is the only one that can face the political problem to make immune the Argentina's assets in the United States.

The second one regards the future sovereign debt restructuring implication. The success by holdout creditors in this litigation, and the fact that holdouts can obtain full payment may affect the feasibility of the restructuring plan, since future creditors will be unwilling to accept an exchange offer.

Commentators warn that rather than submitting to restructuring, bondholders will hold out for the possibility of full recovery on their bonds at a later time, in turn causing second and third order effects detrimental to the global economy and especially to developing countries.

More broadly, the United States of America, the International Monetary Fund (IMF), Republic of France<sup>7</sup>, the Exchange Bondholder Group (that submitted *amicus curiae* brief supporting Argentina position) have warned that the “*rateable payments*” injunctions threaten the international financial system. Indeed, voluntary restructuring of sovereign debt crises is critical to maintain stability in a financially-interconnected world without a sovereign bankruptcy regime. The possibility of obtaining “*rateable payments*” injunctions creates a powerful incentive for creditors to hold out and seek windfall profits by threatening to block payments on restructured debt. This makes voluntary restructuring substantially more difficult, if not impossible.

Eventually, the adoption of the collective action clauses could mitigate the problem of holdout creditors, but not solve it.

The hallmark of the collective action clause (CAC) is that a super-majority of bondholder can impose a restructuring on potential holdout. However, experts warned that CAC do not prevent hold-out creditors from buying up blocking positions in single series of bonds, effectively preventing any debt restructuring of that series.

To sum up, the Argentina case could have pervasive implications for future sovereign debt restructurings by increasing leverage of holdout creditors, as it was clarified by the IMF in the recent document approved by its board of directors in 2013.<sup>8</sup>

<sup>7</sup> Brief for the Republic of France as *amicus curiae* in support of the Republic of Argentina's petition for a writ of certiorari (July 26, 2013). This brief was filed before the Supreme Court of the United States in the case *Republic of Argentina v. NML* (Docket Number 12-1494).

<sup>8</sup> Sovereign Debt Restructuring—Recent Developments and Implications for the Fund's Legal and Policy Framework,

By allowing holdouts to interrupt the flow of payments to creditors who have participated in the restructuring, the decisions would likely discourage creditors from participating in a voluntary restructuring.

By offering holdouts a mechanism to extract recovery outside a voluntary debt exchange, the decisions would increase the risk that holdouts will multiply and creditors who are otherwise inclined to agree to a restructuring may be less likely to do so due to inter-creditor equity concerns.

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