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## Argentina Ordered to Tango With Holdouts: U.S. Court of Appeals holds Argentina breaches *pari passu*

### Speed Read

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In the latest round of litigation arising from the contentious sovereign debt restructuring involving the Republic of Argentina (the **Republic**), the United States Court of Appeals for the Second Circuit (the **Second Circuit**) recently issued a decision in *NML Capital, Ltd. et al., v. The Republic of Argentina* (Docket No.12-105(L) (October 26, 2012). In its decision, the Second Circuit held that as a result of a "*pari passu*" clause in its pre-exchange offer debt, the Republic could not make payments on exchange bonds issued under its sovereign debt restructuring in 2005 and 2010 without making "ratable" payments on the pre-exchange offer debt. While the litigation is sure to continue and the ultimate impact of the Second Circuit decision remains to be seen, the Second Circuit's interpretation of a common contractual provision in sovereign (and other) debt offerings could have broad implications with respect to sovereign debt issuances and restructurings, potentially affecting even multilateral creditors. The case also raises major questions regarding the interpretation of attachments of sovereign property under the Foreign Sovereign Immunities Act.

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# Background

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In 1994, the Republic began issuing bonds (the **FAA Bonds**) pursuant to a Fiscal Agency Agreement, which contains the following *pari passu* clause:

"[t]he [FAA Bonds] will constitute...direct, unconditional, unsecured and unsubordinated obligations of [the Republic] and shall at all times rank *pari passu* and 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...."

In December 2001, the Republic's President declared a "temporary moratorium" on principal and interest payments on more than USD80 billion of its public external debt including the FAA Bonds. In 2005 and 2010, the Republic effected an exchange offer under which it exchanged new, performing bonds (the **Exchange Bonds**) to bondholders who tendered their FAA Bonds. After the two exchange offers, the Republic had restructured more than 91% of the foreign debt on which it had defaulted in 2001. To date, the Republic has kept current on the Exchange Bonds.

To induce its creditors to participate in the exchange offers, the Republic stated in the exchange offer prospectuses for the Exchange Bonds that it does not intend to make any further payments on the FAA Bonds:

"FAA Bonds that are in default and that are not tendered may remain in default indefinitely and, if you elect to litigate, the Republic intends to oppose such attempts to collect on its defaulted debt...the Republic does not expect to resume payments on any FAA Bonds in default that remain outstanding following the expiration of the [exchange offer]...there can be no assurance that you will receive any future payments or be able to collect through litigation in respect of [the FAA Bonds] in default."

Further, in February 2005, the Republic adopted legislation which prohibited it from "conducting any type of in-court, out-of-court or private settlement with respect to its public debt," including the FAA Bonds (the **Lock Law**).

## Proceedings—District Court Decision

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The plaintiffs—holders of the FAA Bonds who did not participate in the exchange offers—sued the Republic in 2009 in the United States District Court for the Southern District of New York (the **District Court**), alleging that the Republic breached the *pari passu* clause by making full

payment on the Exchange Bonds while making no payments on the FAA Bonds. The District Court determined that the Republic violates the *pari passu* clause "whenever it lowers the rank of its payment obligations under [the FAA Bonds] below that of any

other present or future unsecured and unsubordinated External Indebtedness." The court determined that the Republic had lowered the rank of the FAA Bonds in two ways: "[1] when it made payments currently due under the Exchange Bonds, while persisting in its refusal to satisfy its payment obligations currently under [the FAA] Bonds and [2] when it enacted the Lock Law and [suspended the Lock Law in order to issue Exchange Bonds in 2010]." Accordingly, the District Court granted injunctive relief, ordering that whenever the Republic pays any amount due under the terms of the Exchange Bonds, it must concurrently or in advance make a "ratable" payment to the holders of the FAA Bonds. The District Court also ordered

the Republic to provide copies of the injunctions to all parties involved in processing payments on the Exchange Bonds and further ordered that such persons were bound by the terms of the injunctions.

When the Republic subsequently appealed, the District Court stayed the effectiveness of its injunctions pending the Second Circuit's decision. This stay was contingent on the Republic not altering or amending the process or specific transfer mechanism by which it makes payments on the Exchange Bonds.

## Appeal—Second Circuit Decision

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On appeal, the Republic presented a number of arguments against the District Court's decision. The Republic argued that the *pari passu* clause is a boilerplate provision that is universally understood in the sovereign debt context to provide protection only from legal, or formal, subordination. The Second Circuit was "unpersuaded" by the Republic's argument and found that:

"[I]n pairing the two sentences of its [*pari passu* clause], the [Fiscal Agency Agreement] manifested an intention to protect bondholders from more than just formal subordination. The first sentence...prohibits Argentina, as bond issuer, from formally subordinating the bonds by issuing superior debt. The second sentence...prohibits Argentina, as bond payor, from paying on other bonds without paying on the FAA Bonds. Thus, the two sentences of the [*pari passu* clause] protect against different forms of discrimination: the issuance of other superior debt (first sentence) and the giving of priority to other payment obligations (second sentence)."

Further, the Second Circuit found that this interpretation of the *pari passu* clause was particularly applicable in the sovereign debt context, given the unique circumstances surrounding sovereign defaults:

"When sovereigns default they do not enter bankruptcy proceedings where the legal rank of debt determines the order in which creditors will be paid. Instead, sovereigns can choose for themselves the order in which creditors will be paid. In this context, the [*pari passu* clause] prevents Argentina as payor from discriminating against the FAA Bonds in favor of other unsubordinated, foreign bonds."

Based on this interpretation and as a result of the Republic's refusal to make payments on the FAA Bonds, in the press as well as in the exchange offer prospectuses, and the enactment of the Lock Law, the Second Circuit had "little difficulty concluding that Argentina breached the [*pari passu* clause] of the [Fiscal Agency Agreement]." The Republic's overt actions and explicit statements indicating that it would

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not pay the holders of the FAA Bonds appear to have played a significant role in persuading the Second Circuit to endorse the District Court's analysis, as evidenced by the Second Circuit noting that the plaintiffs contended "with good reason[ ] that Argentina's disregard of its legal obligations exceeds any affront to its sovereign powers resulting from the Injunctions."

The Republic advanced various arguments against the injunctions, all of which the Second Circuit found to be unpersuasive. The Second Circuit rejected the Republic's argument that the plaintiffs were solely limited to the contractually agreed upon remedy of acceleration of the FAA Bonds, and holding that in the absence of limiting language in the Fiscal Agency Agreement, the "full panoply of appropriate remedies remains available."

The Republic also argued that the injunctions resulted in an attachment of its property, violating the Foreign Sovereign Immunities Act of 1976 (the **FSIA**). The Second Circuit was equally unimpressed with this argument, finding that the injunctions could be complied with "without the court's ever exercising dominion over sovereign property." In the view of the Second Circuit, the District Court's imposing conditions on the flow of Exchange Bond payments would not violate the FSIA, so long as the Republic still had a

choice over how much, or whether, to pay Exchange bondholders. The Second Circuit also reasoned that the injunctions did not violate the FSIA because Argentina had waived its immunity from jurisdiction of the District Court, and the FSIA imposes no additional limitations on the equitable powers of a District Court that has obtained jurisdiction over a foreign sovereign.

While the Second Circuit agreed with the substance of the District Court's holding, the Second Circuit was concerned with two aspects of the lower court's injunctive order. The Second Circuit found that the "ratable payment" mechanism in the injunctive order was ambiguous and could be read to provide vastly different scales of payment to bondholders. The Second Circuit also expressed concern that the application of the injunctions to "pure intermediaries" involved in Exchange Bond fund transfers could potentially violate the protections afforded to such intermediaries under the Uniform Commercial Code's Article 4-A. Accordingly, the Second Circuit remanded the case to the District Court for proceedings to clarify the operation of the "ratable payment" formula and the injunctions' application to third parties and intermediary banks.

## Implications

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The full implications of the Second Circuit's decision remain to be seen. The impact of the court's interpretation of the *pari passu* clause could have wide ranging effects on public policy with respect to sovereign debt issuances and restructurings, the treatment of multilateral creditors and the interpretation of the FSIA. It is uncertain whether the Second Circuit expects its interpretation of the *pari passu* clause to apply to all sovereign issuers who choose to restructure existing debt, or whether the court's holding should be limited to recalcitrant sovereigns who stridently

refuse to make payments on pre-exchange debt, including through legislation. While many recent sovereign debt issuances include collective action clauses designed to address holdouts in the restructuring process, we note that *pari passu* clauses such as the one at the heart of this litigation already exist in a wide variety of outstanding debt issuances, from sovereign to corporate.

There are implications for multilateral institutions as well. The Second Circuit declined to address whether "policies favoring preferential payments to multilateral

organizations like the IMF would breach *pari passu* clauses like the one at issue here." While the Second Circuit did not directly address the issue, the reasoning behind the decision could be extended to multilateral involvement in debt restructurings, with negative implications for those multilateral institutions that attempt to take priority over existing debt. In such circumstances, multilateral institutions should consider whether they may eventually find themselves in the same position as holders of the Exchange Bonds. As the U.S. Government's amicus brief noted, the District Court's interpretation of the *pari*

*passu* clause could prevent sovereign debtors from servicing debts to international financial institutions, with wide ranging implications for foreign relations.

The Second Circuit's ruling with respect to the FSIA could also have a broad impact with respect to foreign relations. It will likely be difficult for sovereigns to agree that the requirement that the Republic make ratable payments to the FAA Bonds should payment be made to the Exchange Bonds is not "exercising dominion over sovereign property" in violation of the FSIA.

## What's Next?

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On remand, the District Court will be required to address the mathematical operation of the payment formula and how the injunctions should apply to third party intermediaries. A schedule for briefing on these points has already been established by the District Court, with the District Court intending to finalize the injunctions by the

end of November (before the next payment on the Exchange Bonds). In the meantime, the Republic has indicated it intends to file a petition for *en banc* review of the Second Circuit's decision, with the specter of an appeal to the Supreme Court looming.

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# Key Contacts

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