TO RANK *PARI PASSU* OR NOT TO RANK *PARI PASSU*: THAT IS THE QUESTION IN SOVEREIGN BONDS AFTER THE LATEST EPISODE OF THE ARGENTINE SAGA

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"Justice is the crowning glory of the virtues."

CICERO (106-43 BC)

"And maybe people who might consider lending money to the Republic of Argentina in the future might realize what difficulties they're going to run into if they are naïve enough to rely on what the Republic offers."

HON. THOMAS P. GRIESA[1]

I. INTRODUCTION

IT can be said that the *pari passu* clause mistakenly migrated from secured private lending to unsecured sovereign lending.[2] Once rooted in unsecured sovereign lending instruments, it faced certain provisions similar to those in Spain or the Philippines, which allowed a creditor to better position itself *vis-á-vis* other creditors,[3] and become a

1. Hon. Thomas P. Griesa, New York District Judge, on a hearing on January 12, 2006 in *EM Ltd. v. Republic of Argentina*, 03 CV 2S07 (TPG) (unreported hearing); *NML Capital Ltd. v. Republic of Argentina*, 03 CV 8845 (TPG) (unreported hearing) & 05 CV 2434 (TPG).
2. *See* Lee Buchheit & Jeremiah Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 913 (2004).
3. Articles 913(4) of the Spanish Commercial Code and 1924(3)(a) of the Spanish Civil Code refer to the preference of creditors whose credit is instrumented by means of a public deed (notarized by a Notary Public). As noted by Wood, these types of credits have a preference over those—although of the same type—not instrumented in a public deed. See Philip Wood, International Loans, Bonds and Securities Regulation: Law and Practice of International Finance, 41 (Sweet & Maxwell 1995).

   The Spanish Insolvency Law 22/2003 of July 9, 2003 amended section 1924 of the Spanish Civil Code. Although under section 91of the new insolvency law a whole new ranking of preferences, not including credits instrumented through public deeds, is included—subsection (3)(a) of section 1924 of the Spanish Civil Code has not been amended. Therefore, in the event of sovereign issuances—not subject to insolvency laws—the un-amended section 1924(3)(a) of the Civil Code still applies. The Philippines—strongly influenced by the Spanish Civil Code—have a norm similar to the ones of Spain. Article 2244(14) of the Philippines Civil Code grants priority to those credits that appear in a public instrument or a final judgment. These two cases are the main reason of the emergence of the pari passu clause in

'must have' provision in this type of debt instrument. Then, *pari passu* clauses stayed in unsecured debt instruments due to the fear of the earmarking revenues, or the risk of the sovereign, preferring a group of creditors over another.[4] These two fears were tackled by an expanded negative pledge clause and the *Libra Bank Limited v. Banco Nacional de Costa Rica S.A.*[5] and *Allied Bank International v. Banco Credito Agrícola de Cartago*[6] cases. Therefore, if a proper due diligence was conducted; there was no need to have a *pari passu* clause unless there was an exceptional circumstance, like the ones of Spain or the Philippines. Unfortunately, a misguided interpretation of the *pari passu* clause in the *Elliot Associates LP v. Banco de la Nación y República del Perú* case[7] opened the door to litigation on incorrect grounds, which mainly focused on payment interpretation or broad interpretation of the *pari passu* clause.[8] It was an 'aberration', but one that caused furor.[9]

In *Elliot*, there was no breach of the *pari passu* clause, but rather a wrong understanding of its meaning. In the case of Argentina, the whole story could be different since it can be correctly interpreted as a breach of the *pari passu* clause in its ranking or narrow form. This article will focus on the recent Argentine sovereign debt restructuring exercise that might re-ignite litigation based on the *pari passu* clause. It is important to stress the difference between the two scenarios, i.e. litigation pre and post Argentina's sovereign debt exchange offer. Pre-Argentina's litigation was based on an incorrect interpretation of the *pari passu* clause made by a Belgium court. Post-Argentina's potential litigation could be based on an

sovereign debt bond instruments. Buchheit and Pam also consider Argentina a country that forced the inclusion of the pari passu clause since 1972, when they re-enacted a practice dating back to 1862 where foreign creditors were subordinated to local creditors in the bankruptcy of an Argentine debtor. *See* Buchheit, *supra*, note 2 (quoting EMILIO J. CARDENAS, INTERNATIONAL LENDING: SUBORDINATION OF FOREIGN CLAIMS UNDER ARGENTINE BANKRUPTCY LAW, IN DEFAULT AND RESCHEDULING 63 (David Suratgar eds., 1984).

4. *See* WILLIAM TUDOR JOHN, SOVEREIGN RISK AND IMMUNITY UNDER ENGLISH LAW AND PRACTICE IN INTERNATIONAL FINANCIAL LAW 95-96 (Robert S. Rendell ed., 2nd ed. 1983).
5. *See Libra Bank Ltd. v. Banco Nacional de Costa Rica S.A.*, 570 F. Supp. 870 (S.D.N.Y. 1983).
6. *Allied Bank Int'l v. Banco Credito Agrícola de Cartago,* 566 F. Supp. 1440 (S.D.N.Y. 1983), 757 F. 2d 516 (2d Cir.), 473 US 934 (1985).
7. Elliott Assoc. v. Republic of Peru, 948 F. Supp 1203 (S.D.N.Y 1996); Elliott Assoc. v. Republic of Peru, 961 F. Supp 83 (S.D.N.Y 1997); Elliott Assoc. v. Republic of Peru, 12 F. Supp 2d 328 (S.D.N.Y 1998); Elliott Assoc. v. Republic of Peru, 194 F.3d 363 (2d Cir. 1999); Elliott Assoc. v. Republic of Peru, 194 F.D.R. 116 (S.D.N.Y. 2000); *see also* Elliot Assocs, L.P., General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000), (not reported, on file with the author).
8. *See* Buchheit, *supra* note 2; Philip Wood, *Pari Passu Clauses-What Do They Mean?*, 18 Butterworths J. of Int'l Banking & Fin. L. 10 (2003); *Pari Passu Clauses: Analysis of the Role, Use and Meaning of Pari Passu Clauses in Sovereign Debt Obligations as a Matter of English Law* (Fin. Markets Law Comm't Issue 79, 2005), *available at* www.fmlc.org [hereinafter Fin. Market Law Comm't Issue 79].
9. *See* Rodrigo Olivares-Caminal, *Understanding the Pari Passu Clause in Sovereign Debt Instruments: A Complex Quest*, INT'L LAW. (forthcoming Fall 2009).

actual breach of the *pari passu* clause. If this is the case, if there was an actual breach of the *pari passu* clause, a new wake of litigation can be triggered. This article is the second part of a study on the *pari passu* clause in sovereign debt instruments. Part I was published by The International Lawyer in the Fall Issue 2009, under the title *Understanding the Pari Passu Clause in Sovereign Debt Instruments. A Complex Quest*.[10]

II. ARGENTINA: A NEW CHAPTER IN THE *PARI PASSU* SAGA?

On December 23, 2001, in an ill-famed assembly, the Argentine Congress gave the President of the nation a standing ovation when he announced a moratorium on the Argentine sovereign debt. The message given to the international investors who had decided to invest in Argentine debt securities, however, was far from respectful to the rule of law. A 38.4 percent of the defaulted debt was held by individuals and corporations domiciled in Argentina, while the rest was scattered throughout the world.[11]

To overcome the default status, Presidential Decree 1735/04[12] ordered the restructuring of two Argentine securities, first, debt instrumented in the form of bonds, and second, payment of which had been deferred under the provisions of Article 59 of Argentine Law No. 25,827.[13] The restructuring was carried out through a domestic and international exchange of sovereign debt bonds for new securities. The domestic exchange offer comprised three phases: 1) local debt,[14] 2) debt of political subdivisions, and 3) and the international exchange offer.

On January 13, 2005,—after thirty-six months in default—Argentina released, by means of Resolution 20/05 (issued by the Ministry of Economy), the final offering prospectus and supplement, including the terms

10. It is recommended that the two parts should be read as a whole, they each can be accessed through Westlaw and Lexis Nexis.
11. *See* Dr. Guillermo Nielsen, Speech of Secretary of Finance: Argentina's Restructuring Guidelines (Sept. 22 2003), *available at* http://www.argentinedebtinfo.gov.ar/ing_presen.htm.
12. Presidential Decree 1725/04 (Dec. 9, 2004). A Spanish version is available at http://www.infoleg.gov.ar/infolegInternet/anexos/100000-104999/101861/norma.htm.
13. Law No. 25,829 (passed Nov. 26, 2003). A Spanish version is available at http://www.infoleg.gov.ar/infolegInternet/anexos/90000-94999/91229/texact.htm.
14. It was referred to as 'local debt' because either the creditors were: (1) Entities registered in Argentina or Argentine residents; or (2) that the place of payment was located within the Argentine territory. According to § 58 of Argentine Law No. 24,156, public debt can be classified into internal and external debt as well as direct and indirect debt. Internal debt is the debt owed to persons or legal entities that reside or are registered within the territory of the Republic of Argentina and that its payment can be claimed within the same territory. On the other hand, external debt is the debt owed to another State, international institutions or persons or legal entities that do not reside or are not registered within the territory of the Republic of Argentina and that its payment can be claimed throughout the territory of the Republic of Argentina. Direct public debt is the debt incurred directly by the National Government as principal debtor. Indirect public debt is any debt incurred by any person or entity—be it private or public-different from the National Government but that the latter guarantees.

and conditions of the exchange offer. The exchange was implemented between January 14 and February 25, 2005, and obtained an acceptance of 76.17 percent of the total eligible amount (approximately US$ 62,300 million). Argentina—inexplicably, in comparison to other default experiences in the 1990s[15]—stayed in a default situation for over three years before concluding its exchange offer.

The Republic of Argentina exchanged 152 series of bonds, governed by the laws of eight different countries, for an aggregate eligible amount (representing par value plus accrued and unpaid interest) of approximately US$ 81,800 million,[16] into a total of eleven series of Par Bonds, Quasi Par Bonds and Discount Bonds and five series of GDP Linked Units.[17]

This sovereign default has certain particular characteristics. For one, it is the biggest default ever, in terms of monetary amounts and number of creditors (over 700,000). Moreover, it has other complex characteristics: (1) eight applicable laws; (2) the geographical distribution of creditors; (3) the longest time elapsed before curing the default (thirty-seven months); and, (4) a reduction in the acceptance percentage threshold (from over ninety percent to 76.17%).

With regards to the first issue, Argentina defaulted on approximately 81,800 million US$ of debt obligations, while the second biggest bond defaulter was Russia in 1998 with 31.6 billion US$. Argentina's default is 66.7% greater. Also, more than 700,000 creditors atomized within the international financial community.[18] The creditor's base in sovereign debt episodes has been enlarged as the result of the Brady Plan, which replaced sovereign syndicated loans with bonds. While syndicated loans were held by a small group of banks, the bonds ended up being sold in the secondary market to thousands of creditors. Due to the recurrent need for external financing, Argentina's push for the atomization of creditors that resulted from a bond issuance, was taken to an extreme. According to official data, institutional investors held fifty-six percent of the eligible restructured debt, while the remaining forty-four percent is held

15. The longest default duration during the 1990s was the 1998 Russian default which lasted eighteen months, followed by the 1999 Ecuadorian default which lasted ten months. Ukraine and Pakistan's default lasted three months and one month, respectively.

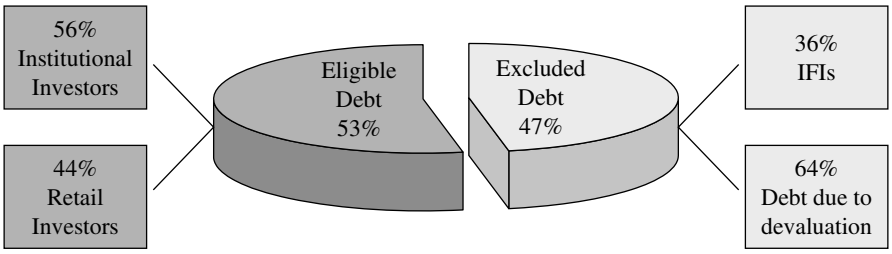
16. A complete list of the eligible debt is included as Annex A of Argentina's Prospectus Supplement to the Prospectus dated December 27, 2004 of the Republic of Argentina exchange offer to exchange eligible securities for Par Bonds due 2038, Discount Bonds due December 2033, Quasi-Par Bonds due December 2045, and GDP-linked Securities that expire in December 2035 [hereinafter Prospectus Supplement] Article 60 of Argentine Law No. 25,827, however, states which debt instruments are excluded from the restructuring.

17. Argentine Ministry of Economy, Oferta de Canje–Anuncio Final 5 (Mar. 18, 2005).

18. Andrew Balls & Adam Thomson, *Argentina Defiant Towards Private Creditors*, FIN. TIMES, Mar. 11, 2004, *available at* http://search.ft.com/ftArticle?queryText=Argentina+defiant+towards+private+creditors&id=040311000937&ct=0.

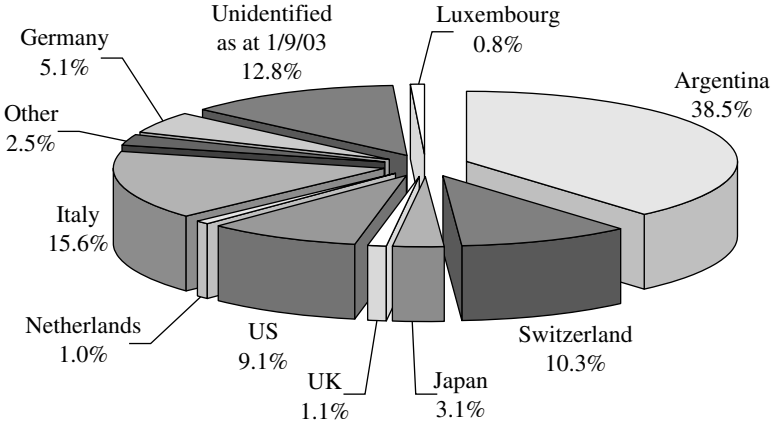
by retail investors.[19]

ELIGIBLE DEBT: ALL DEBT ISSUED PRIOR TO THE CUT-OFF DATE (31/12/2001)



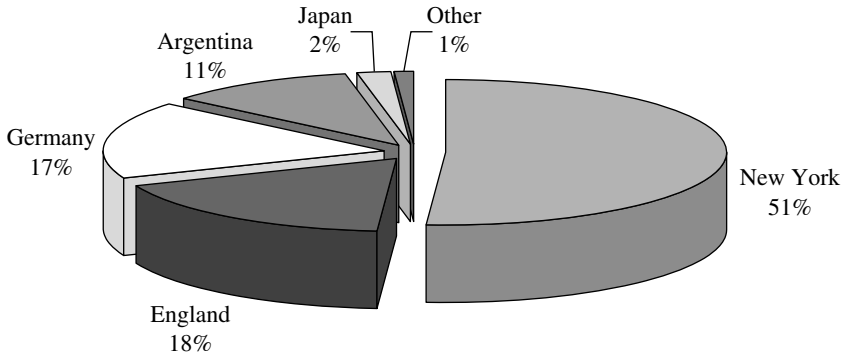
Furthermore, there were 152 different series of bonds, with eight different governing laws: fifty-one percent of Argentine debt was subject to New York law, eighteen percent to English Law, seventeen percent to German law, eleven percent to Argentine law, two percent to Japanese law, and the remaining one percent to Italian, Spanish, and Swiss law.[20] The jurisdictions under which the debt instruments have been issued provide a good indication of which is the target market. This leads to the issue of geographical distribution of creditors. Almost forty percent of Argentine defaulted debt is held by Argentinean bondholders, and the remaining sixty percent is distributed in at least eight countries: Germany, Italy, Japan, Luxembourg, Netherlands, Switzerland, the United Kingdom, and the United States.[21]

BANKHOLDERS' GEOGRAPHICAL DISTRIBUTION



19. *See* Nielsen, *supra* note 11.
20. *Id*.
21. According to the data provided by the Argentine Ministry of Economy there is 12.8 percent that has not been geographically identified, and 2.5 percent that corresponds to other countries not listed above.

GOVERNING LAW



Whether Argentina's situation, vis-à-vis holdouts, would have been different had the exit consents[22] mechanism been used is a conjectural matter, which only time will solve. The only thing that might be asserted in the field of probabilities is that if the exit consents had been resorted to, the number of holdouts would have been lower, as well as the number of potential disputes. Possible collection attempts by the holdouts will remain latent until Argentina reaches a satisfactory agreement with each of them.

Besides, there are many elements that might be taken into account in connection with the level of acceptance, irrespective of the use—or not—of the exit consents mechanism. Among other arguments, Argentina was the country that obtained the largest haircut, since, if a comparison is made between the seventy-five percent obtained in terms of par value (sixty-six percent net present value) against Ecuador's forty percent or Russia's thirty-six percent (Ukraine, Pakistan and Uruguay made no haircut). Argentina's haircut was much larger, and this could have discouraged participation by certain creditors, who opted to recover their claims through court actions. In addition, Argentina's debt restructuring was the most complex one in terms of number of series (152) and creditors (more than 700,000) scattered through various countries. It might be also argued that the absence of dialogue with creditors may have affected the level of participation.[23] Apart from the absence of dialogue with creditors, the international markets will not easily forget the Executive Branch's hostile attitude, even if it is used as a bargaining tool.

Another issue that is noteworthy, in light of the attachments decreed in Brussels against the financial agents of the Republic of Peru and Nicaragua, is that in all the new bonds subject to New York and English law, the

22. Exit consent is a mechanism used in sovereign bond restructuring to enhance creditor participation. It was used for the first time in Ecuador's debt restructuring in 2000. A further analysis on the extent and use of exit consent is provided infra.
23. *See* Arturo C. Porzecanski, *Rogue Creditors to Rogue Debtors: Implications of Argentina's Default,* 6 CHI. J. INT'L L. 311 (2005); *see also Argentina's Foolish Debt Gamble*, FIN. TIMES, Jan. 14, 2005, *available at* http://www.ft.com/cms/.

fiscal agent has been replaced with a trustee.[24] The difference lies in the fact that while a fiscal agent is an agent of the debtor (the sovereign), the trustee acts on behalf of the creditors. Regretfully, in the case of Argentina, this does not apply to those bonds that are subject to the Argentine law. The only logical explanation is that although certain Argentine courts have already ruled against the laws that declared an economic emergency and which are the legal basis of the whole crisis legislation, among which the rules that led to the restructuring are included, it is highly unlikely that the Argentine Supreme Court would rule against such laws if a suit is brought in Argentina.

Despite the tools available to restructure sovereign debt (exit consents, term enhancers, etc.), the Argentine Government was unable to limit or reduce to a minimum the threat posed by the holdouts. The greater the amount of holdout creditors, the greater there is a possibility of being threatened in a court. Besides, additional debt was issued locally while in default, thus further extending the cure of the distressed situation. These factors impacted on the risk rating of future issues and also affect the debt rating assigned to private corporations.

As of December 31, 2001, Argentina's stock of debt was US$ 144.4 billion, while as of December 31, 2004, it was US$ 191.2 billion. Argentina experienced an increase of US$ 46.8 billion, equivalent to a variation of almost twenty-five percent in only three years.[25] This increase in the stock of debt occurred during a period of time where no principal or interest payments were made on the defaulted debt. Not only did Argentina fail to save the sums that were not repaid under the external debt, but it also increased its indebtedness, the costs that a debt exchange implies, and the amounts claimed in foreign courts (which are continuously updated).[26] In sum, as it has been stated, '[t]he 'Lavagna' debt has featured the greatest historical increase within the shortest period of time.[27]

24. Rodrigo Olivares-Caminal, *Sovereign Bonds: A Critical Analysis of Argentina's Bond Exchange Offer*, 10 J. BANKING REG. 28 (2008).

25. *See* Adrián Ventura, *Encrucijada: por hechos más o menos actuales como el corralito, la pesificación y el default, y por otros de larga data, en la Argentina hay miles de millones en litigios*, LA NACIÓN, June 20, 2004, at 1, *available at* http://www.lanacion.com.ar/nota.asp?nota_id=611711.

26. According to an unofficial report there are: (1) 327,250 suits in Argentine courts claiming the total sum of US$ 7.3 billion. Also, there are 89,086 claims of uncertain amount that should be added; (2) sixty-one claims in arbitral tribunals (CIADI and others) filed by privatized companies in the amount of 14.2 billion US$; (3) claims over 1 billion US$ filed in the courts of New York and Europe (Frankfort, Roma, Milan, Florence and Vicenza); and, (4) claims filed by the argentine banks due to their mismatches that resulted from the mandatory conversion of the deposits into ARP and the result of judicial claims, which approximately total 7 billion US$ approximately. *See* Ignacio Molinari, *La Deuda 'Lavagna'*, EL DIAL, Aug. 2004, *available at* http://www.eldial.com/suplementos/economico/doctrina/ec040820-d.asp .

27. 'Lavagana' refers to Rodolfo Lavagana who acted as Argentine Minister of Economy between April 16, 2002 and November 28, 2005, i.e. soon after the default up to some months after the restructuring was settled. *See id*.

Apart from the outcome of the restructuring and the various opinions that might have risen, there are other facts that should not be left unmentioned. Although in the recent debt exchange Argentina has offered bonds with forty-two years tenure, it should be borne in mind that none of the major governments in Latin America has fully repaid a thirty-year bond.[28]

Yet another significant aspect is that the debt/GDP ratio as of December 2001, was 62.4%, while after the exchange offer it stands at eighty-eight percent,[29] despite the seventy-five percent haircut on the par value of the bonds. The debt/GDP ratio is used as an indicator of debt sustainability. An extensive study by Reinhart, Rogoff, and Savastano concluded that the debt/GDP ratio for Argentina—to be sustainable—should be fifteen percent.[30]

In connection with the foregoing, the same study has concluded that default may become a way of living: The more it happens, the more it is probable that it will happen again, since the debtor has less to lose and is prone to defaulting again.[31] Argentina defaulted in 1982 during the Malvinas/Falklands affair, in 1990 when they achieved a Brady deal in 1992, and again in 2001-2002.[32] Since Argentina does not have a reputation of a country that serves its debt and abides by the rule of law, someone may wonder if it will default (or restructure) again in 2012, when its ten year cycle becomes due again. On the contrary, as to its reputation, it has been said that "Argentina emerged as the single most resistant debtor in international finance."[33] One cannot ignore that Argentina has been blessed during the last five years due to the liquidity abundance as result of the favorable global economic situation and the ever high price of commodities.

28. *See A Victory by Default*, THE ECONOMIST, Mar. 3, 2005.
29. The information used to determine the debt/GDP ratio of 2001 was: (1) The external debt stock of Argentina expressed in US dollars; and (2) the GDP in constant US$, both values provided by the IMF. The same formula used to calculate the 2001 debt/GDP ratio has been used to determine the debt/GDP ratio of 2004, but based on the IMF forecasts for 2004 adjusted by the information on the post-exchange debt stock provided by the Argentine Ministry of Economy (as reported Argentine Ministry of Economy, Oferta de Canje–Anuncio Final (Mar. 18, 2005)). It is worth noticing that based only on the figures provided by the Argentine Ministry of Economy in the previously referred brief, the debt/GDP ratio for 2001 and 2004 would be 113 percent and 72 percent, respectively. The difference between the figures quoted in this work and these of the Ministry of Economy result from the fact that the Argentine Ministry of Economy used a GDP estimated at the 2004 real exchange rate while the figures of this work were calculated based on the GDP in constant US dollars provided by the IMF.
30. Carmen M. Reinhart Et Al., *Debt Intolerance, Brookings Papers on Economic Activity*, Aug. 2003, at 10.
31. *Id*.
32. It is worth mentioning that besides the Argentine default of 2001-2002, in early June 2001, Argentina performed the so–called megacanje, a voluntarily mega bond exchange offer to extend bond maturities and gain breathing space. Argentina swapped existing bonds with an original value of 29.5 billion US$ for 31.04 billion US$ of new instruments.
33. ERNEST J. OLIVERI, LATIN AMERICAN DEBT AND THE POLITICS OF INTERNATIONAL FINANCE, 164 (1992).

The role of the Argentine government should be to warrant the well-being of society without compromising the property of future generations and honoring its goodwill. These are two aspects that seem to have been overlooked since December 23, 2001, to date, by the Argentine Government. Holdouts are individual or institutional investors (e.g. pension funds or vulture funds) exercising a right and seeking justice as result of a breach to their contractual agreement. It is not that they should not be compassionate with the debtor, but what happens when the debtor keeps asking for forgiveness and promises that it will not happen again? The answer is similar to Aesop's fable of *The Shepherd Boy and the Wolf*, that nobody would believe in Argentina.

After providing a critical analysis of Argentina's most recent sovereign debt restructuring episode, the next section will analyze the developments that took place during Argentina's default and its restructuring exercise vis-á-vis the *pari passu* clause.

III. *MACROTECNIC INTERNATIONAL CORPORATION AND EM LTD. V. ARGENTINA*

The first issue to consider is the *Macrotecnic International Corporation and EM Ltd. v. Argentina* cases. On January 15, 2004, upon the filing of the memorandums of law of Argentina and the plaintiffs, the US Statement of Interest,[34] and the amicus curiae briefs filed by the Federal Reserve Bank of New York[35] and the New York Clearing House,[36] a New York court was asked to consider whether the *pari passu* covenant in Argentina's bonds could not be used by judgment creditors as a legal basis

34. In the US statement of interests, it was stressed that "[a] novel reading of the pari passu clause, however, that would prohibit sovereign debtors from making payments to third party creditors or require sovereign debtors to make simultaneous, ratable payments to all creditors would undermine [a] well understood established framework . . ." (*see* Statement of Interest of the United States at 14; Macrotecnic Int'l Corp. v. Republic of Argentina, No. 02 CV 5932 (TPG) (S.D.N.Y. Jan. 12, 2004); EM Ltd. v. Republic of Argentina, No. 03 CV 2507 (TPG) (S.D.N.Y. Jan. 12, 2004).

35. The Federal Reserve Bank of New York urged the court to interpret the *pari passu* clause narrowly "so as to discourage the terrorism of payments and settlement systems, and to encourage parties to compromise in sovereign debt restructurings" (*see* Memorandum of Law of Amicus Curiae Federal Reserve Bank of New York in Support of Defendant's Motion for an Order Pursuant to CPLR § 5240 Denying Plaintiffs the Use of Injunctive Relief to Prevent Payments to Other Creditors at 13, Macrotecnic Int'l Corp. v. Republic of Argentina, No. 02 CV 5932 (TPG) (S.D.N.Y. Jan. 12, 2004); EM Ltd. v. Republic of Argentina, No. 03 CV 2507 (TPG) (S.D.N.Y. Jan. 12, 2004).

36. The New York Clearing House Association L.L.C. stated that its members "have long understood [the *pari passu*] clause . . .to prohibit a debtor from creating unsecured debt that ranks senior in legal rights of payment to the payment obligations the debtor has." *See* Memorandum of Amicus Curiae the New York Clearing House Association L.L.C. in Support of Motion Pursuant to CPLR § 5240 to Preclude Plaintiff Judgment Creditors from Interfering with Payments to Other Creditors at page 2, Macrotecnic Int'l Corp. v. Republic of Argentina, No. 02 CV 5932 (TPG) (S.D.N.Y. Jan. 12, 2004); EM Ltd. v. Republic of Argentina, No. 03 CV 2507 (TPG) (S.D.N.Y. Jan. 12, 2004).

to interfere with Argentina's payment of its other indebtedness. The question one should ask is: should the Argentine Government continue paying international organizations such as the IMF or other non-defaulted unsecured creditors as the holders of domestic bonds? Although the court did not resolve the *pari passu* issue, the plaintiffs had to sign an agreement giving the court thirty days notice before filing papers intended to stop such payments under the *pari passu* clause.[37] Although the core issue was not resolved, an order was issued by the court ordering Argentina to divulge information about government property outside the country that is used for commercial purposes: A discovery measure.

IV. THE ARGENTINE PROSPECTUS USED FOR THE EXCHANGE OFFER

The Argentine Prospectus Supplement used for the exchange offer included certain language that could be considered a common practice. Nevertheless, if this language is analyzed under the subsequent developments, it turns relevant. This section analyses such language. In its Prospectus Supplement, Argentina stressed its intentions vis-á-vis the holdouts under the heading 'Risk Factor'. Argentina expressly stated that:

> Eligible Securities that are not tendered may remain in default indefinitely. Eligible Securities not exchanged pursuant to the Offer will remain outstanding. Argentina has announced that it has no intention of resuming payments on any Eligible Securities that remain outstanding following the expiration of the Offer. Consequently, if you elect not to tender your Eligible Securities pursuant to the Offer there can be no assurance that you will receive any future payments in respect of your Eligible Securities. If the Offer is completed, the trading market for any series of Eligible Securities not exchanged may become illiquid, which may adversely affect the market value of any Eligible Securities of such series. . . .[38]

Although this can be understood as a common practice to discourage creditors from holding-out, special attention should be made to the wording. All the risks (the 'threats' posed by the sovereign) are not actual and are only potential. The language has been carefully chosen: 'May', 'no intention', 'can', etc. . . The only time that 'will' has been used, no clarification was made as to when: (1) 'Will remain outstanding' during the exchange offer? (2) 'Will remain outstanding' until the settlement date? (3) 'Will remain outstanding' during the first year after the settlement? (4) 'Will remain outstanding' until enough pressure from international organizations build up? Or, (5) 'will remain outstanding' forever? Since it is not clear what 'will' means, there is only a potential risk. Creditors

37. Transcript of hearing before Judge Thomas P. Griesa at 9; *Applestein v. Republic of Argentina* Province of Buenos Aires (S.D.N.Y. 15 January 2004) (No. 02 CV-1773 (TPG)).
38. Prospectus Supplement, *supra* note 16.

holding the bonds, however, would not care much because they already have a right to claim as result of the contractual breach resulting from the default. In any event, it will be reduced to a financial analysis as to what is the best option for its interests (including recovery chances). This does not pose any actual risk to trigger a breach of the *pari passu* clause included in the so-called old bonds.

Argentina was trying to reassure the participating creditors that the offer was the only possible choice and that there would not be a second opportunity. Therefore, Argentina decided to also strengthen this position by including a 'most favored' creditor clause. The analysis of this clause follows.

V. THE 'MOST FAVORED CREDITOR CLAUSE'

In anticipation of the potential problems that might arise with holdouts, the 'most favored creditor's clause' is a clause that was included in the Argentine Prospectus Supplement used for the exchange offer to settle the Argentine exchange offer.[39] This clause governs the treatment to be afforded to those creditors who accepted the debt exchange offer, in the event that after the exchange the Argentine Government decided to make a new exchange offer or otherwise improve the conditions offered to holdouts, in order to induce them to consent to and participate in the debt exchange. The aim of this clause is to prevent those who decided to participate in the exchange offer from suffering a loss in case of a subsequent improvement of the terms of the offer.

Since prior to the exchange offer there has been a big speculation around the amount of creditors that would finally participate, the Argentine Government decided to include this clause to prevent creditors from not taking part in the exchange offer due to the possibility of making an offer at a later stage to the holdout creditors with better terms and conditions. The Argentine Government expressly stated on several occasions (and particularly at the road show presentation of January 12, 2005[40]), that it would not make a new offer after launching the debt exchange and that the 'most favored creditor clause' reaffirms the unique nature of the offer. This clause will be applicable until December 31, 2014.[41]

The clause states that (emphasis added):[42]

1. Argentina reserves the right—in its absolute discretion—to: (a) purchase; (b) exchange; (c) offer to purchase or exchange; or, (d) enter into a *settlement* in respect of any eligible securities that are not exchanged pursuant to the exchange offer. And—to the extent

39. *See* Prospectus Supplement *supra* note 16, at S-18, S-60.
40. Exchange Offer Presentation Performed by the Argentine Ministry of Economy on 12 January 2005, *available at* http://www.argentinedebtinfo.gov.ar/documentos/argentina_roadshow_presentation_enero_12_2005_v_final_web.pdf [hereinafter Exchange].
41. *See* Prospectus Supplement, *supra* note 16.
42. *See id*.

permitted by applicable law—to purchase or offer to purchase eligible securities in the open market, in privately negotiated transactions or otherwise.

Provided that:

2. Any such purchase, exchange, offer to purchase or exchange or *settlement* will be made in accordance with applicable law.
3. The terms of any such purchases, exchanges, offers or *settlements* could differ from the terms of the exchange offer.

Therefore,

4. Holders of the new bonds will be entitled to participate in any voluntary purchase, exchange, offer to purchase or exchange extended to or agreed with holders of eligible securities not exchanged pursuant to the exchange offer [*NOTE: the word settlement does not appear in this paragraph*].

The Argentine Government—on many occasions but particularly in the exchange offer presentation,[43] expressly argued that there will not be any further exchange offers and that the 'most favored creditor clause' reinforces this. The rights granted to holders of the new bonds extends until December 31, 2014.[44]

It is worth noticing that the clause refers to the possibility of 'settlements' with holders of the eligible securities (see 1, 2, and 3 above). But, curiously, in the last part of the clause where the rights of the creditors who decided to participate in the exchange offer are reinforced (see 4 above), the word '*settlement*' is not included. This implies that it can be understood, unless it is challenged and resolved by a court on the contrary, that the Argentine Government can reach a settlement with a holdout creditor without triggering the applicability of this clause.

The Argentine Government enacted Presidential Decree 1735/04 on December 9, 2004. This decree included in its Annex I an English version of the latest draft of the Prospectus Supplement before being submitted to the US Securities and Exchange Commission. In the last part of the 'most favored creditor clause,' as of that date, holders of the new securities were entitled to "participate in any voluntary purchase, exchange, offer to purchase or exchange or settlement extended to or agreed with holders of [e]ligible securities not exchanged," pursuant to the exchange offer. As of that date, the word 'settlement' was still included in the draft.[45]

Therefore, the clause that was originally included to protect creditors' rights produced exactly the contrary. These type of amendments to a draft prospectus supplement, i.e. the elimination of a word in complex documents drafted by various highly qualified professionals and reviewed

43. Exchange, *supra* note 40.
44. *See* Prospectus Supplement, *supra* note 16.
45. Global Position on Argentina Bondholders, Position Paper: Most Favorite Creditor Clause (Jan. 31, 2005), http://www.tfargentina.it/download/GCAB%20Most%20Favored%20Creditor%20Clause%20paper%201-31-05.pdf.

by several experts, cannot be considered as an involuntarily omission. Due to a last-minute amendment, the clause that was intended to provide increased assurances to creditors finally produced exactly the contrary.

VI. LAW 26,017 ('PADLOCK LAW') AND THE IMF

In view of the potential ineffectiveness of the 'most favored creditor clause', the Argentine Government passed Law No. 26,017,[46] also known as the Padlock Law, which prevents the Argentine Executive Branch from reopening the exchange process or making any kind of court, out-of-court or private transaction, or settlement with respect to the bonds subject to the exchange offer. This law intended to send a message to the creditors during the exchange process, the moment where the law was passed and promulgated, which assured creditors that their rights would not be breached. In other words, those that decide not to participate in the exchange offer (i.e. holdouts) would not have a second chance.

Although the passage of Law 26,017 solves the difficulty raised by the language of the 'most favored creditors' clause' included in the Prospectus Supplement, it prevents the Argentine Government from meeting the International Monetary Fund's (IMF) requirement of providing a solu-

46. Padlock Law. Law No. 26017, Feb. 10, 2005 (promulgated on Feb. 10, 2005). The following is a free translation:

ARTICLE 1—Notwithstanding the validity of other applicable norms, the sovereign bonds eligible for the exchange offer established by Decree No. 1735 dated 9 December 2004, that were not tendered according to what has been established in said decree will be subject to the provisions of this law.

ARTICLE 2—The national Executive Branch shall not re-open the exchange offer established under Decree 1735/04, in relation to the bonds referred in article 1 hereof.

ARTICLE 3—The National Government is prohibited from performing any type of judicial, extra-judicial or private transaction in relation to the bonds referred in article 1 of this law.

ARTICLE 4—The National Executive Branch shall, according to the terms of the issuance of the bonds and the applicable norms in each jurisdiction, pass the required administrative acts and adopt the required measures to de-list from all stock exchanges—local or foreign—the bonds mentioned in the previous article."

ARTICLE 5—The National Executive Branch will send a report to the honorable National Congress reflecting the effects of the exchange offer and the new levels of debt and its decrease.

ARTICLE 6—Notwithstanding what has previously been established, eligible sovereign bonds as established by Decree No. 1735/04 that were deposited under any cause or title under the name of any instance, type or jurisdiction's court, whose legally owners had not adhered to the exchange offer referred by the previously mentioned decree nor had expressly stated their will of not taking part in the exchange offer on the judicial file, before the closing date according to what has been established in the timetable of the referred decree No. 1735/04, will be replaced as a matter of law by "STEP UP PAR BONDS 2038 of the ARGENTINE REPUBLIC" according to the conditions set forth for the allocation, settlement and issuance of said bonds by means of Decree No. 1735/04 and its complementary norms.

The Ministry of Economy and Production has the right to pass the required complementary norms to implement the exchange ordered by this article.

ARTICLE 7—Decree No. 1733 dated 9 December 2004 is hereby ratified.

ARTICLE 8—Inform the National Executive Branch.

tion to those creditors who decided not to participate in the exchange offer. Failing to provide a solution to those creditors who did not participate in the exchange would breach the principle of 'good faith' established by the IMF in its lending into arrears policy.[47] This resulted in a formal action of what was originally materializing the language of the Prospectus Supplement that expressly provided that "[e]ligible [s]ecurities that are not tendered may remain in default indefinitely,"[48] and by Argentina's written refusal to reopen the exchange to those creditors who originally decided not to participate.

On December 15, 2005, Argentina announced that it will pre-pay the outstanding balance of payments with the IMF in the amount of 9.9 billion US$. The payment was performed on January 3, 2006[49], using free central bank reserves in order to—as stated by the Argentine President[50]—to gain 'autonomy' from IMF policies.

Decree 1599/05, amended law 23,928, established what are considered free central bank reserves, and Decree 1601/05 instructed the Argentine Central Bank to cancel the outstanding debts with the IMF. Decree 1599/05 was ratified by the Argentine Congress by means of Law 26,076. Central Bank reserves (gold and foreign currency) should support 100% of the monetary base.[51] Those reserves in excess of the monetary base and that are not used for support purposes are considered free reserves.[52] Central bank reserves and free reserves cannot be frozen or attached, and if they produce a neutral effect, they can be used to pay international financial institutions.[53]

Using reserves of the Central Bank to pay the IMF is a common practice since sovereigns usually use their central banks (or the body performing those functions) as its financial agent.[54] The Central Bank borrows

47. In this regard *see* International Monetary Fund, Executive Board Meeting 89/61, 24 May 1989; International Monetary Fund, Fund Policy on Sovereign Arrears to Private Creditors (SM/98/8); International Monetary Fund, The Acting Chairman's Summing Up on Fund Policy on Arrears to Private Creditors–Further Considerations (EBM 99/64, 14 June 1999); International Monetary Fund, Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion, prepared by the International Capital Markets, Policy Development and Review and Legal Departments (in consultation with the other Departments) and approved by Gerd Häusler, Timothy Geithner, and François Gianviti, 30 July 2002.
48. *See* Prospectus Supplement, *supra* note 16, at S-29.
49. *See*, Central Bank of the Republic of Argentina, Central Bank discusses the cancellation of Argentina's debt maintained with the International Monetary Fund (IMF), Communication No. 48,447 (Mar. 1, 2006).
50. Speech of Nestor Kirchner, President of the Republic of Argentina; *see also*, *Histórico: El País saldará en un sólo pago la deuda con el FMI*, La Nación *available at* http://www.lanacion.com.ar/politica/nota.asp?nota_id=765314.
51. Law 23,928, art. 4.
52. *Id*. art. 5.
53. *Id*. art. 6.
54. Section G-1 of the By-laws Rules and Regulations of the IMF reads as follows: "G-1. Each member shall designate a fiscal agency in accordance with Article V, Section 1, and may change the agency after notifying the Fund," *available at* IMF, http://www.imf.org/external/pubs/ft/bl/rr07.htm.

from the IMF and in turn transfers the borrowings to the sovereign. In return it receives an obligation for repayment from the sovereign.[55] There was an unsuccessful attempt from NML Ltd.[56] and EM Capital Ltd.[57] to freeze Argentina's central bank reserves in New York arguing that the enacted decrees and Law 26,076 have changed the nature of funds deposited in the United States from central bank reserves to funds of the sovereign. This argument is not entirely accurate because as previously noted, it is a central bank function protected by §1611(b)(1) of the US Foreign State Immunity Act of 1976 to perform payments to international financial institutions. Also, the Argentine norms were only amended to permit a greater portion of reserves to be used for repayments.

The pre-payment implied the following accounting steps: (1) money was deducted from the assets column in the balance sheet of the Central Bank of Argentina (that was the reason Law 23,928 was amended by means of Decree 1599/05 and ratified by Law 26,076); and (2) the same amount was cancelled from the liabilities column (the Central Bank was instructed to pay the IMF according to Resolution 49/05 of the Ministry of Economy and Decree 1601/05). Nevertheless, this over simplistic exercise also implied that a credit in the same amount was written in the asset column, i.e., the debt 'owed' by the government to the central bank resulting from the payment which was performed on its behalf and was instrumented by debt instruments due in 2016 (Resolution 49/05 of the Ministry of Economy and Joint Resolution Nos. 1/2006 and 4/2006 of the Finance and Treasury Secretariats).[58]

In theory this was not much more than just an accounting exercise and since a payment was done, less money was available. Due to the financial situation of the government, however, it required a new issuance of debt at a higher interest rate. It is important to stress that the monies owed to the IMF were not due, and therefore there was no reason for a pre-payment other than a politically motivated decision. In order to materialize this payment, Argentina issued debt locally that was allocated to certain

55. In the case of Argentina, the obligation for repayment was instrumented by means of a debt title issued as per Joint Resolution Nos. 1/2006 and 4/2006 of the Finance and Treasury Secretariats.
56. NML Capital Ltd. v. Republic of Argentina, 03 CV 8845 (TPG) (unreported hearing) & 05 CV 2434 (TPG).
57. Hon. Thomas P. Griesa, New York District Judge, on a hearing on Jan 12, 2006, *supra* note 1.
58. For an explanation on the credits and debits, see Argentina's Central Bank's balance sheet for the fiscal year ended on December 31, 2006, particularly section 2.1. of the Notes to the Financial Statements, *available at* http://www.bcra.gov.ar/.

governmental institutions[59] and Venezuela.[60] Therefore, 'less money, less debt' translates into 'less money, less debt, and higher debt service costs.' Due to political reasons, Argentina decided to change one creditor for others at a higher interest rate.[61]

It can be argued if it was or was not a correct decision, but it is arguable and it can be analyzed from different angles (political, financial, etc.). Nevertheless, besides the recount of facts, it is important to analyze whether the Padlock Law implied a violation of the *pari passu* clause.

VII. DID THE PADLOCK LAW VIOLATE THE PARI PASSU CLAUSE INCLUDED IN ARGENTINE BOND INSTRUMENTS?

This section will analyze the potential vulnerability of Argentina to a *pari passu* attack, i.e., a creditor initiating a claim against Argentina on the basis of the *pari passu* clause included in the debt instruments. For this purpose, it is necessary to analyze first why Argentina did not resort to the market-oriented established techniques to enhance participation of creditors by means of discouraging holdout creditors. These are: (1) the use of CACs; and (2) exit consent or exit amendments. Subsequently, the analysis of the particular case of Argentina and the risks that it faces vis-á-vis the enforcement of the *pari passu* clause will be analyzed.

A. Collective Action Clauses

Collective action clauses (CAC)'s are clauses that if included in the prospectuses of the bonds, the interaction of the bondholders is required. There are four different types of CACs. These are:[62] (1) collective representation clauses;[63] (2) majority action clauses; (3) sharing clauses;[64] and (4) acceleration clauses.[65] Within CACs majority action clauses are the

59. These governmental institutions include the National Pension Fund (ANSeS), the Argentine Tax Authority (AFIP), a trust created by the government for the strengthening of troubled companies (Fondo Fiduciario para la Reconstrucción de Empresas), a trust created by the government for the development of transport infrastructure (Fondo Fiduciario de Infraestructura de Transporte), Home Office (Ministerio del Interior), National Institute of Agricultural Technology (INTA). *See* Joint Resolution Nos. 11/2005 and 41/2005 of the Finance and Treasury Secretariats. *See also El Tesoro coloca nueva deuda,* La Nación, Jan. 4, 2006, *available at* http://www.lanacion.com.ar/economia/nota.asp?nota_id=769696; *El Gobierno emite títulos por $3.147 millones para financiarse*', Infobae, Dec. 31, 2005.
60. *See* Larry Rohter, *As Argentina's Debt Dwindles, President's Power Steadily Grows*, N.Y. Times, Jan. 3, 2006.
61. Although some governmental bodies received a low interest rate, for example, Venezuela was paid an interest rate amounting to the double of what was being paid to the IMF. *See id.* .
62. *See* Liz Dixon & David Wall, *Collective Action Problems and Collective Action Clauses*, Fin. Stability Rev. (2000).
63. The collective representation clause is intended to coordinate representation of the bondholders as a group.
64. This type of clauses establish that any proceed obtained from the debtor would be shared among all the creditors on a pro-rata basis.
65. This is a common type of clause included in U.S. bonds issued through a Fiscal Agent agreement that requires a 25 % of the outstanding bonds to accelerate unmatured principal upon an event of default.

type of clauses that have been strongly pursued by the official sector and many academics, and they were effectively incorporated in bond issuances. Due to the scope of this article, special focus will be provided to these clauses.

Majority action clauses enable the amendment of any of the terms and conditions of the bonds, including the payment terms, if the required majority therein established is obtained. The origin of these clauses under English law can be traced back to 1879, as the result that debtors facing liquidity problems were faced with one sole alternative: Liquidation.[66] In the United States, the use of majority action clauses in sovereign bonds was not widely accepted as in English law due to Section 316(b) of the Trust Indenture Act of 1939 (TIA)[67] that expressly states that the amount due under a publicly-issued corporate bond cannot be affected without the consent of each bondholder (i.e. 100%) and provides that a deferment of a maximum of three years is acceptable upon the approval of seventy-five percent of the bondholders.[68] As noted by Buchheit and Gulati, "although the TIA is not applicable to foreign sovereign bonds issued in the US, the amendment clauses included in such sovereign bonds have almost invariably followed the TIA-driven approach to amendments."[69]

In 2003, with the bond issuances of Mexico[70] and Brazil,[71] CACs were broadly incorporated in sovereign bonds issued under New York law. The path set forth by Mexico and Brazil was rapidly followed by Belize, Egypt, Korea, Lebanon, Qatar, South Africa, and many more thereafter. Before 2003, only bonds subject to English law and a group of less promi-

66. *See* SIR FRANCIS B. PALMER, COMPANY PRECEDENTS FOR USE IN RELATION TO COMPANIES SUBJECT TO THE COMPANIES ACTS 1862 TO 1900: WITH COPIOUS NOTES, STEVENS AND SONS (9th ed. 1903).
67. Trust Indenture Act § 316(b), 15 U.S.C. § 77aaa.
68. Section 316(b) of the TIA reads as follows: "Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder, except as to a postponement of an interest payment consented [by holders of not less than seventy-five per centum in principal amount of the indenture securities], and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien". According to section 316(a), paragraph 2, the postponement of any interest payment could not exceed three years from its due date.
69. Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L. J. 4, 1329 (2002) (on file with the author).
70. United Mexican States, $1,000,000,000 6.625% Global Notes due 2015. *See* Prospectus and Prospectus Supplement (Dec. 4, 2002), SEC Registrations Registration No. 333-101643 and 333-83312 (on file with the author).
71. Federative Republic of Brazil, 10 % Global Bonds due 2007, US$ 1,000,000,000, Prospectus, Feb. 12 2003 and Prospectus Supplement dated 29 April 2003), SEC File No. 333-81140 (on file with the author).

nent issuers in their New York law bonds[72] included CACs allowing the amendment of any term, even the payment terms.

CACs have been in English bonds since the 19th century and only recently in bonds subject to New York law. As previously mentioned this was due to Section 316(b) of the TIA. But what made everyone change their minds? There are various factors that drove to this change in boilerplate contracts. Gelpern and Gulati have recorded them in a comprehensive study.[73] The most salient of these reasons are: (1) because they were the lesser of two evils, being the other the Sovereign Debt Restructuring Mechanism proposed by the IMF[74]; and (2) arm twisting U.S. pressure[75] and/or quid pro quo.[76] In addition, it should also be borne in mind that sovereign bond restructuring was becoming a recurrent issue (Russia—1988, Ukraine—1999, Pakistan—1999, Ecuador—2000, and Argentina—2001-2002); key and reputable players were involved in their endorse-

72. These less prominent issuers include Bulgaria, Egypt, Kazakhstan, Lebanon and Qatar. *See* Anna Gelpern & Mitu Gulati, Public Symbol in *Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627, 1641 (2006).

73. Gelpern &Gulati, *supra* note 72.

74. Blustein argues that "[t]he idea of introducing the clauses had been proposed years earlier and had stalled amid opposition from Wall Street; only when the more radical SDRM reared its head did private financiers come around to backing CACs as the lesser evil." *See* Paul Blustein, *And the Money Kept Rolling In (and Out): Wall Street, the IMF and the Bankrupting of Argentina*, PUBLIC AFFAIRS 230 (2005)). Also, an article published by The Economist expressly asked the question of why there has been a wide adoption of CACs by borrowers. In its own words, it was stated "[w]hy have borrowers changed their minds? One reason is fear. Once the SDRM was mooted—a far worse idea than collective-action clauses in borrowers' eyes—the thought that it might be put into effect focused minds on the search for a market-based alternative." *See Dealing With Default*, ECONOMIST, May 8, 2003, at 63.

75. Not everything is a bed of roses in the international financial markets, as it was reported that the inclusion of CACs in Chilean bonds ". . . means that the Chilean authorities are bowing to pressure from the US Treasury, which has been pushing for all emerging-market issuers to include such clauses." Nick Ashwell, *Chile Places First Sovereign Bond with Collective Action Clause*, WORLD MARKETS RESEARCH CENTRE (Global Insight), Jan. 27, 2004. In the same line of thinking, Skeel Jr. stated that "[w]ith some serious arm-twisting by the US Treasury, Mexico broke the logjam in 2003. . ." *See* David Skeel Jr., *Why Contracts are Saving Sovereign Bankruptcy*, INT'L FIN. L. REV. 24-32 (2006); and, Blustein noted that "[e]ventually, with U.S. clout working its usual magic, CACs won endorsement from the G-7 and the IMF's policysetting committee of member-country finance ministers, and several emerging-market countries began issuing bonds with the clauses in 2003." *See*Blustein, *supra* note 74. Also, in this regard, the Economist stated that "American pressure also played a part: the Treasury made no secret of its preference for the new clauses." *See Dealing With Default*, *supra* note 74. Authers in the FT stated that CACs resulted "as an alternative to the IMF's bankruptcy proposal and that it would help shield investors from the risk of IMF intervention." *See* John Authers, *Mexico Sends Signal with Bond Clauses*, FIN. TIMES, Feb. 26, 2003, at 31.

76. Authers, quoting an interview to Walter Molano (from BCP Securities) stated that "Mexico is building up a war-chest of favours to the US Treasury, which it's going to claim. . .in the future. . .[t]his deal is going to be an orchestrated success, because there's an enormous amount of political reputation riding on this, specifically for the US Treasury." *See* Authers, *supra* note 75, at 31.

ment (G-10 drafting group,[77] law firms dealing with sovereign issuances,[78] and big institutional investors[79]); the possibility of fearing rogue debtors (Argentina and its defiant position against creditors[80]) and to a certain extent—as in the case of the *pari passu* clause—by inadvertence.[81]

Additionally, also in 2003, Uruguay re-profiled all of its outstanding sovereign debt and included CACs in the terms of the new bonds. This means that future debt restructuring can be performed in an orderly manner by just tendering the votes of the bondholders without having to resort to an exchange offer. Moreover, this would eliminate the problem of the holdouts since an agreeing majority would bind all the dissenting creditors.[82]

So far, the required threshold to amend the terms of the bonds containing CACs has been seventy-five percent in aggregate principal amount of the outstanding bonds (e.g. Egypt, Lebanon, Mexico, Qatar, Uruguay, etc). Brazil has been the only case where an eighty-five percent rate has been required.

Uruguay is a unique case since by way of an aggregation mechanism, amendments to any terms (including payment terms) can be incorporated to one or more series of bonds simultaneously. In order to approve an amendment applicable to two or more series, a double majority is required: (1) eighty percent of the aggregate principal amount of all affected series; and (2) 66 percent of each specific series.[83]

77. In 2002 the Ministers and Governors of the G10 group of countries established the G10 Working Group on Contractual Clauses under the chairmanship of Randy Quarles (US Treasury) to consider how sovereign debt contracts could be modified in order to make the resolution of sovereign debt crises more orderly.
78. Mainly (in alphabetical order): Arnold & Porter, Cleary Gottlieb Steen & Hamilton, and Sullivan & Cromwell.
79. An article published by the Wall Street Journal places Mohamed El-Erian, head of emerging markets at Pimco, as the leading player managing the biggest fund investing in emerging market sovereign debt. The article claims that Mr. El-Erian has been able to negotiate directly with countries issuing the bonds, rather than accepting pre-determined terms. The article quotes a banker familiar with the Mexican bond deal who said that "was really driven by Pimco's need for investment rather than by Mexico's need for financing." *See* Craig Karmin, *Power Player: A Fund Chief Flexes Muscles When Countries Need a Loan—-Pimco's El-Erian Sets Terms Usually Shaped by Bankers In Emerging-Market Debt—-Some Critics Call Him a Bully*, WALL ST. J., Oct. 26, 2004, at A1.
80. *See* Arturo C. Porzecanski, *supra* note 23. *See also Argentina's Foolish Debt Gamble*, *supra* note 23.
81. As noted by Gelpern and Gulati, a London office of a New York Law Firm was doing New York law deals, by cutting and pasting contract terms from an English law form. *See* Anna Gelpern & Mitu Gulati, *supra* note 72.
82. Rodrigo Olivares Caminal, *Reestructuración de Deuda Pública: Diferentes Mecanismos*, LA LEY (Argentina), Nov. 2003, at 97.
83. Uruguay's modifications clause reads as follows: ". . . Any modification, amendment, supplement or waiver to the terms and conditions of the debt securities of a single series, or to the indenture insofar as it affects the debt securities of a single series, may generally be made, and future compliance therewith may be waived, with the consent of Uruguay and the holders of not less than 66-2/3% in aggregate principal amount of the debt securities of such series at the time outstanding. However, special requirements apply with respect to any modification, amendment, supplement or waiver that would [modify the 'reserve matters' (i.e. change

Unfortunately, the Argentine bonds subject to New York law did not include CACs, and in the case of those subject to English law, the Argentine government feared the possibility of having to face a blocking holding, which is what happened in the case of the use of exit consent.[84] The analysis on the use of exit consent as a restructuring technique and the threat of blocking holdings is explained below.

B. Exit Consent

Exit consent is the technique by which holders of bonds in default which have accepted an exchange offer—at the moment of accepting said offer—grant their consent to amend certain terms of the bonds to be restructured. By using the exit consent technique, the exchange offer is conditioned to a minimum threshold of creditors' acceptance and the amendments to the terms are performed once the required majority has been obtained.

By means of these amendments, the defaulted bonds subject to the exchange offer are less attractive (in legal and financial terms), forcing a greater number of bondholders to accept the exchange offer. Otherwise, if bondholders do not accept the exchange offer, they will be holding an impaired bond lacking some of the original contractual enhancements.

Due to the extensive time elapsed since the announcement of the moratorium and the implementation of the exchange offer, Argentina could not make an exchange proposal by availing itself of the use of exit con-

the date of payment; reduce the principal amount or redemption price or premium; reduce the portion of the principal amount which is payable in the event of an acceleration; reduce the interest rate; change the currency or place of payment of any amount payable; change the obligation to pay additional amounts; change the definition of 'outstanding' or the percentage of votes required for the taking of any action; authorize the trustee to exchange or substitute all the debt securities or convert all the debt securities into other obligations; or change the pari passu ranking, governing law, submission to jurisdiction or waiver of immunities provisions)] . . . Any reserve matter modification to the terms and conditions of the debt securities of a single series, or to the indenture insofar as it affects the debt securities of a single series, may generally be made, and future compliance therewith may be waived, with the consent of Uruguay and the holders of not less than seventy-five percent in aggregate principal amount of the debt securities of such series at the time outstanding. If Uruguay proposes any reserve matter modification to the terms and conditions of the debt securities of two or more series, or to the indenture insofar as it affects the debt securities of two or more series, in either case as such modifications may be made, and future compliance therewith may be waived, for any affected series if made with the consent of Uruguay and: the holders of not less than eighty-five percent in aggregate principal amount of the outstanding debt securities of all series that would be affected by that reserve matter modification (taken in aggregate), and the holders of not less than 66-2/3% in aggregate principal amount of the outstanding debt securities of that series (taken individually)." *See* Prospectus Supplement to Prospectus Dated April 10, 2003, Reflecting the additional filings made with the SEC pursuant to Rule 424(b)(3) on April 15, 2003, April 25, 2003 and May 9, 2003, *available at* http://www.bcu.gub.uy/autoriza/sgoioi/reperfilamiento/ultimosup.pdf, pages S-39 to S-40.

84. For purposes of this article, Argentine bonds subject to German law and Japanese law are comparable to bonds issued under New York law and English law, respectively.

sents, as was done by Ecuador and Uruguay (and to a certain extent Ukraine).[85] The reason for this was that the delay in the implementation of the debt restructuring by Argentina resulted in the alignment of those bondholders who opposed the restructuring and held sufficient majority for preventing an amendment to the terms and conditions of the defaulted bonds ('blocking holdings'). This did not permit Argentina to make an exchange offer using a combined mechanism with the use of exit consents. Hence, Argentina lost the chance to use the mechanism that would have lessened the holdout problem discouraging the non-accepting creditors without affecting the payment terms, provided that the required percentage to amend the terms and conditions of the prospectus was obtained.

For this reason, on November 15, 2004, Argentina filed a Memorandum of Law with the District Court of the Southern District of New York in opposition to plaintiffs' motion for a preliminary injunction.[86] Argentina confirmed that it would not use exit consents in their final exchange offer launched on January 12, 2005.[87] The relevant part of Memorandum states:

> Plaintiffs' ex parte motion for a preliminary injunction is based on their incorrect speculation that the Republic's as-yet unannounced Exchange Offer will contain 'exit consents' that will somehow inflict irreparable harm upon them. Of course had plaintiffs simply waited until the November 29 launch of the Exchange Offer (which is not scheduled to close until 2005) they would have learned what the Republic has publicly confirmed: the Exchange Offer will not include exit consents.[88]

Had it resorted to the exit consents mechanism, Argentina would have been able to increase the number of participants by amending the exchange offer terms (without changing the payment conditions); therefore dispiriting those who had decided not to participate.[89] Ecuador and Uruguay made use of the exit consents and obtained ninety-seven percent and ninety-three percent participation, respectively. Ukraine, which used a mechanism similar to the exit consents that included the grant of irrevo-

85. The leading case on exit consents is *Katz v. Oak Industry Inc.*, 508 A.2d 873 (Del. Ch. 1986), where the validity and legitimacy of using this technique was recognized in a case of commercial bonds. Subsequently, New York courts have recognized its validity in many cases, such as *Unigard Security Insurance Co., Inc. v. North River Insurance Co.*, 4 F.3d 1049 (2d Cir. 1993). In *Unigard*, the court recognized the argument that the use of exit consents is legitimate because the drafters of the terms and conditions of the bonds issued after the Oak Industries case did not make any amendments to the contractual terms of the bonds to limit the use of exit consents. Countries which have used exit consents in cases of sovereign debt restructuring include Ecuador and Uruguay.

86. *See* Memorandum of Law in Opposition to Plaintiffs' Motion for a Preliminary Injunction, Seijas v. Republic of Argentina, No. 1:04-CV-0400 (S.D.N.Y. Nov. 15, 2004).

87. *Id.*

88. *Id.*

89. *Id.*

cable mandates, obtained ninety-five percent of participation. As mentioned above, Argentina obtained a 76.17 percent acceptance level. Although this participation percentage might lead to infer that it would have obtained the 66 2/3 percent required to amend the terms of the bonds under New York law, this does not necessarily imply that upon disaggregating each of the series it might have also achieved the required percentage.

The use of exit consents and CACs have curtailed to certain extent the power of holdouts in a sovereign debt restructuring. In addition, the use of a trust structures, particularly with the features of Grenada's issuance in 2005 and subject to New York law, does not provide individual enforcement rights for bondholders (i.e. all enforcement rights vest only with the trustee and may be exercised solely for the ratable benefit of all bondholders only if a demand is made by holders of at least twenty-five percent of the outstanding amount of the bonds).[90]

VIII. THE PARI PASSU CLAUSE AFTER THE ARGENTINA SAGA: THE MYTH OF SISYPHUS

Without having the possibility of using CACs or exit consents, Argentina had run out of options to enhance creditor participation. The only option left was to creatively use the terms of the bonds. Therefore, upon a desperate situation, Argentina resorted to a desperate measure. By passing Law 26,017, Argentina was trying to reassure participating creditors that the offer was the only possible choice. However, something that seemed so simple (like passing a law to gain credibility and leave in the past the blunder with the wording of the 'most favored creditor' clause of the prospectus) might be the center stage for a potential *pari passu* attack.

Argentina made it clear that there was no intention of resuming any payments to the holdouts, which can be implied from both the formal prohibition of any further transactions included in the Padlock Law and the wording under the 'Risk Factors' section in the Prospectus Supplement. The combination of these two factors, however, could result in a formal subordination of the bonds held by those that decided not to participate in the exchange offer.

Subordination, as defined in the Black's Law Dictionary, is "the act or an instance of moving something (such as the right or claim) to a lower rank, class or position."[91] As noted in *In re Enron Corp.*, the "[s]ubordination of a claim alters the otherwise applicable priority of that claim within a creditor class; a subordinated claim receives a distribution only after the claims of other creditors have been satisfied."[92] Subordination is a common feature in debt financing. As noted by Schnebel, "when

90. *See* Offering Memorandum from Grenada to exchange its 9.375 percent Notes due 2012 for US$ and XCD bonds due 2025, Enforcement 64 (on file with the author).
91. BLACK'S LAW DICTIONARY 1440 (7th ed. 1999).
92. *In re* Enron Corp., 333 B.R. 205, 233 (Bankr. S.D.N.Y. 2005).

there are two are more creditors of a common borrower, conflicts will invariably exist."[93] This is the reason why inter-creditor agreements, i.e. agreements to rule the relationship among creditors of a same owner, have developed and, in certain complex financial structures, become very common (e.g. when mezzanine debt is used).

In the process of providing various financing sources, the debtor and its creditors will try to set an order of priority in the event that something goes wrong. This gave rise to various types of corporate debt financing with different priority ranks based on the risk/return trade-off,[94] e.g. (in order of priority) senior debt, second lien, mezzanine finance, high yield debt, payment-in-kind notes, shareholders loans, and equity.

The priority of claims becomes relevant upon a state of insolvency (in the case of corporations) or default (in the case of sovereigns).[95] In the case of insolvency, section 726 of the US Bankruptcy Code[96] describes the priority of claims, with the exception of allowed secured claims that are satisfied by or from the collateral.[97]

The exception to the general system of priorities is contemplated under Section 510 of the US Bankruptcy Code,[98] which provides for the subordination of claims on a contractual or consensual basis (Section 510(a)), or an equitable basis (Section 510(c)). In the same line, the Uniform Commercial Code[99] authorizes subordination under Section 1-209 and in regard to the priority of liens, under Section 9-316. The UCC allows for the alteration of statutory priorities by means of an agreement. Besides these two types of subordination (contractual and equitable), there is also a third type, i.e. legal subordination. Priorities and equitable and legal subordinations are limited by law, while a contractual subordination is the right of a creditor to subordinate the totality or a part of its credit to other creditors.

The contractual or consensual subordination is the most common type of subordination and requires the consent of the creditor that will subordinate itself to other creditors. Usually, the consent is granted by means of a written agreement between the debtor and the creditor. In certain cases, it could also be performed by means of an agreement between creditors. A contractual subordination is governed by general con-

93. Debra J. Schnebel, *Intercreditor and Subordination Agreements - A Practical Guide*, 118 BANKING L.J. 48, 48 (2001).
94. The risk/return trade-off translates in 'lower the risk, lower the return' and 'higher the risk, higher the return'.
95. A parallelism between insolvency and sovereign debt restructuring on the particular issue of subordination is unavoidable even though it is worth stressing that a sovereign cannot go bankrupt. It is done for illustration purposes only.
96. *See* 11 U.S.C. § 726 (2005).
97. The priorities between different secured claims are determined by the applicable non-bankruptcy law.
98. *See* 11 U.S.C. § 510 (2005).
99. The Uniform Commercial Code (UCC) is a uniform law governing commercial transactions (sale of goods, secured transactions and negotiable instruments) that has been promulgated in an effort to harmonize the law. The Code has been adopted in some form by every state in the United States.

tract law and therefore should comply with the usual requirements of a contract (agreement, consideration, capacity, etc.). Although obvious, it is important to stress that a characteristic element of a subordination agreement is that the contracting party decides to subordinate itself, and consequently, others benefit from this action.

Equitable subordination is a type of subordination imposed by the courts based on the force of law for reasons of equity and fairness rather than a contractual agreement.[100] It is an exceptional measure and must meet three requisites: (1) a creditor is engaged in an inequitable conduct; (2) the misconduct injured the other creditors or resulted in unfair advantage; and (3) equitable subordination is not inconsistent with provisions of the US Bankruptcy Code.[101] As clearly stated in *In re EMB Associates, Inc.*, the "[f]undamental aim of equitable subordination under Bankruptcy Code is to undo or offset any inequity in claimed position of a creditor that will produce injustice or unfairness to other creditors in terms of bankruptcy results."[102] The trustee, the debtor, the creditors, or the court can compel the equitable subordination.[103] Examples of conduct that has justified equitable subordination include: fraud, illegality, breach of fiduciary duties, undercapitalization, and claimant's use of debtor as mere instrumentality or alter ego.[104] Wood argues that equitable subordination occurs as the result of the misconduct of the creditor.[105]

Legal subordination derives from the law, e.g. Section 510(b) or Section 747 of the US Bankruptcy Code.[106] The pre-existent general rule provides that in certain situations, the claim will be subordinated. These pre-existent rules are known to all the parties prior to entering in a transaction or situation that might result in the subordination of a claim. It is

100. The foundation of equitable subordination lies in two Supreme Court cases, Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1938) and Pepper v. Litton, 308 U.S. 295 (1939).
101. *In re* M & S Grading, Inc., 541 F.3d 859, 866 (8th Cir. 2008); Custom Fuel Servs, Inc. v. Lombas Indus., Inc., 805 F.2d 561, 566 (5th Cir. 1986); In the Matter of Missionary Baptist Found. of Am., 712 F.2d 206, 212 (5th Cir. 1983); In the Matter of Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977).
102. *In re* EMB Assocs., Inc., 92 B.R. 9, 15 (Bankr. D. R.I. 1988); *see also* Bostian v. Schapiro (*In re* Kansas City Journal-Post Co.), 144 F.2d 791, 800 (8th Cir.1944).
103. *See* David G. Epstein, Et Al., Bankruptcy 437-38 (West Publishing 1993).
104. Custom Fuel Servs., Inc. v. Lombas Indus., Inc., 805 F.2d 561, 566 (5th Cir. 1986); Maryland Nat'l Bank v. Vessel Madam Chapel, 46 F.3d 895, 901 (9th Cir. 1995); United States v. Pride of Texas, 964 F.Supp. 986, 991 (E.D.Va. 1994); Wardley Int'l Bank, Inc. v. Nasipit Bay Vessel, 841 F.2d 259, 262 (9th Cir. 1988); Neptune Orient Lines, Ltd. v. Halla Merchant Marine Co., Ltd., No. CIV. A. 97-3828, 1998 WL 128993, at *3 (E.D.La. Mar. 20, 1998); Nevi Mar. Co., Inc. v. M/V ALEXANDER'S UNITY, No. CIV. A. 92-2561, 1993 WL 386257, at *3 (E.D.La. Sep. 21, 1993); First Bank & Trust v. M/V Point X, No. CIV. A. H-91-1178, 1993 WL 406052, at *3-4 (S.D.Tex. Aug. 03, 1992); Ost-West-Handel Bruno Bischoff GmbH v. Project Asia Line, Inc., 970 F.Supp. 471, 486 (E.D.Va. 1997); United States v. Pride of Texas, No. 2:92CV211, 2:93CV321, 1994 WL 913279, at *4 (E.D.Va. Oct. 05, 1994); Key Bank of Puget Sound v. Alaskan Harvester, 738 F.Supp. 398, 401 (W.D.Wash. 1989).
105. Philip R. Wood, Principles of International Insolvency 270, (Street & Maxwell 2d ed. 2007).
106. *See* 11 U.S.C. §§ 510(b), 747.

important to mention that subordination only affects the priority of payment and not the right of payment.[107]

United States domestic corporate bonds do not include a *pari passu* clause because there is no need to do so. Why? Priorities are well established by law and a creditor cannot be subordinated to another creditor within the same category unless consent is provided (contractual subordination) or by statute (legal subordination or equitable subordination).[108]

As noted by Hagan, the *pari passu* clause in sovereign debt has generally been understood to limit the legal subordination of debt.[109] In this same sense, The New York Clearing House Association L.L.C. (an association of some of the largest U.S. commercial banks) stated that *pari passu* clauses apply to protect creditors against legal subordination to other unsecured obligations of the debtor and eventually to provide certainty in the event of involuntarily subordination.[110]

Although it is fairly straightforward to obtain a favorable judgment, enforcing it is a completely different matter. Although the litigator's imagination has no boundaries, a sovereign does not have many attachable assets abroad. Even the few assets that are located abroad generally receive certain types of immunity. Therefore, unless certain exceptional circumstances, apply a bondholder of a sovereign state would be better off participating in a restructuring arrangement where it can have certain leverage as a group. And, here is precisely where it is relevant for holdouts to try to invoke a breach of the *pari passu* clause. If that is the case, it will increase their chances to collect.

Going back to the Argentine analysis, it can be argued that holdouts were provided with the same exchange offer that the participating creditors were provided, and were also advised of the possible outcome in the event of refusing the exchange offer. Following this line of thinking, assuming arguendo it can be claimed that holdout creditors subordinated themselves intentionally in order to trigger the *pari passu* clause: Subordination as a result of a 'no' action. In addition, it can be stated that although the Padlock Law 'locked' the exchange offer, it did not affect the holdouts since by not accepting the exchange offer holdout creditors waved their right in the first place. Besides, holdouts creditors can still resort to litigation to collect on their non-performing bond based on the breach of contract as result of the default.

107. *See* In re Kreisler, 331 B.R. 364, 381 (Bankr. N.D. Ill. 2005); In re 203 N. LaSalle St. P'ship, 246 B.R. 325, 332 (Bankr. N.D. Ill. 2000).

108. It can be argued that the bedrock of equitable subordination is fairness and equity and not the law but it is the law that authorizes the courts to provide equitable subordination (§510(c)).

109. Sean Hagan, *Designing A Legal Framework To Restructure Sovereign Debt*, GEORGETOWN J. OF INT'L L. (Winter, 2005).

110. *See* Memorandum of Amicus Curiae the New York Clearing House Association L.L.C. in Support of Motion Pursuant to CPLR § 5240 to Preclude Plaintiff Judgment Creditors from Interfering with Payments to Other Creditors, *supra* note 36, at 5.

The holdout creditor has two related although distinctive rights: (1) the right to accept (or reject) an exchange offer; and (2) to recover its credit invoking a breach of the *pari passu* clause. They are related because the common feature is the bond and its terms (prospectus and prospectus supplement), but they are different since they derive from different actions of the sovereign: (1) an exchange offer made by the sovereign that gives the right to those holding the debt instrument to accept it or reject it; and (2) the breach of the *pari passu* clause as result of an alteration in the ranking of claims within the same category of creditors. Waiving the former (the right to enter the exchange offer) shall not infringe or have any influence on the latter.

The party that voluntarily enters into a contract to subordinate its claim makes an express demonstration of its will of not being equal to other creditors in its same standing at the moment of payment (in the event of liquidation). The creditor that enters into a subordination agreement relinquishes its *pari passu* right. Therefore, priority and subordination are exceptions to the *pari passu* principle.

The holdouts did not waive their *pari passu* right; on the contrary—and continuing with the assuming arguendo—it can be said that other creditors altered the status of the holdouts by exchanging their debt instruments for a new 'performing' instrument. If it could be claimed that the holdout creditors subordinated themselves by a 'no' action, it can also be argued that the participating bondholders in the exchange offer subordinated the holdouts. None of the arguendo scenarios ('no' action subordination or the subordination of the holdouts as result of the exchange offer) should cause any effect on the holdouts. In the case of Argentina, however, the holdouts are different. Argentina expressly stated that the bonds of the holdout creditors will remain 'non-performing.' Argentina then passed a law by which the exchange offer was locked, indirectly granting a legal priority to those creditors that entered the exchange offer.

As noted by Tudor,[111] Buchheit, Pam, and the Financial Markets Law Committee,[112] the *pari passu* clause was originally intended: (1) to prevent the earmarking of revenues of the government towards a single creditor; (2) against legal measures which have the effect of preferring one set of creditors against the others (e.g. enacting a specific norm); and/or, (3) against legal measures which discriminate between creditors creating an involuntary subordination.

The earmarking of revenues has been curtailed by an expanded nega-

111. *See* John, *supra*, note 4, at 95-96.

112. *See* Fin. Market Law Comm't Issue 79, *supra* note 8. The role of the Financial Markets Law Committee is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed (*see* http://www.fmlc.org/history.html).

tive pledge clause[113] (1 above). Legal measures adopted to create a preference for one set of creditors against others (2 above) has been addressed by means of judicial decisions where it was concluded that US Federal Courts do not need to refer to the actions or norms emanated from a foreign government if there are connecting elements to the US (e.g. place of payment or governing law).[114] The legal measures that can lead to an involuntary subordination (3 above) can be curtailed by means of an exhaustive due diligence of the issuer.

The *Pari Passu* Clause in Historical Perspective		
No.	**Historical Purpose of the *Pari Passu* Clause**	**Market/Judicial Reaction-Solution**
1	To prevent the earmarking of revenues of the government towards a single creditor	Expanded negative pledge clause
2	Against legal measures which have the effect of preferring one set of creditors against the others (e.g. enacting a specific norm)	*Libra Bank Limited v. Banco Nacional de Costa Rica S.A.* and *Allied Bank International v. Banco Credito Agrícola de Cartago*
3	Against legal measures which discriminate between creditors creating an involuntary subordination (e.g. the Philippines and Spain)	Exhaustive due diligence of the issuer

The Argentine Padlock Law can be interpreted as falling within 2 above, i.e. a legal measure preferring one set of creditors against the others, which was already addressed in the *Libra Bank Limited v. Banco Nacional de Costa Rica S.A.*[115] and *Allied Bank International v. Banco Credito Agrícola de Cartago*.[116]

In *Libra*, the plaintiffs (seven banks[117]) brought an action to recover their share of principal amounts, plus interest, of a Forty Million US$ syndicated loan to Banco Nacional de Costa Rica (Banco Nacional). Banco Nacional was the defendant, a banking concern wholly owned by the Costa Rican government that defaulted on the payments due under the loan agreement. As its sole defense, Banco Nacional asserted that it was barred from making any repayment by an act of the Costa Rican government—a resolution from the Central Bank of Costa Rica and an

113. The inclusion of expanded negative pledge clauses was the market reaction to action initiated by Citibank against Export-Import Bank of the United States, which in the end was settled by the parties. *See Citibank N.A. v. Export-Import Bank of the United States*, No. 76 Civ. 3514 (CBM) (SDNY Aug. 9, 1976).
114. *See, e.g.*, *Libra Bank Ltd.*, 570 F. Supp. at 870; *Allied Bank Int'l,* 566 F. Supp. at 1440
115. *Libra Bank*, 570 F. Supp. at 870.
116. *Allied Bank*, 757 F. 2d at ,517, 77 A.L.R. Fed. 281.
117. The seven plaintiffs are Libra Bank Limited; Libra International Bank S.A.; Banco de la Provincia de Buenos Aires; Banco Espirito Santo e Comercial de Lisboa; Banco de Vizcaya S.A.; Banque Internationale a Luxembourg S.A.; Banque Rothschild; and, The National Bank of Washington. There were other nine banks that took part in the loan as lenders but were not part in this action.

Executive Decree—and that the court is barred from entering decision by the act of state doctrine.

In *Allied*, Allied Bank International acted as the agent for thirty-nine creditor banks to recover on promissory notes issued by Banco Credito Agricola de Cartago, Banco Anglo Costarricense and Banco Nacional. These three Costa Rican banks, the defendants, are wholly owned by the Republic of Costa Rica and subject to the direct control of the Central Bank of Costa Rica. While the action was still pending before the District Court, the parties reached a rescheduling agreement and dismissed the claim in July 1982. In September 1983, a refinancing agreement was executed. Fidelity Union Trust Company of New Jersey, one of the members of the Allied syndicate, did not accept the agreement and was the one who managed to obtain a rehearing before the Court of Appeals, which vacated its previous decision and overturned the District Court's decision.

The banking laws of Costa Rica at that time provided that foreign state transactions had to be authorized by the Central Bank of Costa Rica. The Costa Rican Central Bank's resolution was adopted on August 27, 1981, to remedy Costa Rica's problems in servicing its external debts (debts to foreign creditors in foreign currency), providing that only repayments of external debts to multilateral international agencies would be authorized. Subsequently, on November 24, 1981, a decree was enacted prohibiting payment of principal or interest on external debt in foreign currency without the prior approval of the Central Bank in consultation with the Minister of Finance. This decree was applicable to all public sector entities. The Costa Rican Central Bank subsequently refused to authorize any foreign debt payments in U.S. dollars, thus precluding payment on the loan and the notes.

In both cases, the courts were faced with the question of whether the act of state doctrine barred them from entering a decision. It is worthy noticing that both the loan and the notes were payable in U.S. dollars in New York and subject to New York law (similar to the Argentine bonds held by some of the holdouts).[118]

The *Libra* case has been very clear as to the validity of the claim of the act of state doctrine resulting from the enactment of a norm by a foreign state which affects a debt instrument not considered to be 'located' with a foreign state. The court resorted to *Menendez v. Saks*, where it was stated that '[f]or purposes of the act of state doctrine, a debt is not 'located' within a foreign state unless that state has the power to enforce or collect it."[119] It is important to note that the loan was issued in U.S. dol-

118. It is difficult to assert if all the debt instruments held by the holdouts have the same features since there were 152 series, subject to eight different laws and denominated in seven currencies (originally fourteen but resulted in seven due to the adoption of the EUR).

119. *Menendez*, 485 F. 2d at 1364. Also, in the same line of thinking, *see United Bank, Ltd. v. Cosmic International, Inc.* where it was ruled that '[a]ll that remained was the right to repayment, which was to be made in New York City. This right existed

lars, payable in the United States and subject to New York law. Therefore, the court understood that the Costa Rican decrees purport to alter the legal relations of the parties because they attempt to extinguish plaintiffs' rights[120] and concluded that: "[A] foreign state's effective confiscation of property, without compensation, is repugnant to the Constitution and laws of the United States and,[the court] would not give effect to Costa Rican currency decrees authorizing only repayment of external debts to multilateral international agencies."[121]

In addition, the Court of Appeals in *Allied* stated that the "[a]ct of state doctrine operates to confer presumptive validity on certain acts of foreign sovereigns by rendering nonjusticiable claims that challenge such acts."[122] Under the traditional application of the act of state doctrine, the principle of judicial refusal of examination of sovereign's acts applies only to a taking by a foreign sovereign of property within its own territory.[123] When the property is within the US at the time of the attempted confiscation (situs of the debt), however, US courts will only give effect to the foreign state acts of state if they are consistent with the policy and law of the US.[124] Therefore, the Court of Appeals concluded that:

> [the] [a]ct of state doctrine did not apply to preclude judicial examination of Costa Rican decrees which conditioned all payments of external debt on express approval from Central Bank of Costa Rica, which refused to authorize any foreign debt payments in United States dollars, thus precluding payment on promissory notes issued by Costa Rican banks, where situs of the debts when the decrees were promulgated was in United States.[125]

Finally, it is worth noticing that in *Allied* it was stressed that:

> [T]he [United States] has an interest in ensuring that creditors entitled to payment in the United States in United States dollars under

before December 16, 1971, the date the new Bangladesh government gained control of East Pakistan. The act of state doctrine is inapplicable because the situs of the debts was New York. . ." United Bank, Ltd. v. Cosmic International, Inc., 392 F.Supp. 262, 265 (S.D.N.Y.1975).

120. *See Libra*, 570 F. Supp. at 878.
121. *Libra*, 570 F. Supp. at 878; *see also United Bank*, 542 F.2d at 873; *Menendez*, 485 F.2d at 1364; *Republic of Iraq*, 353 F.2d at 51.
122. *Allied Bank*, 757 F.2d at 520, 77 A.L.R. Fed. 281.
123. *See Libra*, 570 F. Supp at 877.
124. *See e.g.*, Banco Nacional de Cuba v. Chemical Bank of New York, 658 F.2d 903, 908 (2d Cir. 1981) (Kearse, J.) (quoting Republic of Iraq v. First National City Bank, 353 F.2d 47, 51 (2d Cir. 1965) (Friendly, J.), cert. denied, 382 U.S. 1027, 86 S.Ct. 648, 15 L.Ed.2d 540 (1966)); *see also* First National Bank, et al. v. Banco Nacional de Cuba, 658 F.2d 895, 901 (2d Cir. 1981); *Menendez*,,485 F.2d 1355, 1364, reversed on other grounds sub nomine; Alfred Dunhill of London, Inc. v. Republic of Cuba, 425 U.S. 682, 96 S.Ct. 1854, 48 L.Ed.2d 301 (1976); *United Bank*, 542 F.2d 868, 873 (2d Cir. 1976), affirming and modifying, 392 F.Supp. 262 (S.D.N.Y. 1975); Stroganoff-Scherbatoff v. Weldon, 420 F.Supp. 18, 20 (S.D.N.Y.1976); F. Palicio y Compania, S.A. v. Brush, 256 F.Supp. 481, 483-84 (S.D.N.Y. 1966), affirmed per curiam, 375 F.2d 1011 (2d Cir.), cert. denied, sub nomine, Brush & Bloch v. Republic of China, 389 U.S. 830, 88 S.Ct. 95, 19 L.Ed.2d 88 (1967).
125. *Allied Bank*, 757 F. 2nd 516, 77 A.L.R. Fed. 281.

> contracts subject to the jurisdiction of United States courts may assume that, except under the most extraordinary circumstances, their rights will be determined in accordance with recognized principles of contract law[126]

and that an unilateral attempt to repudiate private, commercial obligations is inconsistent with the orderly resolution of international debt problems. These arguments were later affirmed and restated in *Pravin Banker Assocs. v. Banco Popular del Peru*;[127] and *National Union Fire Ins. Co. of Pittsburgh, Pa. v. People's Republic of the Congo*.[128] It is worth noticing that in between the *Allied* Court of Appeals decision and its re-hearing; an article published by the Financial Times, included in its title the following statement: "New York law unsafe for loan agreements."[129] Moreover, the opening lines of the press article include a statement by a leading European law authority stating that:

> IT'S MONSTROUS, it's a scandal, nothing like this has happened before! From now on no-one in his right mind will specify New York law and New York as a place of litigation in a loan agreement.[130]

The situs of the debt was New York and, hence, the act of state doctrine did not preclude the courts inquiring into the validity of the Costa Rican foreign currency decree despite the fact that it was enacted upon an emergency situation and granting a legal priority to multilateral international agencies, which already enjoy an ad-hoc priority. Therefore, it can be concluded that the Argentine Padlock Law can also be questioned by U.S. courts since the act of state doctrine would not apply.[131]

The most authoritative arguments against the discrimination by the lender where made by Buchheit on three different occasions (one jointly with Walker). This author clearly stated that the purpose of the *pari passu* clause is to prevent the creation of a preferred creditor:

> A pari passu covenant will, however, restrict the borrower from subordinating in a formal way the debt being incurred (or restructured) pursuant to the agreement containing this clause in favor of some

126. *Id*. at 521-522.
127. Pravin Banker Assoc., Ltd. v. Banco Popular, 895 F.Supp. 660, 664 (S.D.N.Y. 1995).
128. National Union Fire Ins. Co. v. People's Rep. of the Congo, 729 F.Supp. 936, 944 (S.D.N.Y. 1989).
129. *Allied Bank*, 757 F. 2nd 516, 77 A.L.R. Fed. 281.
130. A. H. Hermann, *Business Law: New York Law Unsafe for Loan Agreements-Applying the Extraterritoriality Doctrine, the US Court of Appeal in New York Extended the Protection of Chapter 11 of the US Bankruptcy Code to Foreign States*, FIN. TIMES, May 24, 1984, at 36.
131. Buchheit has noted that the most interesting issue raised by the Second Circuit is the extent to which a comity defense may be available to a defendant in a lawsuit to recover a debt obligation in a context different to that of a bankruptcy proceeding as was the case in the Allied cases. *See* Lee C. Buchheit, *Act of State and Comity: Recent Developments*, in Daniel Sassoon and Daniel Bradlow (eds), Judicial Enforcement of International Debt Obligations, 1987, p, 104.

> other external obligation.[132]
>
> [I]f a sovereign borrower intends as a practical matter to discriminate among its creditors in terms of payments, the pari passu undertaking will at least prevent the sovereign from attempting to legitimize the discrimination by enacting laws or decrees which purport to bestow a senior status on certain indebtedness or give a legal preference to certain creditors over others. . .[133]
>
> The purpose of the pari passu clause is to ensure that the borrower does not have, nor will it subsequently create, a class of creditors whose claims against the borrower will rank legally senior to the indebtedness represented by the loan agreement.[134]

The Padlock Law provided a basis for considering an alteration in the legal ranking of the existing unsecured creditors resulting in the involuntary subordination of the holdouts by means of the positive action by other lenders ratified by law. The relevant issue is the Padlock Law, a legal measure adopted by the Argentine government. The arguendo actions or 'no' actions are irrelevant because without the Padlock Law there is no subordination. In all, it is obvious that Argentina's ultimate purpose by passing the Padlock Law was to regain the confidence of the majority participating creditors and to achieve a more successful restructuring of its debt (not with the intention of giving a legal preference to the participating creditors over the holdouts). When applied to inter-creditor proceedings, the established legal principle of *pari passu* provides that all participants comprising a class of creditors shall be entitled to participate equally in stature and without preference. As discussed previously, the obligation imposed on a sovereign debtor under the ranking interpretation of the *pari passu* clause was generally to prevent sovereigns from adopting legal measures which have the effect of preferring one set of creditors against the others. Unfortunately, disregarding the consequence of such formal legislative action, Argentina then made itself more vulnerable; a legal subordination of the holdout creditors was formally made that might give rise to a breach of the *pari passu* clause. As a result, the holdouts can meet their end by resorting to litigation in the hope of obtaining a better outcome than that of the exchange offer.

Moreover, Articles 4 and 6 of the Padlock Law take positive actions towards the alteration of the rights of the holdouts. Article 4 instructs the executive branch to adopt all the necessary actions to delist the bonds. Article 6 states that all bonds deposited that are part of a claim and where presented before a judge to collect will be de facto converted into

132. Mark A. Walker & Lee Buchheit, *Legal Issues in the Restructuring of Commercial Bank Loans to Sovereign Borrowers*, in SOVEREIGN LENDING: MANAGING LEGAL RISK 139, 146, Euromoney, (Michael Gruson & Ralph Reisner, eds 1984).

133. Lee Buchheit, *The Pari Passu Clause Sub Specie Aeternitatis*, INT'L FIN. L. R., Dec. 1991, at 11-12.

134. Lee Buchheit, *How to Negotiate Eurocurrency Loan Agreements*, in EUROMONEY 83 (2nd ed., 2000).

Par Step-up Bonds due in 2038.[135]

In Greek mythology, Sisyphus was a competent and astute king of Corinth who was considered capable of challenging even the Gods. Sisyphus, however, had angered the Gods so much that they condemned him to the task of eternally pushing a rock up a mountain. Upon Sisyphus' arrival at the summit of the mountain, his load—the rock—rolled along the slope by which he had just ascended. Sisyphus had to return to the base of the mountain again and again to repeat his useless efforts. Albert Camus analyzed the myth of Sisyphus and stated that the Gods had thought that there is no more dreadful punishment than futile and hopeless labor.[136] Argentina's situation might be that of Sisyphus—futile and hopeless—if a solution is not found to deal with the holdouts.

In *In re Pinnacle Brands, Inc.*, it was stated that "[w]hile bankruptcy courts, as courts of equity, have the power to equitably subordinate claims, there is no statutory provision permitting bankruptcy courts to elevate the priority of an existing claim."[137] The same should apply to a sovereign as well. This is precisely why Argentina might face litigation as result of the breach of the *pari passu* clause on valid grounds and not based on a wrongful interpretation of the *pari passu* clause.

In summary, it can be said that the *pari passu* clause mistakenly migrated from secured private lending to unsecured sovereign lending. Once rooted in unsecured sovereign lending instruments it faced provisions like the ones in Spain or the Philippines and become a 'must have' provision in this type of debt instrument. Then, *pari passu* clauses stayed in place out of fear of earmarking revenues and the risk that the sovereign preferred one group of creditors over another. These fears, however, were tackled by an expanded negative pledge clause and the *Libra* and *Allied* cases. Therefore, if a proper due diligence was conducted there was no need to have a *pari passu* clause except in exceptional circumstances like the ones in Spain or the Philippines. Unfortunately, a misguided interpretation of the *pari passu* clause in the *Elliot* case opened the door to litigation on unjust grounds (payment interpretation or broad interpretation of the *pari passu* clause). It was an 'aberration,'[138] but one that caused furor. The problem was that in *Elliot* there was no breach of the *pari passu* clause, just a wrong understanding of its meaning. In the case of Argentina, the whole story is different because the language can be correctly interpreted as a breach of the *pari passu* clause in its ranking or narrow form. The importance of this article lies precisely in explaining the different interpretations of the *pari passu* clause in sovereign debt

135. Although the Padlock Law does nor delimit the jurisdiction and expressly says 'any jurisdiction', this is only applicable within the territory of the Republic of Argentina.

136. *See* Albert Camus, *The Myth of Sisyphus*, EDITORIAL LOSADA, 2002, at 129-133.

137. In re Pinnacle Brands, Inc., 259 B.R. 46, Bankr.D.Del. 2001.

138. *See* Stephen Choi & Mitu Gulati, *Contract as a Statute*, 104 MICH. L. R. 1129 (2006).

instruments in context to provide a clear understanding of the issue for the sake of the international capital markets.

IX. SOME FINAL CONSIDERATIONS

Usually, an exchange offer has a termination date, a date until which bondholders can exchange their 'defaulted' old bonds for new bonds. Another feature is the possibility of leaving the exchange offer open for those creditors that did not participate. The non participation of bondholders does not necessarily means that they decided to holdout, it can mean that bondholders were not aware of the exchange offer.[139] Therefore, it would be convenient and in good faith to leave the exchange offer open for those creditors that are willing to join the exchange offer after closure. This might pose a threatening speculative dilemma to the sovereign, because bondholders would not enter the restructuring and would wait to see the participation degree. For that reason, the announcement of this feature should be performed once the required majority or the desired threshold by the sovereign has been achieved.

In this respect, it is important to note that Argentina not only closed the exchange offer tendering period but also 'locked-it' by passing the so-called Padlock Law. The fact that Argentina passed Law 26,017 prohibiting future offers to the holdout creditors could be interpreted as a formal subordination of creditors. The fact that these creditors where subordinated could be interpreted as a violation of the *pari passu* clause. Thus, holdout creditors affected as the result of this possible subordination might have a right to claim a breach of the *pari passu* clause. As Buchheit has noted, "you can do pretty much whatever you want in discriminating among creditors (in terms of who gets paid and who does not) but do not try to justify your behavior by taking steps that purport to establish a legal basis for discrimination."[140]

Following this line of thinking, another relevant fact of the Argentine saga that could also be considered as discrimination to bondholders is the fact that the Argentine government offered more favorable terms to the Argentine pension funds.[141] The more favorable terms were represented in certain accounting benefits granted to Argentine pension funds. Therefore, the net present value of the exchange offer was not the same to the Argentine pension funds than to other creditors. The rationale behind this measure was to ensure the participation of the pension funds in the restructuring since they held approximately twenty percent of the

139. As practitioner experienced that when trying to delist a company some stockholders were not able to be traced and the intervention of a court was required. This problem is amplified in the case of a sovereign where the bondholding is atomized.

140. Lee Buchheit, *supra* note 133.

141. *See* Ismaél Bermudez, *Hay 10 millones de argentinos alcanzados por el canje de la deuda'*, DIARIO CLARÍN, Jan. 13, 2005, *available at* http://impresion.clarin.com/imprimir7.jsp?pagid=90312; *Clave: anuncian un primer paso para salir del default*, INFOBAE, Oct. 7, 2004, *available at* http://www.infobae.com/notas/nota_imprimir.php?Idx=144306.

defaulted debt. This might not only affect the *pari passu* clause but also the non-discriminatory treatment of foreign nationals and foreign financial institutions (i.e. the principle of 'national treatment') under WTO-GATS[142] principles.

All these potential threats could have been avoided in first place by not including a *pari passu* clause in the debt instruments. Could the inclusion of a *pari passu* clause have been avoided? The answer would be 'yes' except in the cases of Spain and the Philippines' debt instruments (and any other jurisdiction that allows the creditors to create post-issuance preferences).

It can be said that the *pari passu* clause mistakenly migrated from secured private lending to unsecured sovereign lending. Once rooted in unsecured sovereign lending instruments, it faced certain provisions like those of Spain or the Philippines that allow the creditor to create an ex-post priority. For that reason, the *pari passu* clause had a *raison d'être* and become a popular provision in this type of debt instrument. Then, *pari passu* clauses stayed in unsecured debt instruments due to other the fears: (1) the earmarking revenues or (2) the risk of the sovereign preferring a group of creditors over another. These two fears were tackled by an expanded negative pledge clause and the *Libra* and *Allied* cases, respectively. Therefore, if a proper due diligence was conducted there was no need to have a *pari passu* clause unless in limited exceptional circumstances. A misguided interpretation of the *pari passu* clause opened the door to litigation on incorrect grounds. In Argentina's case, however, the whole story could be correctly interpreted as a breach of the *pari passu* clause in its ranking or narrow form. If the Padlock Law is interpreted as a sovereign creating a priority in favor of certain creditors against others (resulting in an involuntary subordination of a group of creditors), despite the fact that it is already recognized in legal precedents, the *pari passu* clause will perpetuate in unsecured sovereign debt instruments.

142. Article XVII of the General Agreement on Trade in Services.