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The Vultures v. The Delinquent Sovereign: The Fight over Argentine Bonds in *NML Capital, Ltd. v. Republic of Argentina*

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Holders of sovereign debt face a risk that creditors of private enterprises do not – all creditors run the risk that the debtor may renege and refuse to pay, but the sovereign debtholder runs the additional risk that the defaulting sovereign will close its court system to its creditors as they seek to collect what is indisputably owed. Sovereign default is not a new issue – Philip II repeatedly repudiated Spain's debts in the mid- to late 16th century, and Charles II ruined some of England's most prominent creditors when he instituted a partial debt repudiation in 1672. But in today's globalized and connected world, the stakes are rising. Billions of dollars are at risk in a battle currently being played out in court between the Republic of Argentina and some hedge fund creditors, who are seeking to collect monies owed in connection with Argentina's 2001 default and refusal to pay holders of certain of its bond debt incurred during the 1990's. As the Argentine bond conflict reaches its next stage (it has been going on so long that one hesitates to use the term "culmination"), this case – *NML Capital, Ltd. v. Republic of Argentina*, originally filed in the Southern District of New York, and currently on appeal to the Second Circuit Court of Appeals – provides a useful vehicle to examine the issues surrounding sovereign debt and the remedies which may (or, depending on the Second Circuit's ultimate ruling, may not) be available to a creditor seeking to collect.

First, some background. In 2001, Argentina defaulted on over $100 billion worth of sovereign bonds. It then developed a restructuring program whereby new bonds would be exchanged for the defaulted bonds, at approximately 25 cents on the dollar. A majority of the bondholders took their lumps and accepted the deal, but a minority did not. Rather, they declined to participate in this exchange and continue to hold the defaulted bonds. Some sold their holdings to hedge funds, or, more pejoratively, "vulture" funds, but regardless, since the debt restructurings, Argentina has continuously made all of its payments on the exchange bonds while failing to make any payments to holders of the defaulted bonds. In fact, the Argentine government has taken affirmative measures to prevent payment on the old bonds. Argentina declared a moratorium on its outstanding debt in 2001 and has renewed that moratorium in its budget laws every year since then. Additionally, the Argentine legislature enacted the Lock Law, which precludes officials from paying defaulted bondholders and bars Argentine courts from recognizing plaintiffs' judgments.

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Several lawsuits have been filed in the United States against Argentina by holders of the defaulted bonds. One holdout group of investors, led by NML Capital, Ltd., filed suit in the United States District Court for the Southern District of New York alleging that Argentina breached its promise to pay bondholders after default on its sovereign debt. The plaintiffs specifically objected to Argentina's payment to holders of the new exchange bonds, but not holders of the old bonds, arguing that this constituted a violation of an equal treatment or "pari passu" clause in the bonds.

Judge Thomas P. Griesa of the Southern District granted partial summary judgment to the plaintiffs and permanently enjoined Argentina from making payments on the bonds issued pursuant to the debt restructuring without making comparable payments on the defaulted bonds. Judge Griesa held that the "pari passu" clause in the bonds prohibits Argentina from discriminating against the plaintiff's bonds in favor of the exchange bonds. The pari passu clause in the bonds provides that:

> [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. . . .*

Judge Griesa also concluded that injunctive relief was necessary because of Argentina's "unprecedented, systematic scheme of making payments on other external indebtedness, after repudiating its payment obligations to Plaintiffs" in violation of the pari passu clause. Anticipating that Argentina, as a sovereign, would ignore the injunction, the Southern District held that the injunction applied to third parties, including "all parties involved, directly or indirectly, in advising upon, preparing, processing, or facilitating any payment on the Exchange Bonds." Argentina appealed the District Court's order.

On October 26, 2012, the Second Circuit affirmed the District Court's judgment. In reaching its decision, the Second Circuit examined the bonds' pari passu clause and held that it prohibits Argentina from discriminating against the defaulted bonds in favor of the exchange bonds. The court concluded that the clause protects against different forms of discrimination as follows:

> The first sentence ("[t]he Securities will constitute ... direct, unconditional, unsecured, and unsubordinated obligations....") prohibits Argentina, as bond *issuer,* from formally subordinating the bonds by issuing superior debt. The second sentence ("[t]he payment obligations ... shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness.") prohibits Argentina, as bond *payor,* from paying on other bonds without paying on the FAA Bonds.

The court also specifically acknowledged Argentina's budget laws and Lock Law, and concluded that:

> the combination of Argentina's executive declarations and legislative enactments have ensured that plaintiffs' beneficial interests do *not* remain direct, unconditional, unsecured and unsubordinated obligations of the

> Republic and that any claims that may arise from the Republic's restructured debt *do* have priority in Argentinian courts over claims arising out of the Republic's unstructured debt. Thus we have little difficulty concluding that Argentina breached the *Pari Passu* Clause.

In so holding, the Second Circuit found itself at odds with competing interpretations of pari passu clauses, notably by the English courts, which construe such clauses more narrowly.

The Second Circuit also held that the District Court's injunction did not violate the Foreign Sovereign Immunities Act of 1976 (28 U.S.C. § 1609) (the "FSIA"). The FSIA prohibits a court from legally attaching sovereign property unless it is used in commercial activity. The Second Circuit held that compliance with the injunctions would not deprive Argentina of control over any of its property. The court reasoned that:

> [The injunctions] 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. . . . Argentina can pay all amounts owed to its exchange bondholders provided it does the same for its defaulted bondholders. . . .[But, t]he 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 do not violate § 1609.

While upholding the District Court's pari passu analysis and general injunctive powers, the Second Circuit remanded the case to the District Court to clarify two issues concerning the injunctions: (1) how the injunctions' payment formula was intended to function and (2) how the injunctions applied to third parties, including such parties "involved, directly or indirectly, in advising upon, preparing, processing, or facilitating any payment on the Exchange Bonds" – who, by the express terms of the injunction, were bound by it. Expressing concern about the injunction's application to third parties, specifically intermediary banks, the Second Circuit determined that before it would address whether application of the injunctions to third parties is reasonable, it would require that the District Court "more precisely determine the third parties to which the Injunctions will apply."

Judge Griesa wasted no time in clarifying. On November 21, 2012, he entered an order, holding that the payment formula under the injunctions requires that whatever percentage of the amount due under the exchange bonds is paid, the same percentage due under the defaulted bonds must be paid. Therefore, if Argentina makes a payment of 100% of what is due on the exchange bonds at any given time, then it would be required to pay the entire amount currently due under the defaulted bonds, which was at that time approximately $1.33 billion. Judge Griesa further ordered that the third parties to which the injunctions applied, included, among others, the bond indenture trustee and the clearing systems that transmit money for Argentina. Judge Griesa, however, held that the injunction did not apply to any "third party acting solely in its capacity as an 'intermediary bank' under Article 4A of the U.C.C."

Finally, in light of a planned $3 billion interest payment to exchange bondholders on December 15, 2012 and "continuous declarations by the President of Argentina and cabinet

officers, that Argentina will not honor or carry out the current rulings of the District Court and Court of Appeals," the District Court specifically ordered that, in compliance with the formula under the injunction, Argentina must set aside the entire $1.33 billion it owed to the plaintiffs if and when it made its scheduled $3 billion payment to holders of the new bonds on December 15, 2012.

Judge Griesa's order set off a firestorm, and another round of appeals. The same panel that heard the appeal from Judge Griesa's original order issued a stay of the injunction and established an expedited schedule, which culminated with a hearing on February 27, 2013. The stay ensures that the exchange bondholders will continue to receive payment on their bonds until the Court of Appeals issues its decision. Argentina is scheduled to make a $182 million interest payment to the exchange bondholders on March 31, 2013.

Predictably, Argentina itself appealed, and argued at the hearing on February 27th that it has no intention of obeying the outstanding District Court order and would only accept an alternative payment plan that it prefers regardless of how the court rules. Judge Reena Raggi challenged Argentina's position stating that because, "You would not obey any order but the one you proposed . . . Basically you're dictating what the court would order." Argentina responded by stating that it is trying to persuade the Court to adopt an agreement that is workable for the country and that Argentina's law prohibit payment to the holdouts, but its administration would advocate for a change in the law, if it could make those payments under its preferred terms.

Additional appeals were also filed by affected third parties, including the holders of the exchanged bonds, holders of Euro-denominated (as opposed to US Dollar-denominated) bonds, trustees under the bond indentures, and operators of the payment clearing system. The third parties argued generally that they were not given sufficient opportunity to participate in Judge Griesa's attempts to fashion an appropriate injunctive remedy. In addition, they argued that his injunction would do violence to international payment system, and expose parties such as the clearing system operators to inconsistent obligations, and to liability both for following and not following his order. Also, the exchange bondholders argued, the injunction simply enlists them as hostages to the plaintiffs' attempts to collect on their sovereign debts – when, as we have seen, one risk that sovereign debt holders assume is that the sovereign may renege and close off avenues of collection.

In response to the alternative payment plan proposed by Argentina at the hearing, the Second Circuit ordered that "on or before March 29, 2013, Argentina submit in writing to the court the precise terms of any alternative payment formula and schedule to which it is prepared to commit." The Court requests that Argentina specify:

> (1) how and when it proposes to make current those debt obligations on the original bonds that have gone unpaid over the last 11 years; (2) the rate at which it proposes to repay debt obligations on the original bonds going forward; and (3) what assurances, if any, it can provide that the official government action necessary to implement its proposal will be taken, and the timetable for such action.

While this order may be a preview of things to come, how the Second Circuit will rule is ultimately anybody's guess. In addition to reviewing the payment order, the injunction order will require the Second Circuit to decide questions of the scope of the court's authority

that it did not fully consider earlier. The Second Circuit's earlier opinion demonstrated the judges' hesitation concerning the applicability of the injunctions to third parties. Furthermore, if the Second Circuit is unwilling to apply the injunction to third parties, the court may be required to consider whether Judge Griesa's order is really a legal attempt to attach Argentine property in violation of the FSIA.

The Second Circuit's decision could have large implications in the international payments system and the sovereign debt markets. Judge Griesa's order has been sharply criticized by economists and scholars as an erosion of sovereign immunity that will thwart future sovereign restructurings and encourage vulture funds. Other commentators, however, are doubtful that this case will have such a pervasive impact, noting that Argentina's persistent refusal to pay is anomalous. Unlike Argentina, most countries eventually pay off old bonds, and restructurings tend to go relatively smoothly despite holdouts.

Regardless of its ultimate impact, this case has gained the attention of governments and creditors worldwide. And, given the possible impact upon international finance, and the shakiness of much sovereign debt generally (Greece, anyone?), it is entirely possible that whatever the Second Circuit panel rules will not be the final word on the issues.