New York Law Journal
A NEW YORK LAW JOURNAL SPECIAL SECTION
An ALM Publication
Corporate Restructuring And Bankruptcy
WWW.NYLJ.COM
MONDAY, JUNE 23, 2014

Courtside Seats: **Sovereign Restructurings** In the Supreme Court Arena

SCOTUS rules on Argentina's default.

BY CHRISTOPHER KIPLOK AND DUSTIN SMITH

This past Monday, Argentina's hold-out bondholders posted a hat trick, prevailing in three cases before the Supreme Court. The high court held that, notwithstanding the Foreign Sovereign Immunities Act, bond holders could subpoena financial institutions for information relating to Argentina's assets, and separately denied two petitions for certiorari leaving intact a Second Circuit decision that orders Argentina to pay billions of dollars. These decisions have had an immediate impact on sovereign bond markets and should inform the future of sovereign restructurings.

The cases have their origin in Argentina's 2001 default, which presented creditors with a take-it-or-leave-it proposal: Accept a fraction of the original value of the debt in a restructured bond or get paid nothing at all. Most creditors took Argentina's offer, but a minority refused. After years of litigation, the Second Circuit affirmed a ruling that Argentina cannot pay creditors who accepted the restructured bonds unless it also pays the hold-out bond-holders full value, and the Supreme Court has now declined to review of the Second Circuit's ruling.

Argentina has in the past made clear that it had no intention of paying on the original bonds, but following the Supreme Court's denial, will have to further assess the impact of this position on the nation's access to the international capital markets. Effectively, Argentina will need to decide whether to pay the holdouts—a political quagmire that would potentially encourage additional "me-too" litigation—or carry out its original pledge to force a second default. More broadly, the hold-out bond-holders' litigation with Argentina may serve as a road map to challenge other sovereign restructurings.

Even before the Supreme Court's decision, the Argentina litigation had resulted in changes to the terms of sovereign bonds and renewed discussion about the establishment of multinational approaches to sovereign restructurings. These trends will continue, if not accelerate, as sovereigns and bond market participants digest the impact and significance of the Supreme Court's recent rulings.

CHRISTOPHER KIPLOK *is a partner and* DUSTIN SMITH *is an associate at Hughes Hubbard & Reed. Associates* ERIN DIERS *and* HANNAH MILLER *assisted in the preparation of this article.*

Background: Default and Consequences

The Argentina bond default arose from a series of bonds that were issued beginning in 1994 under a Fiscal Agency Agreement (the FAA Bonds). The heart of the current dispute is based on the interpretation of a pari passu clause contained in the Fiscal Agency Agreement:

> The [FAA Bonds] 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 [FAA Bonds] shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness.

Following a period of severe economic, social, and political tumult in 2001, Argentina defaulted on more than $80 billion of external debt, including the FAA Bonds. After the default, Argentina followed established practice by voluntarily restructuring. Starting in 2005 and again in 2010, Argentina offered the holders of FAA Bonds the opportunity to exchange for a new series of bonds (the Exchange Bonds) at a rate of 25-29 cents on the dollar. As part of the exchange, holders of the FAA Bonds agreed to forgo various rights and remedies previously available to them under the terms of the Fiscal Agency Agreement, and also accepted the collective action clauses contained in the Exchange Bonds

Argentina also clearly stated in the prospectus of the exchange offers that it had no intention of resuming payment on any of the FAA Bonds and that it would oppose any efforts to collect on the defaulted FAA Bonds. In addition, the Argentine legislature passed a law that prohibited the government from conducting any type of settlement with respect to any of the FAA Bonds. Despite the fact that previous sovereign defaults had typically paid 50-60 cents on the dollar, 93 percent of holders of the FAA Bonds accepted the exchange offer.

The remaining 7 percent of holders of the FAA Bonds or "hold-outs," who refused to accept Argentina's exchange offer, comprise a diverse group, including some 60,000 Italian pensioners, where Argentinian Bonds were a popular retail investment. The most active of the holdouts has been a group of distressed investors (the Hold-Out Litigants) that bought many of the un-exchanged FAA Bonds on the secondary market, some as late as 2010. Spurning Argentina's exchange offer and ignoring its repeated forewarnings regarding its intentions regarding the non-payment of the FAA Bonds, the Hold-Out Litigants commenced a worldwide, full-court press of litigation to collect full value.

The Bond Battles

Litigation centered in the Southern District of New York, namely in a series of breach of contract and injunctive actions demanding that Argentina be held to the pari passu clause in the FAA Bonds.[1] First, the district court granted partial summary judgment to the Hold-Out Litigants, holding that Argentina had breached the pari passu clause by effectively subordinating the holders of the FAA Bonds to the holders of the Exchange Bonds.[2] Later, it issued a temporary restraining order enjoining Argentina from making payments on the new Exchange Bonds absent similar payments to holders of the FAA Bonds.[3]

On appeal, the Second Circuit rejected Argentina's arguments that the District Court improperly interpreted the pari passu clause, holding that by passing a moratorium on payments to holders of the FAA Bonds while simultaneously paying the exchange bonds, Argentina had "effectively ranked its payment obligations to the plaintiffs below those of the exchange bondholders" in violation of the pari passu clause.[4] The court also rejected Argentina's argument that the injunctions violated the Foreign Sovereign Immunities Act because the injunctions only directed Argentina to comply with its pre-existing contractual obligations.

On Feb. 18, 2014, Argentina filed a petition for certiorari in the Supreme Court requesting review of the Second Circuit's decision.[5] Argentina put forth two arguments. First, it argued that the interpretation of the pari passu clause in the bonds should be certified to the New York court, asserting that "[i]f New York courts want New York law to upset settled expectations, impede restructurings, and endanger New York's status as the law of choice for sovereign debt, that is their prerogative. But they should not have those consequences thrust upon them."[6] Second, Argentina argued that the injunctions affirmed by the Second Circuit violate sovereign immunity because they "effectively reach into Argentina's borders, coercing it into violating its sovereign debt policies and commandeering billions of dollars of core sovereign assets."[7] Argentina contended that these rulings "flout the Foreign Sovereign Immunities Act … and have upended expectations in the sovereign debt markets."[8]

In response, the Hold-Out Litigants argued that the issues Argentina raised in its petition were not worthy of certiorari because they did not sufficiently implicate federal questions or circuit splits and rely on unfounded speculation about the effects of the injunction. The Supreme Court agreed, declining to hear the case in a one-line opinion issued on June 16, 2014.

Just 45 minutes after denying Argentina's petition for certiorari, the court issued a related opinion holding that the FSIA does not bar the Hold-Out Litigants from subpoenaing financial institutions to determine where Argentina's assets are located and to gain an understanding of Argentina's "financial circulatory system" as part of enforcing their judgments. Argentina had appealed a Second Circuit decision authorizing the Hold-Out Litigants to take such discovery,[9] arguing that financial institutions' compliance with the order would infringe on its sovereign immunity and

violate the FSIA. The court rejected this argument and upheld the Second Circuit's decision on the ground that the FSIA, which was intended to serve as a comprehensive framework for resolving issues pertaining to sovereign immunity, contains no provision "forbidding or limiting discovery in aid of execution of a foreign-sovereign judgment debtor's assets."[10] The court further concluded that concerns about the international relations consequences of its decision, which had been raised by Argentina and echoed in an amicus brief filed by the Solicitor General of the United States,[11] should be directed to Congress, not the courts.[12]

What's Ahead

The litigation and uncertainty of Argentina's default has renewed interest in improving sovereign debt restructuring with a focus on bringing greater predictability, transparency, and efficiency to the global bankruptcy arena. Discussion has coalesced around two broad categories, each with their own benefits and shortcomings: contractual solutions and multilateral approaches.

Contractual solutions aim to improve the terms in sovereign debt contracts to achieve the appropriate balance between facilitating sovereign debt restructuring in case of default and safeguarding creditors' enforcement powers. One proposed solution is the inclusion of collective action clauses in new sovereign bonds—an approach that has seen wide-scale adoption in the wake of Argentina's default (including inclusion in the Exchange Bonds referenced above). Collective action clauses bind all bond-holders to any debt restructuring plan that is agreed upon by a supermajority of bond-holders. This solution facilitates cooperation among bond-holders, is easy to implement in new bonds, and is likely enforceable. Collective action clauses do not, however, completely eliminate the holdout problem because a minority of dissenting bond-holders can still block the restructuring process. For example, in Greece's recent debt crisis, only 17 of the 36 eligible bonds with collective action clauses were successfully restructured due to the influence of a minority of holdout creditors. Collective action clauses are also mostly a prospective solution that may not entirely address issues with existing bonds.

Exit consents, which allow a majority of bond-holders to change the terms of the bonds (e.g., by removing protective covenants or waivers of sovereign immunity) such that the bonds lose value, are another contractual tool that could mitigate hold-out creditor issues as the declining bond value removes incentives to hold out. Although this market-based approach was successfully employed during Ecuador's debt restructuring in 2000, its efficacy is limited by two key factors: (i) the enforceability of exit consents is unclear, bringing further uncertainties and risks of litigation;[13] and (ii) the completion of a voluntary restructuring results in a lower total debt burden, and thus increases the value of the original bonds, negating the effect of any change in terms. Thus, exit consents represent a useful, but imperfect solution to the holdout problem.

The limitation of contractual solutions in solving the issues presented by sovereign debt restructurings has renewed interest in multilateral approaches to sovereign default, including the International Monetary Fund's Sovereign Debt Restructuring Mechanism (SDRM) proposal, which is effectively akin to a voluntary Chapter 11 proceeding for sovereigns. Upon determining that a country's debt is unsustainable, the sovereign would request that the SDRM be activated, which would result in a temporary stay in creditor enforcement actions to allow the debtor to work with the IMF to evaluate the state's capacity to pay, determine a proper haircut, and create a restructuring proposal. The proposed reform would then be voted on by all creditors across different bond issues (unlike collective action clauses, which operate on an issue by issue basis) and, if supported by 75 percent of the outstanding claims on an aggregated basis, the proposal would bind all creditors. Although the IMF's proposal would provide more global consistency, if adopted, the SDRM could adversely affect the market for capital in the developing world, and some worry it could make it too easy for sovereigns to default.

Conclusion

The Supreme Court's decisions will have far-reaching ramifications for future sovereign debt restructurings. By indirectly affirming the Second Circuit's decision, the court added weight to the pari passu clause in debt instruments, opened the door to future challenges by other hold-outs, and may create incentives for creditors to hold out in future sovereign debt restructuring negotiations.

1. See, e.g., Compl. Against the Republic of Argentina, *NML Capital v. Republic of Argentina*, No. 09-CV-07013 (TPG) (S.D.N.Y. Aug. 7, 2009); Compl. Against the Republic of Argentina, *NML Capital v. Republic of Argentina*, No. 09-CV-01707 (TPG) (S.D.N.Y. Feb. 24, 2009); Compl. Against the Republic of Argentina, *NML Capital v. Republic of Argentina*, No. 08-CV-06978 (TPG) (S.D.N.Y. Aug. 5, 2008); Compl. Against the Republic of Argentina, *NML Capital v. Republic of Argentina*, No. 08-CV-03302 (TPG) (S.D.N.Y. April 2, 2008); Compl. Against the Republic of Argentina, *NML Capital v. Republic of Argentina*, No. 07-CV-06563 (TPG) (S.D.N.Y. July 20, 2007).

2. *NML Capital v. Republic of Argentina*, No. 08 Civ. 6978 (TPG), 2011 WL 9522565 (S.D.N.Y. Dec. 7, 2011).

3. *NML Capital v. Republic of Argentina*, No. 08 Civ. 6978 (TPG) (S.D.N.Y. Feb. 23, 2012), ECF No. 371; *NML Capital v. Republic of Argentina*, No. 08 Civ. 6978 (TPG), 2012 WL 5895786 (S.D.N.Y. Nov. 21, 2012).

4. *NML Capital v. Republic of Argentina*, 699 F.3d 246, 259 (2d Cir. 2012).

5. Petition for Writ of Certiorari at ii, *Republic of Argentina v. NML Capital*, No. 13-990 (Feb. 18, 2014).

6. Id. at 22.

7. Id. at 1.

8. Id.

9. *EM Ltd. v. Republic of Argentina*, 695 F.3d 201 (2d Cir. 2012), cert. granted, No. 12-842, 134 S. Ct. 895 (2014).

10. *Republic of Argentina v. NML Capital*, 12-842, 2014 WL 2675854, at *5 (U.S. June 16, 2014).

11. Brief for the United States as Amicus Curiae in Support of Petitioner at 10, *Republic of Argentina v. NML Capital*, No. 12-842 (March 3, 2014).

12. *Republic of Argentina v. NML Capital*, 12-842, 2014 WL 2675854, at *7 (U.S. June 16, 2014).

13. See, e.g., *Federated Strategic Income Fund v. Mechala Grp. Jamaica*, 99 CIV 10517 HB, 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999).