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Developments in Sovereign Debt Restructurings:

NML Capital v. Republic of Argentina

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This outline discusses NML Capital v. Republic of Argentina, a highly contentious litigation currently before the Court of Appeals for the Second Circuit, which presents some interesting developments in the area of sovereign debt restructuring. Notwithstanding the facial similarity between sovereign debt restructurings and corporate debt restructurings, they really are quite different because there is no bankruptcy alternative for sovereigns. Therefore, inasmuch as this outline is intended principally for advanced bankruptcy practitioners, it starts with a short – and only semi-serious -- primer on sovereign debt restructurings to set the context for a more serious discussion of the Argentina case.

I. Sovereign Debt Restructurings Are Not Like Chapter 11 Cases

A. No bankruptcy laws for sovereigns

1. Sovereign governments print money (in the EU, it is more complicated), expect that they can dictate terms, pass laws, have their own (often cooperative) courts, and have armies to deal with those who disagree. Nonetheless, sovereign debt defaults and restructurings are not rare.

2. Generally, a government does not engage in the somewhat circular activity of passing a law that it is obligated to enforce to deal with its actual or prospective inability to perform what it is already obligated to do. In the Argentina case discussed below, Argentina did this an then suspended the law.

3. Motivated largely by concerns about Europe, various academics and groups have recently discussed possible sovereign restructuring laws – and have even developed model laws – that would enable sovereigns to employ "collective action" principles to restructure their debt, even where there were no prior contractual or statutory collective action provisions. As used in this outline, "collective action" means a statutory or contractual provision enabling a vote of a supermajority of the holders of a class of debt to bind dissenting or non-voting members of the class. Bankruptcy practitioners will recognize this as a key feature of chapter 11. For interesting discussions of possible sovereign restructuring laws, *see* Stephen L. Schwarcz, *Sovereign Debt Restructuring Options and Analytical Comparison,* 2 Har. Bus. L. Rev. 95 (2012); Mark L.J. Wright, *Sovereign Debt Restructuring: Problems and Prospects*, 2 Harv. Bus. L. Rev. 153 (2012); Anna Gelpern, *The Seventeenth Annual Frankel Lecture: Commentaries: A Skeptic's Case for Sovereign Bankruptcy*, 50 Hous. L. Rev. 1095 (2013).

4. Few, if any, sovereign bankruptcy laws of this type have actually been enacted.

B. Debt Restructurings/Exchange Offers

1. The agreements covering much of the universe of sovereign debt are expressly governed by New York or U.K. law. Because the agreements covering much of the sovereign debt does not contain a collective action provision, the conventional manner of effecting a sovereign debt restructuring is an exchange offer, *i.e.* the holders of existing debt are offered the right to exchange for new debt (typically having a lower principal amount), and only exchanging holders are directly affected by their exchanges.

2. The sovereign may take a variety of actions to induce holders to exchange. While bankruptcy is not an alternative to a failed exchange, the sovereign can offer greater likelihood of paying the exchanged debt, promise not to pay the old debt, use exit consent techniques to make the old debt somewhat less attractive, and provide other economic and political incentives.

3. Nonetheless, as in the case of corporate exchange offers, the possibility that non-exchanging holders (so-called "holdouts") will collect the full amount of their debt while cooperating exchanging holders agree to substantial concessions can make it difficult for sovereign exchange offers to succeed (*i.e.* obtain high levels of participation). While other sovereigns and major financial institutions may feel compelled to join in collective consensual efforts to restore sovereigns to a semblance of financial health and collect at least a portion of their debt claims, other holders (such as hedge funds, some of whom may have purchased the already distressed debt at a deep discount) may not be subject to the same pressures that caused the majority to cooperate and, instead, may view the debt as an inviting investment opportunity. Moreover, holders of debt who have hedged their credit risk with credit default swaps may be better off economically with a default that will constitute a Credit Event under their swaps, rather than agreeing to any concessions.

C. Contractual collective action

1. There has been a trend, at least in sovereign debt documentation governed by New York law, towards inclusion of collective action provisions covering reduction of principal or interest, deferral of maturity or other major economic terms. *See* II.B.G. below.

2. Contractual collective action provisions operate within a particular debt issue, but do not generally aggregate votes of multiple debts issues so as to bind the holders of debt in all of those issues with a single collective vote. Therefore, in the case of a sovereign that has multiple debt issues – which is common with larger sovereigns – free-riding holdout concerns are reduced, but it is still possible that one or more debt issues will reject a proposal that has been accepted by the requisite majorities within other debt issues. Consequently, a sovereign bankruptcy law that would aggregate all similar claims, even if evidenced by separate debt agreements, would be a

more effective collective action mechanism than contractual collection action provisions.

II. NML Capital, Ltd. v Republic of Argentina

A. Background.[1]

1. In 1994, Argentina commenced issuing debt securities ("FAA Bonds") pursuant to a Fiscal Agency Agreement ("FAA") governed by New York law. The FAA provides for jurisdiction in "any state or federal court in The City of New York." The FAA also contains an anti-subordination provision:

> "The 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...."

The second sentence of the anti-subordination provision will be referred to below as the "Equal Treatment Provision."

2. Argentina defaulted on the FAA Bonds in 2001. Argentina conducted exchange offers in 2005 and 2010 in which a substantial majority of holders tendered their FAA Bonds in exchange for new debt securities ("Exchange Bonds") having principal amounts ranging between 25 and 29% of the principal amount of the tendered FAA Bonds. A par value of more than $62 billion, representing more than 76% of the eligible debt (including the FAA Bonds and other public debt), was tendered in the 2005 exchange offer. Following the 2010 exchange offer, Argentina had restructured more than 91% of its public debt.

3. Argentina took aggressive actions to induce holders to accept the exchange offers of a kind not common in corporate exchange offers. For example:

a) In the prospectus for the 2005 exchange offer, Argentina stated:

> "The Government has announced that it has no intention of resuming payment on any bonds eligible to participate in [the] exchange offer...that are not tendered or otherwise restructured as part of such transaction. Consequently, if you elect not to tender your bonds in an exchange offer there can be no assurance that you will receive any future payments in respect of your bonds."

b) In 2005, Argentina enacted Law 26,017 (known as the "Lock

1 This background is based on information contained in the Second Circuit and District Court decisions cited in the outline.

Law"), which included the following declarations with respect to the FAA Bonds and certain other pre-exchange public debt:

"Article 2 – The national Executive Power may not, with respect to the bonds…reopen the swap process established in the [2005 exchange offer].

Article 3 – The national State shall be prohibited from conducting any type of in-court, out-of-court or private settlement with respect to the bonds….

Article 4 – The national Executive Power must…remove the bonds…from listing on all domestic and foreign securities markets and exchanges."

c) **Because the Lock Law would have prevented Argentina from conducting a second exchange offer for the FAA Bonds and other public debt, Argentina suspended the Lock Law before it conducted the 2010 exchange offer. The 2010 exchange offer was on terms similar to the 2005 exchange offer. The following language in the prospectus for the 2010 exchange offer was particularly prescient:**

"Eligible securities that are in default and that are not tendered may remain in default indefinitely and, if you elect to litigate, Argentina intends to oppose such attempts to collect on its defaulted debt.

Eligible Securities in default that are not exchanged pursuant to the Invitation may remain in default indefinitely. In light of its financial and legal constraints, Argentina does not expect to resume payments on any Eligible Securities in default that remain outstanding following the expiration of the Invitation. Argentina has opposed vigorously, and intends to continue to oppose, attempts by holders who did not participate in its prior exchange offers to collect on its defaulted debt through…litigation… and other legal proceedings against Argentina."

4. Each series of Exchange Bonds contains a collective action provision that bound all holders of the series to changes accepted by holders of between 66 2/3% and 75% (depending on the particular series) of the aggregate principal amount of the series. The FAA Bonds do not contain collective action provisions.

5. Argentina has made all payments due on the Exchange Bonds, but did not make payments on the FAA Bonds following the 2005 exchange offer.

Under the indentures for the Exchange Bonds, Argentina makes principal and interest payments to a trustee in Argentina that in turn makes an electronic funds transfer to U.S.-registered bondholders. The funds transfers are made from the trustee's non-U.S. bank to the registered holder's U.S. bank, generally routed though one or more intermediary banks.

6. Hedge funds managed by Elliott Management and Aurelius Capital Management ("Plaintiffs") accumulated sizeable positions in the FAA Bonds at a discount, and did not participate in the exchange offers. Between 2009 and 2011, Plaintiffs or their affiliates obtained U.S. judgments on their FAA Bonds and other defaulted Argentina bonds in the Southern District of New York but the Argentina courts held that the Lock Law and payment moratoria prevented them from recognizing the New York judgments. Plaintiffs were also largely unsuccessful in a series of cases seeking to attach reserves and other Argentina assets in the U.S. to satisfy judgments on other Argentina bonds due to constraints on the attachment of assets of foreign sovereigns contained in the Foreign Sovereign Immunities Act ("FSIA"). *See NML Capital, Ltd. v. Banco Central de la Republica Argentina*, 652 F.3d 172, 197 (2d Cir. 2011); *Aurelius Capital Partners, LP v. Republic of Argentina*, 584 F.3d 120, 131 (2d Cir. 2009); *EM Ltd. v. Republic of Argentina,* 473 F.3d 463, 472 (2d Cir. 2007); *but see NML Capital Ltd. v Republic of Argentina*, 680 F.3d 254, 260 (2d Cir. 2012); *EM Ltd. v. Republic of Argentina*, 389 F. App'x 38, 43 (2d Cir. 2010).

7. Then the Plaintiffs added a new chapter to this saga by seeking a different remedy.

B. *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012), *rehearing en banc denied* (March 26, 2013), *petition for certiorari filed*, 82 USLW 3011 (June 24, 2013)

1. In this decision, the Court of Appeals for the Second Circuit affirms in part, and remands in part for clarification, injunctions (the "Injunctions") entered by District Court Judge Griesa. Judge Griesa found that Argentina's payment of the Exchange Bonds, while refusing to pay the FAA Bonds, violated the Equal Treatment Provision of the FAA. He ordered Argentina to specifically perform its obligations under the Equal Treatment Provision by requiring that, whenever Argentina pays any amount due under the terms of the Exchange Bonds, it must contemporaneously pay Plaintiffs the same fraction of the amount due to them under the FAA Bonds (the "Ratable Payment").

2. Knowing that Argentina would not comply with the foregoing injunction, Judge Griesa enjoined certain non-sovereigns who were not in a position to ignore a Federal court order with impunity. He ordered that copies of the Injunctions be provided to "all parties involved, directly or indirectly,

in advising upon, preparing, processing, or facilitating any payment on the Exchange Bonds." These parties included Argentina's agent banks located in New York that hold money in trust for the holders of Exchange Bonds and process payments to them under the terms of the relevant indentures. The Injunctions prohibit Argentina's agents from –

"aiding and abetting any violation of this ORDER, including any further violations by [Argentina] of its obligations under [the Equal Treatment Provision], such as any effort to make payments under the terms of the Exchange Bonds without also concurrently or in advance making a ratable payment to [Plaintiffs]."

The Injunctions also prevent Argentina from changing its payment processes to circumvent the Injunctions, and require Argentina to certify its compliance contemporaneously with any payments on the Exchange Bonds.

3. The Second Circuit largely affirmed the District Court, holding:

a) **The Lock Law and Argentina's moratorium on paying the FAA Bonds effectively ranked the payment obligations on the FAA Bonds below the Exchange Bonds in violation of the Equal Treatment Provision. 699 F.3d at 259-60.**

b) **Plaintiffs were not limited to acceleration as a remedy for breach of the Equal Treatment Provision. In the absence of an express provision in the FAA restricting remedies available for a breach of the FAA, "the full panoply of appropriate remedies remains available [citation omitted." *Id.* at 262.**

c) **Monetary damages are an ineffective remedy because "Argentina will simply refuse to pay any judgments." Therefore, the District Court properly ordered specific performance. *Id.***

d) **The Injunctions did not violate the FSIA because they did not deprive Argentina of control over any of its property and, thus, were not attachments of foreign property prohibited by the FSIA:**

> "The Injunctions at issue here are not barred by [28 U.S. C.] § 1609. They do not attach, arrest, or execute upon any property. They direct Argentina to comply with its contractual obligations not to alter the rank of its payment obligations. They affect Argentina's property only incidentally to the extent that the order prohibits Argentina from transferring money to some bondholders and not others. The Injunctions can be complied with without the court's ever exercising dominion over sovereign property. For

example, Argentina can pay all amounts owed to its exchange bondholders provided it does the same for its defaulted bondholders. Or it can decide to make partial payments to its exchange bondholders as long as it pays a proportionate amount to holders of the defaulted bonds. Neither of these options would violate the Injunctions. The Injunctions do not require Argentina to pay any bondholder any amount of money; nor do they limit the other uses to which Argentina may put its fiscal reserves. In other words, the Injunctions do not transfer any dominion or control over sovereign property to the court. Accordingly, the district court's Injunctions does not violate § 1609." *Id. at* 262-63.

The FSIA does not impose limits on the equitable powers of a District Court so long as the exercise of those powers does not conflict with the execution immunities in § 1609. *Id.* at 263.

e) The Second Circuit flatly rejected Argentina's argument that the balance of equities and the public interest tilt in its favor:

"The FAA bondholders contend with good reasons that Argentina's disregard of its legal obligations exceeds any affront to its sovereign powers resulting from the Injunctions. [footnote omitted]" *Id.*

The text of the omitted footnote is particularly interesting:

"Argentina repeatedly expresses its frustration with plaintiffs for refusing to accept the exchange offers. *See* Appellant's Br. 47 ("A holder of defaulted debt cannot *voluntarily* decline to participate in a restructuring and then afterward assert that the creditors who elected to settle their claims are a 'preferred class.'" (emphasis in original). But plaintiffs were completely within their rights to reject the 25-cents-on-the-dollar exchange offers. And because the FAA does not contain a collective action clause, Argentina has no right to force them to accept a restructuring, even one approved by a supermajority." *Id.* at 263 fn. 15.

f) The Second Circuit considered, but rejected, Argentina's contention that the Injunctions would plunge it into a new financial and economic crisis, finding that it had sufficient reserves to pay the FAA Bonds. *Id.* at 263.

g) The United States attempt to support Argentina also failed. The Second Circuit rejected the United States' contention in its amicus brief that the Injunctions enabled "a single creditor to thwart the implementation of an internationally supported restructuring plan." The Second Circuit also said that:

"it is highly unlikely that in the future sovereigns will find them-

selves in Argentina's predicament. Collective action clauses – which effectively eliminate the possibility of 'holdout litigation' – have been included in 99% of the aggregate value of New York-law bonds issued since January 2005, including [the Exchange Bonds]. Only 5 of 211 issuances under New York law during that period did not include collective action clauses, and all of those issuances came from a single nation, Jamaica. [footnote omitted] Moreover, none of the bonds issues by Greece, Portugal, or Spain – nations identified by Argentina as the next in line for restructuring – are governed by New York law." *Id.* at 264.

4. While expressing little sympathy for Argentina's views on fairness – which is not terribly surprising in view of Argentina's history in disregarding prior judgments – the Second Circuit did express concerns about banks who were acting purely as intermediaries in the process of sending money from Argentina to the holders of Exchange Bonds. *Id.* Notably, however, the Second Circuit did not express concerns about the holders of Exchange Bonds caught in the crossfire between the Plaintiffs and Argentina, who might have their payments cut-off it Argentina carried out its threats to continue not to pay the FAA Bonds.

5. The Second Circuit remanded to the District Court to clarify the application of the Injunctions to intermediaries and to clarify the operation of the Ratable Payment provision (*i.e.* whether the entire accelerated principal and interest due on the FAA Bonds must be paid if Argentina makes an interest payment on the Exchange Bonds).

C. Remands to the District Court – 2012 WL 5895786 (S.D.N.Y Nov. 21. 2012 2012) and 2012 WL 5895650 (S.D.N.Y. Nov. 21, 2012)

1. On remand from the Second Circuit, the District Court clarified that the Ratable Payment provision in the Injunctions would require that all amounts due on the FAA Bonds (*i.e.* the entire accelerated principal plus interest) must be paid if an interest payment (*i.e.* with no payment of principal) is fully paid on the Exchange Bonds. 2012 WL 5895786 at 7-16.

2. Judge Griesa acknowledges arguments by Argentina and certain Exchange Bondholders to the effect that it is unjust for them to be receiving only "thirty cents on the dollar" (*i.e.* the reduced principal amount of the Exchange Bonds in relation to the original FAA Bonds for which they were exchanged), while the holders of the FAA Bonds receive full payment of the original principal amount. Judge Griesa was unmoved:

"This is hardly an injustice. The exchange bondholders made the choice not to pursue the route which plaintiffs have pursued. Moreover, it is hardly an injustice to have legal rulings which, at long last, mean that Argentina must pay the debts which it owes. After ten years of litigation this is a just result." *Id.* at 15.

On the other hand, the District Court does not address whether it is unjust to the Exchange Bondholders if they cease to receive payments solely because Argentina chooses to continue not to pay the FAA Bondholder holdouts.

3. The District Court also clarified that, consistent with FRCP 65(d), the Injunctions would bind Argentina, the indenture trustee, the registered owners (*i.e.* Depository Trust Company and Bank of New York Depositary), and the clearing system. While noting that not all of those parties may be agents of Argentina, the Court stated that they "surely" are acting in concert or participation with Argentina. *Id.* at 17. Intermediary banks protected by U.C.C. Article 4A are carved-out of the injunctions.

4. In a remarkably harsh accompanying opinion, Judge Griesa makes clear that the Injunctions should have immediate effect, noting that "[t]he less time Argentina is given to devise means for evasion, the more assurance there is against evasion." 2012 WL 5895650 at 2. While the author hesitates to describe any jurist as "angry," Judge Griesa's opinion leaves no doubt that he is deeply perturbed by Argentina's disregard, indeed open defiance, of orders entered by a Federal court to whose jurisdiction it expressly consented.

D. Status as of the Date of the Outline. Notwithstanding the District Court's determination that the Injunctions should become effective in November 2012, it is the author's understanding that the Injunctions have been stayed by the Second Circuit pending its consideration of the District Court's clarifications of the Injunctions. Accordingly, the Exchange Bonds continue to be paid, and the FAA Bonds have still not been paid. Time will tell whether:

1. There will be a settlement.

2. The Supreme Court will grant certiorari.

3. The Second Circuit will affirm or modify the Ratable Payment provision of the Injunctions.

4. Argentina pays.