Pari Passu Undone: Game-Changing Decisions for Sovereigns in Distress

By **JAMES M. BLAKEMORE** *and* **MICHAEL J. LOCKMAN**[1]

On December 22, 2016, Judge Griesa of the District Court for the Southern District of New York issued an opinion in *White Hawthorne, LLC v. Republic of Argentina*, heralding a new understanding of the infamous *pari passu* clause: going forward, a sovereign's decision to pay some of its creditors and not others does not, on its own, breach the clause.[2] Around five years had passed since Judge Griesa's first interpretation rattled the global sovereign-debtor community and threatened the accepted understanding of customary international law. *White Hawthorne* ended the so-called "Ratable Payment" interpretation in the Southern District.

Background

Following macroeconomic misfortunes in the early 2000s, the Republic of Argentina entered an economic recession plagued by capital flight, devaluation of the peso, and a loss of investor confidence. Unemployment and poverty surged, dozens died in riots in the streets of Buenos Aires, and Argentina cycled through five presidents in ten days. By the end of 2001, Argentina found itself unable to service its more than $80 billion in debt and still maintain essential government services.

No bankruptcy regime exists for insolvent sovereigns. As a result, Argentina resorted to two voluntary global exchange offers in 2005 and 2010 to restructure its distressed bonds. Although the restructuring was largely successful—Argentina exchanged more than 90% of its outstanding external debt—roughly eight percent of creditors rejected both offers. These holdouts consisted primarily of hedge funds that purchased Argentina's often steeply discounted distressed debt and subsequently demanded full payment of principal and interest. Following the first exchange offer, Argentina responded to these tactics by passing the so-called Lock Law, which prohibited "reopening the swap process established in the [2005 exchange offer] with the holdout creditors."[3]

2005 and 2010 Restructuring

1. More than 90% of debt exchanged
2. Par, quasi-par, and discount bonds (between 25 and 35% of original value)

In 2011, several offshore hedge-fund creditors sought to compel repayment based on a novel reading of a previously overlooked boilerplate provision in Argentina's debt instruments. The contractual clause purported to rank the bonds "*pari passu*," i.e., on equal footing, "without any preference among themselves," and required the "payment obligations of the Republic . . . [to] rank at least equally" with all other present and future unsecured debt.[4] The so-called *pari passu* clause traditionally had been understood to be a covenant of "equal ranking," preventing debtors from changing the *legal* ranking of *pari passu* debt through subordination. The hedge funds put forward a different theory, arguing that the *pari passu* clause compels "equal payment": an insolvent state must pay all of its creditors ratably, or pay none at all.[5]

Judge Griesa ruled in favor of the creditors and entered an order enjoining Argentina from paying the holders of restructured bonds without making simultaneous ratable payments to all holdout creditors.[6] Notably, the injunctions similarly restricted the third-party financial intermediaries that assisted Argentina in servicing the bonds it issued as part of its restructuring.

When the Second Circuit affirmed the interpretation and injunction in 2012,[7] the sovereign debt market was thrown into chaos. Sovereigns scrambled to reassess their external-debt fiscal strategies, lawyers pored over the language of bond documentation, and Argentina's financial intermediaries, charged with processing payments on Argentina's performing debt, sweated the potential consequences of violating the order.

The injunctions raised immediate concerns about the judiciary's power to frustrate sovereign debt restructurings, which have historically been conducted as extrajudicial, voluntary processes. The traditional remedy for sovereign debt default is acceleration or a money judgment. When Argentina waived jurisdictional immunity in its bond documents, it relied on the Foreign Sovereign Immunities Act's regime of limiting enforcement to the attachment of commercial property in the United States. Moreover, it waived its jurisdictional immunity in reliance on the traditionally voluntary nature of sovereign debt dispute resolution and restructurings.[8] The injunctions—entirely absent from the FSIA's approach to enforcement—also infringed upon Argentina's rights under customary international law to be free from foreign tribunal rulings that purport to compel a state to act or not act in a certain manner.

In November 2015, Argentina elected Mauricio Macri as President, whose campaign promises had included proposals to resolve the creditors' claims. Agreements in Principle were signed in February 2016 with a group of creditors holding 85% of the claims brought by creditors with *pari passu* injunctions, and Argentina set terms for a proposal to settle *all* non-time-barred claims. Judge Griesa noted that these changes rendered the injunctions no longer equitable, and lifted them accordingly in March 2016.[9]

Key Provisions of 2016 Agreements in Principle

1. Standard proposal: 150% of each bond's original principal amount
2. Payment of settlement dependent on lifting of all *pari passu* injunctions
3. Bondholders must deliver their bonds against payment
4. Elliot and Aurelius: 75% of full judgments including principal and interest

White Hawthorne

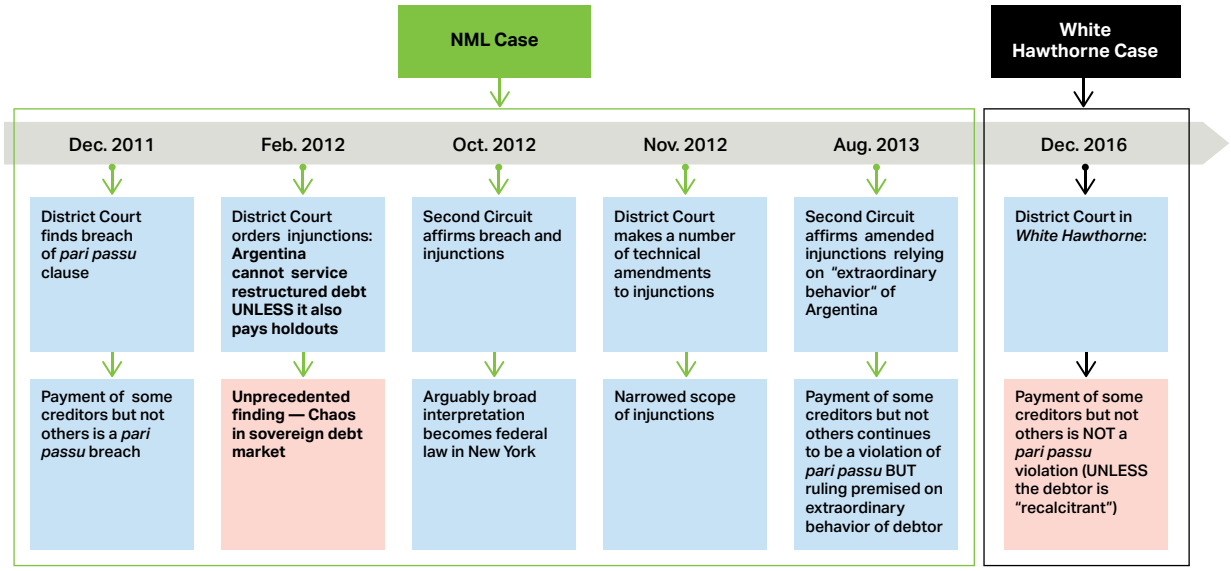
The *White Hawthorne* plaintiffs are a group of hedge funds that filed suit in February 2016 in the Southern District following Argentina's announcement of its global proposal to settle all defaulted debts. Because their holdings were time-barred and thus unacceptable under Argentina's proposal, the plaintiffs brought suit, seeking breach-of-contract damages based on nonpayment of principal and interest, as well as injunctive relief and money damages under the *pari passu* clause.

The plaintiffs argued that Argentina was again in breach of the *pari passu* clause.[10] This time Judge Griesa disagreed, and in so doing, he clarified the nature of Argentina's 2011 breach. The court held that there was no "one element" that resulted in the breach, but rather "a complicated set of circumstances."[11] The court pointed to the "extraordinary conduct," "harmful legislation," and "incendiary statements" of the Kirchner government: "In short, Argentina violated the *pari passu* clause not merely by being a sovereign nation in default, but by being a '*uniquely* recalcitrant debtor.'"[12] From this one can distill *White Hawthorne*'s holding: absent a sovereign's unique recalcitrance, payment to some creditors and not others does not breach the *pari passu* clause.

The *pari passu* clause, in one form or another, is not unique to Argentina's debt, and concern for the effect of Judge Griesa's interpretation has long extended beyond the particular case before him. Unnerved by the court's unprecedented reading, skittish sovereign issuers and other market participants have revised equal treatment provisions to repudiate the district court's interpretation and have added or strengthened collective action clauses.[13] Thus, Judge Griesa's reading of the *pari passu* was fortified against on two fronts: one interpretive and the other practical. On the first front, revised rankings clauses have tended to state that, while the issuer's bonds will rank equally among themselves and certain other debt, equal ranking does not require ratable payments. On the second, collective action clauses have sought to limit the power of holdouts by reducing the number of holders whose consent is required to amend certain key payment terms like the interest rate and principal amount of the bonds.

For debt issued before the *pari passu* decisions, however, whether and to what extent the district court's understanding of Argentina's clause might apply beyond Argentina's debt remained an open question. *NML I* suggested the possibility that dangerous, unexploded ordnance lay strewn throughout numerous outstanding sovereign debt instruments, waiting to be activated.

In its 2013 opinion affirming the district court's amended *pari passu* injunctions, the Second Circuit dismissed these concerns on the grounds that Argentina, in the appellate court's view, was a "uniquely recalcitrant debtor" whose "extraordinary behavior" was unlikely to be repeated by other sovereigns.[14] Still, the *pari passu* clause had, to great effect, become something it was not before, and powerful precedents can be difficult to contain. The series of decisions implementing and affirming the *pari passu* injunctions left unclear precisely which elements of Argentina's conduct sufficed to make it "extraordinary," and sovereigns were left to wonder whether similarly worded clauses in their own debt documents might be refashioned and turned against them.[15]



White Hawthorne has done much to quell anxiety regarding potential fallout from the *NML* rulings. First, the district court deployed an important limiting principle to its interpretation of the *pari passu* clause, applicable regardless of the behavior of the sovereign in question. Payment to other creditors pursuant to a court-approved settlement, the court confirmed, does not violate the *pari passu* clause. The contrary ruling urged by the plaintiffs would have opened the door to a sequence of derailed settlements, in which one holdout wields the clause to prevent payment on bonds and achieve settlement, only to have its own settlement blocked by the next holdout in line. In the district court's view, the *pari passu* clause is constructive rather than destructive, its aim to encourage and enable settlements rather than blow them up. *White Hawthorne* sensibly rejected an application of the *pari passu* clause that would unravel the clause itself.

Second, *White Hawthorne* takes seriously the Second Circuit's view that *NML* was an exceptional case. We now know that the bare decision to pay some creditors and not others, absent other actions on the part of the sovereign, does not violate the *pari passu* clause. Crucially, while Argentina demonstrated its good faith by repealing the Lock Law and other key legislation and signaled its determination to settle with its creditors, it continued to pay and settle with holders of bonds similar to the defaulted bonds on which the *White Hawthorne* plaintiffs brought suit. That such action does not implicate the equal treatment provision significantly curtails *NML*'s precedential value. To quote Judge Griesa's description of Macri's election, *White Hawthorne* "changed everything."

To be sure, *White Hawthorne* is "only" a district court decision. Wary sovereigns might take some comfort, however, in the fact that the Second Circuit's endorsement of the *pari passu* injunctions was circumspect and cabined.[16] Importantly, while the affirmance relied on Argentina's "extraordinary behavior," it left undefined the boundaries and content of that behavior. Favoritism among creditors, for example, was a necessary element, but was it sufficient? In *White Hawthorne*, the district court—the very district court that first gave its imprimatur to what was at the time an unorthodox reading of the *pari passu* clause—answered no.

The decision has dealt a serious blow to creditors who would seek to follow in the hedge funds' footsteps and rouse a dormant equal treatment provision to stymie a sovereign's restructuring efforts in hopes of a windfall. The decision reaffirms that an equal treatment clause is violated in only the rarest of cases—perhaps in only one *sui generis* case. A new Argentina means a disarmed *pari passu* clause, a change that may be the first step in limiting an interpretation of the aberrant facts of a unique case. In the future, judicious sovereigns in default will avoid promulgating lock laws or their kin, and will make clear their willingness to negotiate with their creditors. So long as the offending course of conduct underlying the *pari passu* decisions remains unique to these cases, any *pari passu* clause lurking in the bond documentation of another sovereign is likely to remain inert, regardless of whether the debtor decides to pay one creditor and not another. ■

Pari passu after *White Hawthorne*

1. Argentina no longer breaches the clause by paying some creditors and not others
2. Precedential effect of broad reading of *NML* drastically undermined
3. Sovereigns in default should avoid legislation and public statements signaling unwillingness to negotiate
4. Future cases may build on *White Hawthorne*'s interpretation of the clause

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2. *See generally* White Hawthorne, LLC v. Republic of Argentina, 2016 WL 7441699 (S.D.N.Y. Dec. 22, 2016) ("White Hawthorne").
3. *See* Law No. 26017, art. 2, Feb. 10, 2005, B.O. 30590 (Arg.).
4. *See* Order, NML, 08-cv-06978 at *1 (Dec. 7, 2011); *see* Georges Affaki, Revisiting the Pari Passu Clause, in SOVEREIGN DEBT MANAGEMENT 39, 46 (Rosa M. Lastra & Lee Buchheit eds., 2014).
5. *See* Memorandum of Law in Support of the Renewed Motion of NML Capital, Ltd. for Specific Enforcement of the Equal Treatment Provision at 4–8, NML Capital Ltd. v. Republic of Argentina, 08-cv-06978 (S.D.N.Y. Jan. 6, 2012).
6. Order at 3–4, NML, No. 08–cv–6978 (S.D.N.Y. Feb. 23, 2012).
7. *See generally*, NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246 (2d Cir. 2012); *see also* Lee C. Buchheit & G. Mitu Gulati, *Restructuring Sovereign Debt after* NML v. Argentina, Cap .Markets L. J. * 2–4 (forthcoming 2017) (describing the Second Circuit's holding in *NML*).
8. *See* Brief for the United States as Amicus Curiae at *6, *NML I*, 2012 WL 6777132 (Dec. 28, 2012).
9. Opinion and Order, NML, No. 08–cv–6978 (S.D.N.Y. Mar. 2, 2016).
10. *See* Plaintiffs' Opposition to the Republic of Argentina's Motion to Dismiss Pursuant to Rule 12(b)(6), White Hawthorne *8 (Aug. 25, 2016) ("The *pari passu* counts seek relief for separate violations of Plaintiffs' distinct contractual rights to be treated without discrimination with regard to the holders of external indebtedness.").
11. White Hawthorne, *supra* note 2, at *5.
12. *Id.* (emphasis in original); *see also* W. Mark C. Weidemaier & Ryan Carl, *Creditors' Remedies, in* SOVEREIGN DEBT MANAGEMENT 139, 148 (Rosa M. Lastra & Lee Buchheit eds., 2014) (describing how Argentina was viewed a "uniquely defiant debtor").

13. *See,* e.g., International Capital Market Association, "ICMA New York and English Law Standard CACs, Pari Passu and Creditor Engagement Provisions" (May 2015), *online at* http://www.icmagroup.org/resources/Sovereign-Debt-Information (last visited Mar. 5, 2017).
14. *NML Capital, Ltd. v. Republic of Argentina*, 727 F.3d 230, 247 (2d Cir. 2013).
15. *See* Buchheit & Gulati, *supra* note 7, at *2–4 (explaining that the 2012 *NML* decision did not clarify precisely what constellation of elements of recalcitrance were sufficient to constitute breach of the *pari passu* clause, and noting that the court "simply affirm[ed]" the district court's conclusion that Argentina's course of conduct amounted to a breach").
16. "[W]e have not held that a sovereign debtor breaches its *pari passu* clause every time it pays one creditor and not another, or even every time it enacts a law disparately affecting a creditor's rights. We simply affirm the district court's conclusion that Argentina's extraordinary behavior was a violation of the particular *pari passu* clause found in the FAA." *NML Capital, Ltd. v. Republic of Argentina*, 727 F.3d 230, 247 (2d Cir. 2013) (citations omitted).

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