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Impact of Court Ruling on Argentina's Debt on Future Sovereign Debt Restructurings Is Likely Limited

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On February 18, Argentina filed a petition with the Supreme Court of the United States challenging the US Appeals Court ruling to uphold the right of holdout creditors to be paid in full based on the pari passu clause included in bond contracts.[1] One of the questions presented to the Supreme Court includes "*whether a foreign sovereign is in breach of a pari passu clause when it makes periodic interest payments on performing debt without also paying on its defaulted debt*".

The petition is the latest development in a series of court battles between Argentina and holdout creditors. The litigations have spurred a wide-ranging debate on the possible consequences of the court rulings for future sovereign debt restructurings and have led to proposals from the IMF and others to modify policy responses to sovereign debt crises.[2] In theory, the court ruling can have significant implications for the successful completion of future sovereign debt restructurings, as it can diminish creditor incentives to participate in restructurings and increase the threat of litigation.

In practice, however, implications of the court ruling are likely limited for several reasons.

First, the experience of Argentina with respect to its debt restructuring is unique in the historical context. Of the 36 sovereign bond exchanges that have taken place globally over the past decade and a half, the case of Argentina was the only one that resulted in persistent litigation. There were several unique features about Argentina's experience, including the severity of the economic and banking crises at the time of default, the complexity of the debt restructuring, the steep haircut imposed on investors, and the amount of holdout debt. Argentina was also unique in passing the "Padlock law" in 2005 which forbade the government to settle with creditors who refused to participate in the debt restructuring.

[1] In a parallel case, on February 24, Argentina filed a brief with the Supreme Court in an appeal case involving the question of whether or not holdout creditors have the right to receive information related to Argentine foreign assets from financial institutions.

[2] See IMF Debt Restructuring Proposals Are Credit Negative for Distressed Sovereign Bondholders, June 2013.

Our research[3] shows that in general sovereign bond restructurings were resolved quickly, without severe creditor coordination problems, or litigation. On average, since 1997, sovereign bond restructurings closed seven months after the start of negotiations with creditors and half of exchanges closed within four months. Creditor participation averaged 95%. In only two cases did holdout creditors represent more than 10%. Runs to the courthouse have been the exception rather than the rule in sovereign debt crises.[4]

Second, while it is true that pari passu clauses are a standard feature of sovereign bond contracts, they are not all on equal footing and do not have the same formulation as those in Argentina's bonds. In fact, one of the three common formulations, found in the majority of sovereign bonds issued over the past two decades and in almost all bonds issued earlier, is not susceptible to holdout litigation.

Pari passu clauses exist in three common formulations:

1) The first and most common version states that "the bonds rank pari passu with all External Indebtedness".

2) The second version of the clause might state that "the bonds will rank pari passu in priority of payment and in rank of security".

3) The third formulation adds "and shall be paid as such" to the "rank equally" clause.[5]

Legal experts generally consider the first version of the clause not readily susceptible to legal challenges. The last two versions are more susceptible to Argentina-style litigation as they explicitly require equal treatment at the moment of payment. The first version of the pari passu clause is the more common one: it exists in almost all sovereign bonds issued before 1990, in about two-thirds of sovereign bonds issued in the 1990s, and in almost half of the bonds issued in the 2000s.[6]

Further, the market is starting to adapt to the ambiguity in the interpretation of the pari passu clause by explicitly specifying in sovereign bond contracts that the pari passu clause should not be interpreted to mean "ratable payment".

Finally, Argentina's bonds did not contain collective action clauses (CACs), but CACs are prevalent in sovereign bond contracts and limit the potential effect of the court ruling. CACs allow a supermajority of creditors to amend the bonds payment terms and can be used to bind a larger share of creditors in a restructuring. Further, exit consents, which allow a smaller majority of creditors to change the non-payment terms of the old bonds, can also be used to bind a larger share of creditors in a debt restructuring. CACs and exit consents have already played a significant role in sovereign bond exchanges: 35% of exchanges since 1997 relied on using CACs or exit consents.

[3] Moody's sovereign default research is available at http://www.moodys.com/sdr

[4] For more details, see The Role of Holdout Creditors and CACs in Sovereign Debt Restructurings, April 2013.

[5] The pari passu clause in the old Argentine bond issues reads as follows: "[t]he Securities will constitute … direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all time 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 …"

[6] For more detailed analysis, see our previous comment US Court Ruling on Argentina's Debt Could Have Limited Implications for Sovereign Debt Restructurings, December 2012 and Weidemaier, M., Scott, R. and Gulati, M., Origin Myths, Contracts, and the Hunt for *Pari Passu*, Law and Social Inquiry, Volume 38(1), p. 72-105, Winter 2013.

The vast majority of foreign-law sovereign bond contracts contain CACs: CACs are commonly included in New York law issuances since 2003 and are typical in English law bonds. Moreover, CACs can be retroactively inserted in domestic-law bonds by an act of legislation, as was done in the case of Greece. Thus, the pari passu clause risk is more applicable to New York law bonds issued before 2003, which contain "high risk" pari passu clauses but no CACs. And even in these cases, exit consents can be used to legally subordinate holdout bonds (for example, by waving the pari passu and negative pledge clauses on old debt).

In summary, the risk of Argentina-style litigation is applicable in a limited set of circumstances where all three conditions occur:

» The sovereign bonds contain the formulation of the pari passu clause requiring equal treatment at the moment of payment. This is the less common version of the pari passu clause and the clause is increasingly being modified in new bond contacts.

» The bonds do not contain CACs. This is generally limited to the set of bonds issued under New York law before 2003.

» Significant amount of holdout creditors exist during the sovereign debt restructuring. Historically, this has been extremely rare.

And even in these cases, exit consents can be used to legally subordinate holdout bonds in a sovereign debt restructuring.

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