Global market for sovereign debt: Argentina v. NML Capital ltd, Measuring the strength of contract against sovereign immunity

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[s]12.2 Measuring the strength of contract against sovereign immunity

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The judgment rendered in 2014 by the New York Court of Appeals in the *NML v. Argentina* case will remain in the annals of sovereign debt. First, this decision paved the way for the resolution in March 2016 of Argentina's payment default – one of the longest (2001–16), largest ($93 billion) and most complex defaults in history. Further, this decision confirms the critical role henceforth granted to national courts in the resolution of sovereign defaults, and therefore in the interpretation of the underlying contracts. Finally, the New York court has considerably strengthened the position of minority investors who refused a collective restructuration agreement, by confirming a controversial interpretation of the *pari passu* clause, and by giving them new powerful means to pressure the sovereign issuer.

This chapter reviews the principal stages of the resolution of Argentina's default, as well as the immediate conclusions one may draw from this episode. It then compares the rules for debt restructuring that found their full expression on that occasion to the core principles that back up two somewhat similar experiences: one is the generic the bankruptcy rule as developed historically at the national level, the other is the practice adopted by the IMF during the debt crisis of the 1980s. These two comparisons highlight the scope of the evolutions observed in this field since 1990, but also the unbalanced (and thus unstable) nature of the current non-regime.

[a]1. THE RESOLUTION OF ARGENTINA'S DEFAULT

The main stages of the long Argentine saga are well known. Following the December 2001 default, the local authorities proposed an exchange of bonds in 2005 and again 2010: investors who accepted a 70% write-off on the face value of their debt contracts would benefit from an immediate resumption of debt service. This would have set the stage for Argentina's return to international capital markets. The fact that 93% of the total bondholders accepted the bond exchange should have reinforced the expectation of such a normalization. However, in 2009, vulture funds that held 7% of the bonds and had refused to participate in the first exchange took the whole case to American courts in order to obtain a complete service (at par) on their non-restructured bonds.

As a first step, they obtained in December 2011 the confirmation by the US District Court for the Southern District of New York of a radical and controversial reinterpretation of the *pari passu* clause that had been written into the new "exchange-bonds". This latter clause is actually quite venerable, establishing a vague principle of equality or non-discrimination between two or more issuances of bonds, but whose practical implications have long remained limited.[1] An isolated decision rendered by the Brussels Court of Appeal in 2000 had then paved the way for a much more restrictive reading of this clause: each party was entitled to the same payment terms, whether it held old or new bonds. Hence if new bonds received full interest payments, older ones should as well though the under their own terms. This decision was rendered in the context of a similar case to that of Argentina, though smaller in size, opposing the Republic of Peru to the Elliott Associates group, of which NML is a

[*] Contribution originally written in French, translated to English by Yanis Rahim.

[1] Mitu Gulati and Robert E. Scott. *The 3½ minute transaction, Boilerplate and the Limits of Contract Design*. (Chicago IL, University of Chicago Press 2013).

subsidiary. In 2011, the District Court for the Southern District of New York, that has jurisdiction over Wall Street, confirmed the principle: if Argentina was to serve entirely its new exchange bonds, then it must also serve entirely the residual, 7% of non-restructured bonds.

Then came the issue of enforcement. At first, minority investors (or their counsels) had tried to seize assets owned by Argentina in third countries, but the rules of sovereign immunity proved too powerful and prevented such seizures. This is where the second dimension of the December 2011 decision came into play: the court injunction that prohibited the Argentine Government from servicing the restructured bonds only, also bound any financial intermediaries that would act as 'agents' of Argentina ('in active concert or participation'). If one of them were to execute Argentina's payment orders, it could be sued directly for 'contempt of court.' This provision was then further strengthened and clarified (District Court, decision as of 21 November 2012)[2] upon express request of the Court of Appeals (decision as of 26 October 2012).

The District Court's decision thus opened an entirely new avenue to back up the *pari passu* clause as it shifted the remedial action from stocks of assets to flows of money, relying at this point on the American payment system. Because the Argentine debt was denominated in US dollars and had been issued in New York, payments had to be processed logically through an American bank and American clearing houses. This strategy – which leverages the payment system infrastructure – is both new and highly powerful, in that it builds on the dollar's dominant position at the international level in order to obtain the extraterritorial reach of the decision by the US court. Other things equal, this strategy could probably not be implemented as effectively from London, for example.

After a series of interim decisions, the District Court judgment was upheld by the US Court of Appeals for the Second Circuit in New York, so that after the US Supreme Court had declined to grant certiorari in 2014, the injunction became effective. In July 2014, Argentina decided to actually test its efficacy and transferred $539 million to the Bank of New York for interest payments owed to holders of its 2005 and 2010 bonds. The District Court judge immediately ordered this transfer to be frozen and one month Argentina was duly declared in 'selective default' by Standard & Poor's and Fitch. Holders of restructured bonds were no longer paid, and the Argentine public and private borrowers' access to international markets was closed.

The last episode of this saga followed the victory of centre-right candidate Mauricio Macri in Argentina's presidential election of October 2015. His programme provided for a quick resolution of the debt problem, which had put a heavy strain on the economy since 2001. Discreet negotiations rapidly began and were supported by the New York District Court, who announced that he would lift the injunction on 30 April 2016[3] as a consequence of Argentina's new, more conciliatory position. This was rightly expected to support a rapid settlement with minority bondolders and to open the door to a large bond issue in New York. The Argentine federal government soon issued $19.5 billion and brought at last to its end the 2001 default.

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[2] Mark C. Weidemaier, 'Sovereign debt after *NML v Argentina*' (2013) (8)2 *CMLJ*. 123.

[3] See Tomas M. Araya, 'A Decade of Sovereign Debt Litigation: Lessons from the NML v Argentina Case and the Road Ahead' (2016) 17(2) *Business Law International* 83; Lee C. Buccheit and Mitu Gulati, 'Restructuring Sovereign Debt after *NML v Argentina*' (2017) 12(2) *CMLJ* 224.

While the creditors who had accepted the 2005 and 2001 bond exchange had received approximately 30% of the bonds' initial face value, minority investors eventually obtained 75% thereof. NML in particular realised a total capital gain of 392% on its initial investment. A series of separate agreements were later concluded with small groups of creditors in the months that followed, including by way of arbitration.

[a]2. INTERMEDIARY CONCLUSIONS

The immediate lessons of this long case are relatively easy to draw. First, minority creditors, in particular vulture funds, achieved their goal. Moreover, a number of guidelines have now been put in place, notably in US law, which strengthen the ability of minority investors to resist a debt restructuring agreement, even when an overwhelming majority of creditors support it (93% in the present case). Other things equal, this development should make it more difficult in the future to agree on such operation, especially where the number of bonds issues and categories of holders is high.

For sure, a lot may depend upon the future interpretation of the 2014 decision by the New York Court of Appeals as on the exact wording of the debt contracts and the pari passu clause, which may evolve in response to the NML case. Still, we are in no way in a stable, consolidated regime of sovereign debt restructuring which would guarantee predictable effects, broadly oriented towards an orderly resolution of payment defaults. On the contrary, the risk in the future is that restructurings will be long, costly, unpredictable and subject to dilatory tactics. Moreover, minority creditors would also be in a position to exercise considerable, potentially damaging pressures on the economy of the debtor State, hence as well on the whole society. The decision declaring Argentina in 'selective default' in July 2014 is exemplary in that regard, since it immediately entailed major difficulties in financing all foreign trade operations. The risk as well is that these rules, or close variants of them, may also prove dangerous for the capital markets as whole. The classic example at this point is the series of sovereign defaults of 1931–33 which were resolved only twenty years later, because of the absence of a structured framework for restructuring.

[a]3. THE BANKRUPTCY RULE

Beyond, it is striking how far the present "non-system" is from the basic rules of a generic bankruptcy procedure, envisaged as a collective action by creditors acting under the protection of courts, along with guarantees of execution. Of course, everyone knows that there is no supranational authority similar to that of a public judge who is able to suspend the performance of private contracts, to coordinate creditors and to confirm decisions taken on a qualified majority basis. Such top-down authority is in fact intrinsic to the classical, liberal constitutional framework and to the way it structures the core interaction between public and private spaces, or rights. However, in sound legal doctrine, the creditors' vote in a bankruptcy procedure only indicates or reveals to the judge what is probably the 'least bad' outcome after the common debtor's default. But he is the only one who can make this decision legally binding so that, in particular, the minority's contractual rights will be intervened.

From this vantage point, the New York Court of Appeals' decision does not only remember us that there is no such thing as a supranational court for sovereign debtors. By defending the rights of minority bondholders at all costs against the "least worst" preference of the majority, the New York judge refused to consider the collective of creditors as a single body with a recognised capacity to make up its opinion and have it defended. This may lead to outcomes that would be both neither economically effective nor socially fair.

Remember here that in a market economy, bankruptcy is also the final stop at which the effects of the distressed debt contracts are suspended. The legislator, probably informed by historical experience, knows that debt contracts left on their own can lead to oppressive results – debt bondage, indentured servitude, coolie labour, loan sharks. All things being equal (and admittedly, these things are numerous), the current non-regime on sovereign debt may raise similar problems. Deliberately causing evident harm to the debtor State's economy to satisfy the rights of a tiny minority of creditors may represent raises serious problems of efficiency and fairness. Note that this is not a problem of the "odious debt" type, a line of argument that questions the conditions under which the contracts were initially negotiated and entered it. The argument here is about how strong the hand of creditors should be, and how far it should be allowed to extend – in particular in the hand of minority creditors.

[a]4. THE COUNTER-EXAMPLE OF THE 1980S

A second entry into the discussion over sovereign debt contracts and their restructuring is offered by the experience of the International Monetary Fund (IMF) during the 1980s debt crisis. After the near-default of Mexico in 1982, dozens of developing countries soon followed suit, so that a total of 109 restructurings were agreed upon until 1989, following very similar, stable, though non-formalized rules of negotiation and decision-making. That year, the Brady Plan opened the door to debt write-offs of 30-40% that were associated with a massive loan-for-bond exchange. Intermediated finance was replaced by bond finance.

The main actor in the 1980s restructurings was the IMF, which stood as a third party interposed in the debt dispute, displaying a presumption – or a claim – of neutrality.[4] However, the Fund was less 'above' the parties than 'between': it simultaneously acted as a strong broker between debtor States and creditor banks, as an expert in economic policy, as the financier of crisis countries, and finally as the medium-term guarantor of the agreements concluded by the parties (through the monitoring of conditionality). In the end, however, the justification for this complex model of intervention rested on a notion of common good: "burden sharing" among the parties of a given agreement and "comparability of treatment" across cases referred ultimately to the multilateral nature of the IMF's action – a dimension that is entirely absent from the current 'non-regime.'

Remarkably, during all these years, the final decision on each restructuring depended neither upon a judgment by a national or an international judge, nor upon an arbitration, nor upon a more or less friendly mediator. Rather, it resulted from a very original, three-way decision rule based on a right of veto given successively to each party in the final outcome. The IMF could thus refuse the debt financing agreement if it considered for instance that the banks had not made enough concessions, thereby jeopardising the success of the overall plan. But the banks in turn could reject an agreement on economic policy that they considered too soft, perhaps because the country in question was protected by one of the IMF's major shareholders. And of course the country also had to formally accept these two agreements, which altogether formed a whole in which everyone had to contribute. Lastly, the execution

[4] Jerome Sgard, 'How the IMF Did It? Sovereign Debt Restructurings during the 1980s' (2016) 11(1) *CMLJ* 103.

of this three-way settlement over time was guaranteed by the IMF usual ways of monitoring and enforcing conditionality.

Let's thus underline this point: this stable, predictable procedure did not have any jurisdictional dimension. Furthermore, its practice typically implied a fair amount of power relationship and arm-twisting between the IMF and public authorities in the creditor countries on the one hand, and debtor countries *and* commercial banks on the other. A judge or a trustee would not have been in a position do enter that terrain, for fear of undermining their legitimacy.

But the very specific legal character of this regime was also underlined by the fact that all *ad hoc* clauses inserted in the initial debt contracts, all norms of private international law, all national laws or statutes applicable to the debt contracts were systematically suspended or circumvented. Even the Articles of Agreement of the IMF resulting from the Bretton Woods Conference had been ignored when it was assumed (albeit in a non-written way) that the decision to lend to a Member-State could be *de facto* vetoed by a group of commercial banks. Not least, this group of banks itself had no legal existence. Hence the rule-based, predictable dimension of decision making came with a largely informal character: no treaty, no official decision, no discrete announcement ever made clear how exactly the Fund was dealing with debt restructurings.

[a]5. HOW DID THE IMF NEGOTIATE WITH SOVEREIGNS?

Lets try however to better characterise this unique, extraterritorial procedural space. In fact, the forum was neither the IMF as such, nor an *ad hoc* instance created in the IMF's shadow, nor the proxy of an international court. In fact, the rules of the game were written in the Stand-By Agreement *as such*, i.e. an original model of transaction, invented and developed by the IMF from 1953 onwards, that has allowed him to conjoin lending and conditionality. The key point however is that contrary to what the usual vocabulary suggests, the *Stand-By Agreement is not a contractual arrangement*. Joseph Gold, the founding father of the IMF's legal doctrine and main architect of the Stand-By, often underlined the point: the two parties in a Stand-By commit themselves separately and successively on the terms of their transaction.[5] A country in crisis thus sends to the Fund a *Letter of Intent* (which formalises its policy commitments), and the IMF then announces that a Stand-By Agreement had been decided and makes the money available to the country. Critically, no text is ever signed jointly by both parties.

Gold justified this principle by the fact that the conduct of the economic and financial policy of a sovereign borrower is far too complex, and exposed to too many influences and external shocks, for the notion of a contractual commitment to apply in its hard, legal sense. If a contractual reading of conditionality were to be adopted, any deviation from the terms of the initial agreement, voluntary or not, would have entailed legal consequences, and possibly sanctions. In turn, this might well have generated excessive – if not dangerous – rigidity in the interaction between the parties, before and during the life-cycle of the Stand-By.[6] In particular, a brake-up between the parties, possibly followed by sanctions had to be avoided at all costs: the return to the negotiation table and to the bilateral transaction had to remain the

[5] Joseph Gold, 'The Law and Practice of the International Monetary Fund with Respect to "Stand-By Arrangements"' (1963) 12(1) *ICLQ* 1.
[6] Joseph Gold, 'The "Sanctions" of the International Monetary Fund' (1972) 66(5) *AJIL* 737.

normal option. This is why for instance the IMF has always ruled out any recourse to arbitration proceedings for resolving disputes with Member-States, just as it never asks for the confirmation of Stand-By agreements by national parliaments or supreme courts. In short, one had to take into account the economic context in which the sovereign operates, but also the inevitably open, renegotiable and therefore flexible nature that a transaction with a sovereign always presents.

Put another way, the Stand-By is a transaction which rules respond to the classic forms of action of the sovereign State on the international scene: an actor that is altogether realistic, rational, hard-headed, calculating and independent from any superior authority. Significantly, the Fund interacts exclusively with executive powers (and with central banks). The rules of the Stand-By aim, in essence, at placing the borrowing sovereign within a cooperative framework of interaction from which it may not easily exit and which should lead hopefully to economic stabilisation and a return to international market. The realist character of the Stand-By should thus be assessed by looking at the eventual results of the economic program, not at the process, or the path that led to that result. This is why the very idea of the country 'complying' to each clause of the *Letter of Intent* makes no sense at all.

The debt restructurings of the 1980s were thus negotiated and sealed within this very curious, yet familiar setting. The Stand-By was in fact the jurisdiction within which these contracts were renegotiated. Commercial banks (with all their credits in quasi-default) were thus literally co-opted into this so particular arena which the IMF had built and developed, by ways of trials and errors, since the early 1950s. The 'three-ways veto rule' that was adopted in 1982 just signalled the usual two-ways exchange of unilateral commitments had been extended to a triangular transaction. Significantly, the debt financing agreement between the debtor country and the Steering Committee of banks had no legal value in itself: its scope was limited to the triangular relationship with the IMF and to the practice of the triple veto right. Each single creditor bank would later have to confirm the terms of this agreement in the language and forms of the respective contract law. The concessions granted to the indebted country then became legally binding: they would then impact altogether the bank's balance sheet and its fiscal or regulatory obligations.

[a]6. *ARGENTINA V. NML*, RETROSPECTIVELY

Here are therefore he two main elements that come out when comparing the experience of the 1980s with that of Argentina after 2001: first is the absence today of any binding multilateral rule, as a corollary of the emergence of the national courts of justice as the jurisdictions of reference; and second is the emergence of a set of hard legal norms, in particular contractual norms, whose language now structures the entire discussion on sovereign debts. The regulating principles of these negotiations has thus shifted from a weak standard of substantive justice (resting on the idea of a transaction subject to mutual veto) to a standard of very high substantive and procedural formalisation.

Between these two poles – Mexico in 1982 and *NML* in 2014 – one finds however in 2001 the attempt to create an intermediary or mixed regime: the proposal by the IMF to establish a "Sovereign Debt Restructuring Mechanism" (SDRM) would have given the jurisdiction over sovereign debt contracts to a new, de facto supranational entity, closely linked to the IMF, though with some guarantees of procedural independence.[7] One could

[7] IMF, *The Design of the Sovereign Debt Restructuring Mechanism – Further Considerations*. Prepared by the Legal and Policy Development Reviews Departments. 27 November 2002, 76 pages.

interpret this as an attempt to set up an *ad hoc* jurisdiction, probably of a rather loose arbitral character, where substantive legal constraints would not have born too heavily on the capacity to deal and bargain – just like in the 1980s, though in a more settled forum. This feature was illustrated particularly by the clause advocated by the IMF at that time that it would be itself part of the deliberation, to which it would bring its expertise and economic assessment. The overall assumption, therefore, seems to have been that the sustainability and success of the new regime would have hinged upon the balance it reached between two demands: the pressure by private investors for strong procedural guarantees and an apriori judgement that sovereign debt restructurings should not be constrained by too strict substantive and procedural legal rules.

The SDRM proposal was however rapidly rejected by private financial actors, who clearly did not want to put their assets in the hands of such supranational adjudicator At that time, in the early 2000s, the influence of contractual norms and language was already too powerful to allows for the adoption of such a forum. The transfer of the jurisdiction over sovereign defaults to the national courts was already a *fait accompli*, a feature that fully was indeed reflected in the way the Argentine was dealt with. In other words, the new regime rests on the assumption that sovereign debt contracts can be read and broadly interpreted like private contracts, while their specific, international and sovereign dimensions only comes out when questions of enforcement and remedies have to addressed.

Here is ultimately the paradox of the current non-regime of sovereign debt restructuring. On the one hand, a strict contractual reading has been instrumental in the destruction of all formal multilateral dimensions in these operations: multilateral are rightly perceived as implying a substantial degree of de-formalisation and relative autonomization that de facto leaves room for transactions, power relationships and settlements. By the same token, many features that are specific of sovereign borrowers have also been largely hollowed out. Macroeconomic uncertainty, the domestic political economy, and sovereign realism on the international scene are not expected to shaped the behaviour of a sovereign when in front of a debtor court.

On the other hand, the current rules of the game, as illustrated by the *NML v. Argentina* case, reflect the rejection of any binding limit to the practical reach of contractual rights: in matter of sovereign debts, they are now conceived as thoroughly and exclusively individual, so that the collective and social dimension that is a full part of the generic bankruptcy rule at the domestic level has just no equivalent here. This was illustrated both by the unconditional defence of the rights of a tiny minority of Argentine bondholders, and by the remedies they obtained from the New York court. The disproportion between the value of those claims and the costs induced by the forced default of July 2014 will remain for this reason a striking illustration of this dangerous rule.