

Clients & Friends Memo

U.S. Second Circuit Requires Argentina to Pay Defaulted Sovereign Debt Under “Equal Treatment” Clause

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On 26 October 2012, the United States Court of Appeals for the Second Circuit upheld permanent injunctions designed to remedy Argentina’s breach of a promise to pay certain bondholders after a 2001 default on its sovereign debt.¹ Relying on an “equal treatment” clause which provided that payment of the bonds ranked at least equally with Argentina’s other present and future bond issuances, the court held that Argentina could not discriminate against the defaulted bonds in favour of bonds issued in its 2005 and 2010 sovereign debt restructurings. Accordingly, the court enjoined Argentina from making payments on the 2005 and 2010 bonds without making comparable payments on the defaulted bonds.

The Bonds

In 1994, Argentina began to issue debt securities pursuant to a fiscal agency agreement (“FAA Bonds”). The agreement contained an “equal treatment” clause, providing that:

[t]he Securities will constitute . . . direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank pari passu without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness”

Argentina defaulted on the FAA Bonds in 2001, after which its President declared a temporary moratorium on principal and interest payments on the FAA Bonds and other certain external debt. Each following year, Argentina has passed legislation renewing the moratorium, and has made no principal or interest payments on the FAA Bonds since the 2001 default.

In 2005, Argentina offered to exchange new unsecured and unsubordinated debt (“Exchange Bonds”) for the FAA Bonds, at a rate of 25 to 29 cents on the dollar. To induce holders of the FAA Bonds to participate in the exchange, Argentina stated in the prospectus that “[e]xisting

¹ *NML Capital, Ltd., et al. v. The Republic of Argentina*, Docket No. 12-105(L) (2d Cir. Oct. 26, 2012).

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defaulted bonds eligible for exchange that are not tendered may remain in default indefinitely.” That same year, in order to exert additional pressure on bondholders to accept the exchange offer, the Argentine legislature enacted a “Lock Law” that, among other things, prohibited Argentina from conducting any further settlement with respect to the FAA Bonds. The 2005 exchange offer closed in June 2005, with a 76% participation rate.

In 2010, Argentina temporarily suspended the Lock Law and initiated a second exchange offer. The 2010 exchange offer provided a payment scheme substantially equivalent to the 2005 exchange offer, and included similar risk factors in the prospectus. Upon conclusion of the 2010 exchange offer, Argentina had restructured over 91% of the FAA Bonds.

Argentina has made all principal and interest payments due on the Exchange Bonds. Starting in 2009, certain holders of the FAA Bonds that did not participate in the exchange, began to sue Argentina, alleging breach of contract and seeking injunctive relief, including specific performance of the equal treatment clause. The FAA Bonds are governed by New York law, and Argentina consented to jurisdiction in any state or federal court located in New York City.

District Court Decision

The United States District Court for the Southern District of New York determined that Argentina violates the equal treatment clause of the fiscal agency agreement “whenever it lowers the rank of its payment obligations under [the FAA] Bonds below that of any other present or future unsecured and unsubordinated External Indebtedness.” In particular, the court held that Argentina lowered the rank of the FAA Bonds in two ways: by making payments on the Exchange Bonds while refusing to make payments on the FAA Bonds, and by enacting the Lock Law. As a result, the court granted injunctive relief, ordering Argentina to specifically perform its obligations under the equal treatment clause. The injunctions provided that whenever Argentina pays any amount due under the terms of the Exchange Bonds, it must pay the same percentage of the amount due to the holders of the FAA Bonds. Argentina subsequently appealed the court’s decision.

Second Circuit Decision

On appeal, Argentina advanced several arguments as to why the district court erred, including that (i) the equal treatment clause prohibits only legal subordination, (ii) the injunctions violate the Foreign Sovereign Immunities Act (“FSIA”), and (iii) the balance of the equities and public interest favoured Argentina.

As to the district court’s interpretation of the equal treatment clause, Argentina argued that the equal treatment clause is a boilerplate provision that is universally understood in the sovereign debt context to provide protection from “legal subordination or other discriminatory legal ranking by preventing the creation of legal priorities by a sovereign in favour of creditors holding particular classes of debt.” To that end, Argentina submitted that, even if it favoured the Exchange Bonds in payment, it did not legally subordinate the FAA Bonds because it did not

give the Exchange Bonds a legally enforceable preference over the FAA Bonds in the event of a default on the Exchange Bonds.

The Second Circuit found Argentina's argument unpersuasive, concluding that the preferred construction of equal treatment clauses in the sovereign debt context is far from settled. Instead, the court determined that the equal treatment clause protects bondholders from more than just formal subordination. Specifically, the court held that the first sentence of the equal treatment clause ("[t]he Securities will constitute . . . direct, unconditional, unsecured, and unsubordinated obligations . . .") prohibits Argentina, as bond issuer, from formally subordinating the bonds by issuing superior debt, while the second sentence ("[t]he payment obligations . . . shall at all times rank at least equally with all its other present and future unsecured, and unsubordinated External Indebtedness") prohibits Argentina, as bond payor, from paying on other bonds without paying on the FAA Bonds. The court found this interpretation to be particularly apt in the sovereign debt context, as financially distressed sovereigns do not enter bankruptcy proceedings with a prescribed priority scheme – rather, sovereigns can choose the order in which claims will be paid. Thus, the constraints imposed through the equal treatment clause prevent Argentina as bond payor from discriminating against the FAA Bonds in favour of other external debt.

With respect to the FSIA, Argentina asserted that the injunctions violated its mandate that "the property in the United States of a foreign state shall be immune from attachment, arrest and execution." This argument was equally unavailing because the Second Circuit found that the injunctions would not deprive Argentina of control over any of its property. Specifically, the court concluded that the injunctions did not require Argentina to pay any bondholder any amount of money or limit the other uses to which Argentina may put its fiscal reserves, but merely prohibited Argentina from transferring money to some bondholders without also paying others. The court also determined that the FSIA did not otherwise create any impediment to the injunctions, as Argentina had voluntarily waived its immunity from the jurisdiction of the district court and the FSIA imposes no additional limitations on the equitable powers of a district court that has obtained jurisdiction over a foreign sovereign.

As to the balance of equities and public interest, Argentina argued that the injunctions would "plunge the Republic into a new financial and economic crisis." However, given that the district court had found that Argentina had sufficient reserves to pay the FAA Bonds, the Second Circuit was not concerned about this contingency. Additionally, the court expressed its belief that "it is highly unlikely that in the future sovereigns will find themselves in Argentina's predicament." The court based this belief on the fact that – unlike the FAA Bonds – collective action clauses have been included in 99% of the aggregate value of New York law governed bonds issued since January 2005, including the Exchange Bonds. Collective action clauses permit bond issuers to amend the terms of the bonds and bind dissenting bondholders if a sufficient number of bondholders consent, which greatly reduces the possibility of the type of holdout litigation presently facing Argentina. Furthermore, the court observed that none of the bonds issued by nations identified as eminent risks for restructuring – Greece, Spain, and Portugal – are governed by New York law.

The Second Circuit did, however, have concerns about the injunctions' application to banks acting as intermediaries in the transfer of funds from Argentina to the holders of Exchange Bonds. Under United States commercial law, intermediary banks are not subject to injunctions relating to payment orders, as forcing the banks to comply with stop payments by a particular entity for a particular purpose would impose significant costs on the banks and risk delays in payments unrelated to the targeted stop payments. The court also found that it was unclear how the injunctions' payment formula was intended to function. As a result, the Second Circuit remanded the case to the district court for proceedings to clarify the injunctions' application to third parties and to address the operation of the injunctions' payment formula.

Conclusion

The full impact of the Second Circuit's decision remains to be seen. Taken at face value, the fact that most of the bonds issued by European sovereigns are not governed by New York law and the fact that most New York law governed bonds now include collective action clauses, seem to suggest that the practical implications of the decision may be quite limited.

However, certain scholars and other market commentators disagree, as not all sovereign debt includes or can include collective action clauses, and not all collective action clauses permit majority amendment across multiple bond series. Thus, a significant population of bonds could potentially still be subject to challenge on the basis of an equal treatment clause similar to the one at issue in the FAA Bonds. While the Second Circuit's decision is certainly not controlling authority in other jurisdictions, foreign courts may nevertheless find the decision to be persuasive authority on the interpretation of equal treatment clauses. Following this thread to its logical end, the decision could encourage litigation by dissenting bondholders and make future sovereign debt restructurings more challenging.

Only time will tell which of these schools of thought proves to be correct or, more likely, whether the truth lies somewhere in the middle. In the interim, however, one thing is clear – the decision introduces considerable uncertainty into the sovereign debt market at a critical time in the global economic cycle.

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