ALERT MEMORANDUM

# S.D.N.Y. Denies Securities Fraud TRO And Upholds Ecuador's Use Of Collective Action Clauses In Sovereign Debt Restructuring

*November 4, 2020*

On July 31, 2020, Judge Caproni in the Southern District of New York denied an emergency motion filed by certain bondholders for a temporary restraining order that would have halted efforts by the Republic of Ecuador ("Ecuador") to restructure $17.4 billion of its sovereign debt based on allegations of securities fraud arising from statements made by Ecuador in its restructuring-related press releases. The Court upheld Ecuador's use of the collective action clauses ("CACs") in its indentures as the primary tool to accomplish the proposed restructuring.

In addition to its effects on Ecuador, which is restructuring its debt amidst a severe economic crisis exacerbated by the COVID-19 global pandemic, the decision is also notable as the first-ever ruling by a New York court on the use of CACs in a sovereign debt restructuring. In particular, the Court's ratification of Ecuador's proposed use of CACs to modify an indenture provision that would otherwise constitute an impediment to the proposed transaction can be expected to have implications on future uses of such clauses, which have increasingly become a feature of sovereign-issued bonds governed by New York law since Mexico first introduced them in its bond documentation in 2003.

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## Ecuador's Consent Solicitation And Exchange Offer

Facing a severe economic crisis brought on by the COVID-19 global pandemic and an unprecedented drop in oil prices, Ecuador announced in April 2020 that it would seek to engage its creditors, including bilateral creditors and bondholders, in order to reduce its debt burdens to sustainable levels. On April 8, 2020, Ecuador launched an initial consent solicitation that successfully amended its outstanding bonds to, among other things, defer the payment of interest and provide Ecuador with temporary relief while it engaged creditors and other stakeholders with respect to its medium- and long-term debt sustainability goals. On July 20, 2020, Ecuador announced a debt restructuring proposal, inviting holders of ten series of bonds set to mature from 2022 to 2030 to consent to the amendment of those bonds and exchange them for new bonds in three series set to mature in 2030, 2035 and 2040.[1] The Invitation was scheduled to expire at 5:00 pm CET on July 31, 2020.[2]

The Invitation made use of the CACs included in Ecuador's governing bond documents, which allow for a modification of payment and other material terms upon receiving the consent of a supermajority of bondholders that become binding on all bondholders of a series, irrespective of whether they consented to the proposed modifications. Nine of the Ecuadorian series at issue contain "dual-limb" CACs, permitting binding payment terms modifications with the consent of holders of at least (i) 66 2/3% of the outstanding principal amount of two or more series on an aggregated basis *and* (ii) 50% of the outstanding principal amount of each series affected by the proposed modification. The payment terms of the tenth series can only be modified and become binding on all bondholders on a single-series basis, with the consent of holders of at least 75% of the outstanding principal amount.

All ten series also contain a "No Less Favorable Treatment" provision, which provides that in the event of a consent solicitation for modification combined with an exchange offer, Ecuador must propose amendments that, if approved, would cause the amended security to have the same terms as the security with the largest principal amount offered in the exchange. As part of the mechanics of its Invitation, Ecuador first sought a modification of the No-Less-Favorable-Treatment provision, which would have otherwise constituted an impediment to consummating the Invitation in accordance with its terms.

Two days after the terms of the Invitation were announced, a Steering Committee representing a minority group of bondholders expressed dissatisfaction in a letter to Ecuador, which was leaked to the press. In response, Ecuador issued a press release on July 27, 2020, stating *inter alia* that the Steering Committee's assertions that the Invitation was "coercive" could not "be further from the truth"; that Ecuador was "committed to a fair and transparent process"; and that the proposed restructuring was constructed "within the four corners" of the governing bond documents.[3]

## Plaintiffs' Request For A TRO Based On Alleged Securities Fraud

Two days after the press release was issued—and two days before the Invitation was set to expire—Steering Committee members Contrarian Emerging Markets, L.P. ("Contrarian") and GMO Emerging Country Debt Fund, GMO Emerging Country Debt Investment Fund plc, and GMO Emerging Country Debt (UCITS) Fund (collectively, "GMO") filed a putative class action in the Southern District of New York, seeking a

[1] Invitation Memorandum at ii, *Contrarian Emerging Markets, L.P., et al., v. Republic of Ecuador*, No. 1:20-cv-05890-VEC (S.D.N.Y. filed July 29, 2020) ("*Contrarian*"), ECF No. 1-2 (the "Invitation"). Cleary Gottlieb Steen & Hamilton LLP is counsel for Citigroup, the Dealer Manager for the Invitation.

[2] *Id.* at 46.

[3] Press Release dated July 27, 2020, "The Republic of Ecuador Responds to Certain Press Reports with Respect to Its Invitation to Consent and Exchange" (July 29, 2020), *Contrarian*, ECF No. 1-1.

temporary restraining order to halt the restructuring on the basis that Ecuador allegedly committed securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5(b) by stating in its press releases that:[4]

- ***Plaintiffs' characterization of the Invitation as coercive could not "be further from the truth."*** The Invitation was coercive, plaintiffs claimed, because its intent was to so severely disadvantage non-tendering bondholders that all bondholders would consent and participate.
- ***Ecuador was committed to a transparent process***. Plaintiffs asserted that the process was not transparent, because (i) in designing the Invitation, Ecuador had only engaged with bondholder groups other than the Steering Committee, and (ii) the July 31 deadline did not allow enough time for bondholders, including plaintiffs (who the Court noted are sophisticated investors), to consider the Invitation.
- ***Ecuador was acting "within the four corners" of the bond documents***. Plaintiffs claimed that the Invitation per se breached the No-Less-Favorable-Treatment provision by treating consenting and non-consenting bondholders differently. Plaintiffs argued that the No-Less-Favorable-Treatment provision could not be modified through CACs, as proposed in the Invitation.

Ecuador raised various defenses, including that plaintiffs' claim was unlikely to succeed on the merits, since the alleged misstatements were generic statements of puffery and opinion that could not form the basis for securities fraud.

## The Court Denies The TRO, Finding Plaintiffs Showed No Likelihood Of Success On The Merits

The case was assigned to Judge Caproni, who convened multiple telephonic conferences and ordered expedited briefing over a two-day period.

The Court denied the TRO at the end of a telephonic hearing on July 31, 2020, focusing on Ecuador's defense that plaintiffs were unlikely to succeed on the merits of their securities fraud claim because the alleged misstatements were not indisputably false. Of relevance for other sovereign debt restructurings, Ecuador's statement that it was acting within the "four corners" of the bond documents was held not to be false, since the contemplated restructuring—including the solicitation of consent for modification of the No-Less-Favorable-Treatment provision—involved a permissible use of the CACs under the plain terms of the indenture.[5]

The Court rejected plaintiffs' contentions that the Invitation violated the indenture, because (among other reasons) there was no contractual language preventing modification of the No-Less-Favorable-Treatment provision through the CAC.[6] The Court also rejected plaintiffs' characterization that Ecuador was asking bondholders to excuse a contractual violation in soliciting consent to modification of the No-Less-Favorable-Treatment provision. There was no such contractual violation, the Court ruled, since the modification and exchange proposals were part of one consent solicitation that would pass with the required supermajorities or fail, in which case all holders of bonds of a series for which the consent was not obtained remain in the position they enjoyed prior to the proposal.[7]

In addition, the Court ruled that there was no unequal treatment of bondholders because "all bondholders

[4] *See* Compl. (July 29, 2020), *Contrarian*, ECF No. 1; Pls.' Mem. of Law in Supp. of Proposed Order to Show Cause at 4-9 (July 29, 2020), *Contrarian*, ECF No. 27.
[5] Pursuant to an agreement subsequently reached by the parties, the case was dismissed on August 17, 2020. Letter at 1 (Aug. 14, 2020), *Contrarian*, ECF No. 39; Order at 1 (Aug. 17, 2020), *Contrarian*, ECF No. 40.
[6] Tr. at 29:9-15 (July 31, 2020), *Contrarian*, ECF No. 37.
[7] Tr. at 23:22-24:4 (July 31, 2020), *Contrarian*, ECF No. 37.

have been presented with the exact same offer with the exact same deadline."[8]

## Conclusion

Although CACs have been incorporated in sovereign-issued bonds for many years, this is the first ruling by a New York court on the use of CACs to effectuate a proposed sovereign debt restructuring.[9] This ruling is particularly significant given that CACs have become "almost universal[]" in sovereign-issued bonds governed by New York law, appearing "in 99% of the aggregate value of New York-law [sovereign-issued] bonds issued since January 2005."[10]

In the context of the defaulted bond litigation against the Republic of Argentina, the Second Circuit predicted that CACs would "effectively eliminate the possibility of 'holdout' litigation,"[11] which can prevent a sovereign from restructuring its debt in a comprehensive manner even where the vast majority of creditors support its restructuring proposal (a problem resulting from the lack of a bankruptcy regime for sovereigns). CACs mitigate the holdout problem by establishing each creditor's agreement at the time of entry into the contract that minorities can be bound by supermajorities. And that is just what happened with the Ecuadorian restructuring, which received the support of holders representing 98% of the aggregate principal amount of the series being modified, making the terms of the Invitation binding on all holders.[12]

Judge Caproni's decision lends some support to the Second Circuit's prediction and shows the difficulty investors will face in trying to use securities fraud claims as a potential end-run around CACs (and around contractual dispute resolution provisions[13]). It also upholds the use of CACs to modify contractual terms wherever permitted by the contract's language.

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[8] Tr. at 36:3-5 (July 31, 2020), *Contrarian*, ECF No. 37.
[9] CAC-based arguments have been raised in recent S.D.N.Y. litigation against Venezuela. *See Pharo Gaia Fund Ltd., et al, v. Venezuela*, No. 1:19-cv-3123-AT; *Casa Express Corp. v. Venezuela*, No. 1:18-cv-11940-AT.
[10] *NML Capital, Ltd. v. Republic of Argentina*, 727 F.3d 230, 247 (2d. Cir. 2013); *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246, 263-64 (2d. Cir. 2012).
[11] *NML*, 699 F.3d at 264.
[12] Press Release dated August 3, 2020, "The Republic of Ecuador Announces Successful Results of its Consent Solicitation," https://www.prnewswire.com/news-releases/the-republic-of-ecuador-announces-successful-results-of-its-consent-solicitation-301104960.html.
[13] Plaintiffs argued that the indenture's designation of the London Court of International Arbitration as the forum for dispute resolution was not a barrier because their suit alleged claims of U.S. federal securities fraud, rather than breach of contract. The Court noted in its ruling that questions regarding interpretation of the contract "may ultimately be a question for the arbitral tribunal in London." Tr. at 29:4-5 (July 31, 2020), *Contrarian*, ECF No. 37.