

SECOND CIRCUIT REVIEW

Expert Analysis

Court Approves Broad Injunctive Relief In Case Over Sovereign Debt Instruments

This month, we discuss *NML Capital v. Republic of Argentina*,¹ in which the U.S. Court of Appeals for the Second Circuit affirmed a lower court order imposing injunctive relief against the Republic of Argentina in connection with the nation's 2001 default on its sovereign debt. In its decision, written by Judge Barrington Parker and joined by Circuit Judges Rosemary Pooler and Reena Raggi, the court concluded that Argentina breached a promise to repay certain bondholders in the wake of the nation's default, and upheld a wide-ranging injunction designed to help cure the breach.



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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...."²

In 2001, facing a deep economic crisis, the nation defaulted on the FAA Bonds and the president declared a "temporary moratorium" on principal and interest payments of much of its public debt. In 2005, Argentina offered holders of FAA Bonds the opportunity to exchange their defaulted bonds for new debt at a rate of 25 to 29 cents on the dollar. In making this offer, Argentina specifically noted that it had no intention of resuming payment on the FAA Bonds—indeed, the "temporary moratorium" on the bonds persists to this day. In tandem with the offer, the nation's legislature passed a "lock law," prohibiting the state from conducting any settlement with respect to the FAA Bonds.³ Seventy-six percent of the FAA bonds were exchanged; a second ex-

change offer in 2010 resulted in 91 percent of the nation's foreign debt having been restructured.

A small number of FAA bondholders, however, did not participate in the exchange offer. Some of these remaining bondholders had purchased the FAA Bonds before the default, as early as 1998. Others, primarily funds hoping to collect on Argentina's distressed debt, purchased the FAA Bonds on the secondary market as late as 2010. These "holdout" bondholders protested that Argentina had made all payments due on the 2005 and 2010 Exchange Bonds, but as promised had not made any payments on the still-outstanding FAA Bonds.

The decision in 'NML Capital' addresses issues that have clear ramifications for any investment in sovereign bonds, particularly as nations are increasingly being forced to consider restructuring.

The District Court Case

The holdout bondholders brought multiple suits in the Southern District of New York (under a jurisdiction clause in the FAA) against Argentina throughout 2009 through 2011, alleging that the nation had breached its contracts through

Background

In 1994, the Republic of Argentina began issuing sovereign debt securities pursuant to a Fiscal Agency Agreement (FAA). The FAA Bonds were protected against subordination by certain provisions in the FAA, in particular, a "pari passu clause." This clause provided in part that "[t]he Securities will constitute...direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank pari

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its refusal to pay on the defaulted FAA Bonds. In particular, the plaintiffs emphasized the “equal treatment” aspect of the *pari passu* clause, arguing that Argentina prioritized the Exchange Bonds over the remaining FAA Bonds in contravention of the FAA.

By making payments on the Exchange Bonds but not on the FAA Bonds, the holdouts claimed, Argentina had subordinated their earlier debt to the later-issued bonds in violation of the *pari passu* clause. Argentina responded that the plaintiffs were attempting to create a novel interpretation of the *pari passu* clauses commonly used in sovereign debt instruments that would go beyond prohibiting formal subordination, to instead allow holdout creditors to single-handedly disrupt sovereign debt restructuring.⁴

District Judge Thomas Griesa agreed with the holdout FAA bondholders, ruling that Argentina had breached its contractual duty under the FAA by ranking its payment obligations under the plaintiffs’ bonds below its obligations under the Exchange Bonds. Granting partial summary judgment to the plaintiffs, Griesa then turned to crafting a remedy that would restore the plaintiffs’ priority among Argentina’s creditors.

The judge imposed a wide-ranging permanent injunction, the most critical aspect of which was the requirement that Argentina specifically perform its obligations under the FAA by making a “ratable payment” to the holdout plaintiffs whenever a payment was made under the Exchange Bonds, and explicitly prohibiting any payments under the Exchange Bonds unless such ratable payments were made to FAA bondholders.⁵ In essence, Griesa’s order halted all payments on the Exchange Bonds unless Argentina agreed to lift the lock law and end the decade-long moratorium on payments under the FAA Bonds.

Argentina appealed the injunction on multiple grounds, including that the district court had misinterpreted the *pari passu* clause as applied to sovereign debt instruments, that the lock law did not violate the *pari passu* clause, and

that the remedy imposed by the court was improper. The United States filed an amicus brief in support of Argentina, arguing that the court’s ruling was in contravention of the Foreign Sovereign Immunities Act, and that it would harm the United States’ relations with foreign nations by inhibiting international cooperation and order in the resolution of sovereign debt crises.⁶

The Second Circuit Decision

The Second Circuit affirmed the decision of the lower court, noting that it was upholding both the injunctive relief and the underlying judgment that Argentina had breached the terms of the FAA.

Placing weight on “Argentina’s continual disregard for the rights of its FAA creditors and the judgments of our courts to whose jurisdiction it has submitted,” the panel found it clear that monetary relief would be ineffective.

The panel began by addressing Argentina’s argument that the lower court misinterpreted the equal treatment provision of the *pari passu* clause, applying a new meaning to what Argentina characterized as a “boilerplate provision, that in the sovereign context, ‘has been universally understood for over 50 years...to provide protection from legal subordination or other discriminatory legal ranking by preventing the creation of legal priorities by the sovereign in favor of creditors holding particular classes of debt.’”⁷ In its brief, Argentina added that in the past, parties such as the United States and the Federal Reserve have criticized alternate readings of such provisions as contrary to market understanding, U.S. policy, and the public interest.⁸

The court disagreed with Argentina’s portrayal of this clause as carrying a well-settled meaning, citing a number of

academic sources debating the meaning of *pari passu* provisions. Applying concepts of contract interpretation, the court held that Argentina’s interpretation of the clause—that it only protects from formal subordination, not *de facto* subordination caused by the lock law’s bar on payments—would result in half of the *pari passu* clause being without effect. Rather, the first sentence of the clause prohibits a bond issuer from formally subordinating the bonds through superior debt, whereas the second sentence prohibits the bond payor from prioritizing other debt.

The court further justified this conclusion by pointing out that sovereign debt is unique in that there are no bankruptcy proceedings to resolve defaults; rather, the sovereign itself chooses how to pay creditors. The equal treatment provision acts as protection against a debtor who could otherwise discriminate against particular bondholders at will. Given this interpretation, the panel concluded that Argentina rendered the FAA Bonds as both legally and *de facto* subordinated to the Exchange Bonds, breaching the FAA. The court also disposed of a laches argument propounded by Argentina, finding neither delay nor prejudice.

The panel next addressed Argentina’s contention that the injunctions imposed by the district court were impermissible. The panel first addressed the theory that there was a contractually agreed-upon remedy of acceleration, holding that this was not intended as the exclusive remedy under the FAA. The court then addressed whether monetary damages would have been sufficient, thus foreclosing injunctive relief.

Placing weight on “Argentina’s continual disregard for the rights of its FAA creditors and the judgments of our courts to whose jurisdiction it has submitted,”⁹ the panel found it clear that monetary relief would be ineffective. Over Argentina’s argument to the contrary, the court noted that a party’s effort to frustrate the collection of judgments may itself be sufficient to establish the inadequacy of monetary relief.¹⁰ Given the challenges that the FAA creditors would face in col-

lecting a judgment, the panel concluded that the district court properly imposed specific performance.

The panel next addressed a challenge to the injunctions under the Foreign Sovereign Immunities Act. Argentina cited Section 1609 of the FSIA, which immunizes the property in the United States of a foreign state from seizure.¹¹ The court held that the injunctions do not “attach, arrest, or execute upon any property,” but simply direct Argentina to comply with its obligation under the FAA not to alter the rank of its payment obligations. Rather than depriving Argentina of any of its property, the nation is merely prevented from transferring money to the Exchange bondholders if it does not also transfer money to the FAA bondholders. If it wishes, Argentina could comply with the injunction by not paying any money to any creditors at all; in this sense, then, it cannot be said that Argentina’s property is impaired in violation of the FSIA. The court added that Argentina had voluntarily waived its immunity from the jurisdiction of the district court, freeing the court to impose any equitable relief not in conflict with §1609.

The court also addressed the concerns of the U.S. government that the injunctions would “allow a single creditor to thwart the implementation of an internationally supported restructuring plan,”¹² noting that it is the sovereign’s decision whether to repudiate a debt in a manner that violates a *pari passu* clause. In a footnote, however, the panel declined to explore whether there would be any circumstances where non-payment to one creditor in conjunction with payment to another would satisfy such a provision.¹³ More generally, the court speculated that “holdout” litigation will be less common in the future due to the recent inclusion of “collective action clauses” in sovereign debt instruments. These clauses, which were included in the 2005 and 2010 Exchange Notes issued by Argentina, bind dissenting bondholders to a change in terms if a threshold percentage of bondholders agree to the amendment. The court suggested that most sovereign debt issued

in recent years contains such clauses, and that at any rate the bonds of nations that may engage in restructuring in the near future are not governed by New York law.

Remand and Stay

Despite approving in its entirety the reasoning of the district court, the panel expressed some concern regarding several aspects of the injunctions. The court found the district court ambiguous in its explanation of how the “ratable payment” requirement would function. Additionally, the court expressed reservations about how the order would apply to third parties, including intermediary banks that are protected from certain injunctions under Article 4-A of the UCC. The panel remanded the injunctions to the district court to address these issues.

On remand, Griesa established a more precise payment formula, and maintained that the order contained a sufficient carve-out for intermediary banks to the extent that they are not “in active concert or participation” with Argentina. Regarding the objections of other third parties, in particular those of Bank of New York, Argentina’s indenture trustee, Griesa reasoned that if Argentina complies with the order the injunctions would then not infringe upon the trustee’s duties, and if Argentina attempts to circumvent the order the bank could then properly be held responsible for ensuring that its actions are not being taken for the purpose of violating the law. Separately, in response to rhetoric from Argentinian leaders evincing an intent to disobey the rulings, Griesa ordered the ratable payment provision to take effect immediately, beginning with the December 2012 payments to bondholders.¹⁴

However, a week after Griesa issued his orders on remand, the same Second Circuit panel that upheld the injunctions issued an emergency stay of their implementation.¹⁵ With oral argument now scheduled for February 2013, Argentina has been granted a reprieve that, at least for the time being, permits

it to continue payment to the Exchange bondholders without making ratable payments to the FAA bondholders.

Conclusion

The Second Circuit’s decision in *NML Capital v. Republic of Argentina* addresses issues that have clear ramifications for any investment in sovereign bonds, particularly as nations around the world are increasingly being forced to consider restructuring. It upholds an interpretation of commonly used *pari passu* clauses in a way that may provide protection to holdout creditors at the expense of internationally negotiated and supported restructuring plans, and affirms a set of injunctions that may force a sovereign nation’s hand in its dealings with creditors. While the court expressed an expectation that this impact would be limited, it remains to be seen whether the decision might have effects on investor behavior and foreign policy.

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1. Docket No. 12-105(L), 2012 WL 5275014 (2d Cir. Oct. 26, 2012).

2. *Id.* at *1.

3. *Id.* at *2 (citing Law No. 26,017).

4. Brief of Defendant, *NML Capital v. Republic of Argentina*, No. 08 Civ. 6978, 2010 WL 5888784 (S.D.N.Y. Dec. 10, 2010).

5. Order, *NML Capital v. Republic of Argentina*, No. 08-cv-06978 (S.D.N.Y. Feb. 23, 2012).

6. The authors’ firm filed an amicus brief on behalf of Montreux Partners, L.P. and Wilson Capital in support of affirming the lower court’s conclusion that Argentina violated the equal treatment provision of the FAA Bonds. 2012 WL 1930442 (2d Cir. April 17, 2012).

7. 2012 WL 5275014 at *7.

8. Brief of Defendant-Appellant, 2012 WL 1077763 at *36.

9. 2012 WL 5275014 at *10.

10. *Id.* (citing *Pashaian v. Eccelston Props.*, 88 F.3d 77, 87 (2d Cir. 1996)).

11. 28 U.S.C. §v09.t

12. Brief for the United States of America as Amicus Curiae in Support of Reversal, No. 12-105-cv, 2012 WL 1150791 at *5 (2d Cir. April 4, 2012).

13. 2012 WL 5275014 at *12 n.16.

14. 2012 WL 5895650 (S.D.N.Y. Nov. 21, 2012) (lifting the district court’s stay and immediately imposing ratable payments); 2012 WL 5895786 (S.D.N.Y. Nov. 21, 2012) (discussing the payment formula and injunctions).

15. Order, No. 12-105(L) (2d Cir. Nov. 28, 2012), ECF No. 490.