CURRENT QUESTIONS ON SOVEREIGN DEBT

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In 2001 Argentina defaulted in respect of sovereign debt due to bondholders. The total principal indebtedness was of the order of $80 billion, with interest accruing. In 2006 Argentina restructured its debt on unattractive terms which were not accepted by a large number of overseas bondholders, including a hold-out creditor named NML Capital, which took proceedings in the courts of New York. The decisions at first instance, upheld on appeal by the Second Circuit,[1] caused surprise, not to say consternation, not only in the United States but throughout the financial world. But a further appeal to the US Supreme Court was denied.

For lawyers (as opposed to politicians or economists) there are three main questions arising out of this litigation. The first question is the interpretation, as a matter of contract law, of the terms on which the bonds were issued. The particular focus is on the "*pari passu*" clause which is almost invariably found in those terms. The contractual terms will normally be interpreted in accordance with the governing law, although that will depend, ultimately, on the law of the state in which the proceedings are brought – that is, the *lex fori.* In practice, and not as a coincidence, the governing law and the *lex fori* tend to be the same.

The second question is that of remedies, if the issuing sovereign state (having submitted to the jurisdiction of some national court) is held, as a matter of contract law, to be in breach of its obligations. This is a very different type of problem, as it engages sovereign immunity, which is an old and well-established principle of public international law. In the courts of New York NML Capital succeeded in obtaining an injunction with far-reaching effects.

The third question is whether the best answer to these difficulties, and an acceptable answer for international markets, would be a move towards stronger collective action clauses (CACs), by which a majority of bondholders can bind a dissentient hold-out minority. Particular attention has focused on what are called

[1] *NML Capital v Republic of Argentina* 699 F 3d 246 (Second Circuit, 2012); *NML Capital v Republic of Argentina* 727 F 3d 230 (Second Circuit, 2013). In the UK *NML Capital v Republic of Argentina* [2011] 2 AC 495 contains (in the judgment of Lord Collins at paras 100-108) an erudite and entertaining account of the surprisingly long history of default on sovereign debt

single-limb CACs, by which voting rights are aggregated across bond of different series.

It may be best to start with sovereign immunity. The principle is recognised all over the world, but different national legal systems interpret and apply it in different ways. Most legal systems now accept that sovereign immunity should be limited to activities and assets which a sovereign state undertakes or holds *jure imperii* (that is, in its capacity as a sovereign power) and should not extend to activities or assets undertaken or held *jure gestionis* (that is, for the purposes of trade). Of major trading nations only the People's Republic of China (including Hong Kong) does not recognise the distinction.[2] But among national legal systems which do recognise the distinction, there are many differences on matters of detail. So here too the law of the state in which proceedings are brought – the *lex fori* – is very important.

Anyone unfamiliar with this topic might suppose that with so many different legal systems in play that it would be impossible to make any useful generalisations about litigation in the courts of a multitude of different states. But the IMF has recently estimated that almost 90 per cent of international sovereign bonds (not governed by the law of the issuing state) are governed either by the law of New York (about 48 per cent) or by English law (about 40 per cent). The courts of New York, or those of England, are therefore the natural forum for the first stage of any proceedings by a hold-out bondholder, that is the obtaining of a judgment. But when it comes to the second stage, the enforcement of the judgment, the chosen forum will be any state in which the defaulting state has assets held *jure negotii* which the judgment creditor can attach. This can be illustrated by an appeal heard in London by the Judicial Committee of the Privy Council, on appeal from the Court of Appeal of the island of Jersey, where assignees of sovereign debt (not in that case arising from a bond issue) sought to enforce an arbitral award against the Democratic Republic of the Congo by execution against a Jersey company entitled to a flow of royalties from a state-owned mining company. The claim failed because the Privy Council was not satisfied, despite evidence of government control, that that company should be identified with the republic.[3]

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[2] *Democratic Republic of China v FG* [2011] HKCFA 42

[3] *La Generale des Carrieres et des Mines Sarl v Hemisphere Associates LLC* [2012] Lloyds Rep 443; cf *Kensington International Ltd v Republic of Congo* [2006] 2 BCLC 296 (later proceedings in the case at fn 10)

In the United States and in England the scope of sovereign immunity is defined in a statutory code. In the United States the relevant statute is the Foreign Sovereign Immunities Act ("FSIA"). In England it is the State Immunity Act 1987.[4] In the United States there have been calls for FSIA to be amended, but there is no unanimity about the direction of change. In 2006 Professor Hal S Scott of Harvard called for judgment creditors to given more robust powers of enforcement,[5] but other commentators, including the authors of an IMF paper published in 2014, favour changes to reduce the power of hold-out creditors, especially by the use of more effective collective action clauses.[6]

The particular novelty, and importance, of the recent litigation in the United States in relation to Argentina's sovereign debt is that the court reached, not one, but two unprecedented conclusions.[7] The first was its very wide interpretation of the *pari passu* clause. The second was that it was persuaded, in effect, to concertina what I have called the first and second stages, that is first obtaining a judgment and then enforcing it. The concertina effect was produced by the grant of an injunction directed not only at the defaulting state, Argentina, but also at trustees, paying agents and other intermediaries, prohibiting any payments to holders of restructured bonds unless the hold-out bondholders were paid *pari passu*.

Arguably the remedy granted by Judge Griesa, and upheld on appeal by the Second Circuit, was exorbitant, since in substance (though not in form) it amounted to a decree of specific performance against a sovereign state. In any case there would have been no possibility of its being granted if the court had accepted Argentina's argument on the interpretation of the *pari passu* clause. So I come back to what I called the first question.

One point to note, I suggest, is that the expression *pari passu* – in English, "with an equal step" - has its natural context in national systems of insolvency or bankruptcy law, under which bankruptcy is the collective enforcement of the rights of creditors, under judicial supervision, against the assets of the debtor. A sovereign

[4] The 2004 UN Convention on Jurisdictional Immunities of States and their Property will come into force if and when ratified by 30 member states. At a recent date it had been signed by 28 states (not including the USA or the UK) but ratified by only 14

[5] Scott, Sovereign Debt Default: Cry for the United States, not Argentina, Washington Legal Foundation Working Paper No 140, 2006

[6] IMF Staff Paper, Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring, 2014

[7] There is a detailed account of the litigation in the IMF Staff Paper

independent state may be insolvent but it cannot be made bankrupt. Public international law does not provide any mechanism, or any judicial oversight, comparable to those found in national systems. The IMF did, about twelve years ago, put forward proposals for a Sovereign Debt Restructuring Mechanism, but it attracted more opposition than support, and nothing has come of it. Instead, CACs came to be used more and more frequently.

The fact that a sovereign state cannot be made bankrupt is, I suggest, a disability rather than a privilege. Every time that a trading company goes into Chapter 11 bankruptcy in the United States, or into administration in England, and has a good prospect of success in trading out of its insolvency, there is a practical demonstration that *pari passu* is concerned with equality of rank or status, and not with equality of payment. The company will, with judicial approval in case of doubt, pay its debts to employees and to its essential suppliers who are unwilling to grant extended credit, without making proportionate payments to bondholders or other providers of loan capital.

That is a necessary qualification to the well-known words in Professor Lowenfeld's opinion in the *Elliott* case[8]: "A borrower from Tom, Dick and Harry can't say: I will pay Tom and Dick in full, and if there is anything left over I'll pay Harry."[9] An obligation (the word almost always used in *pari passu* clauses) can arise otherwise than under a loan transaction, and if Tom is an employee, and Dick a supplier of essential goods, Harry may have to wait. The necessity of keeping the business going is even more obvious in the case of a sovereign state whose business is running a country.

Each case must of course turn on the precise words of the clause in question. For instance two bond issues made by Estonia in 2002 and Croatia in 2001 used similar language except that the words "in right of payment" appeared immediately after "*pari passu*" in the Croatian bonds. But they are not clear or emphatic and they admit of alternative explanations. There was a reference to "payment" in the most relevant English decision, *Kensington International*.[10] The judge was disinclined to give it much weight, but ultimately decided the case on other grounds. English courts are increasingly concerned to look for business purpose and business efficacy in

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[8] *Elliott Associates v Banco de la Nacion [of Peru]* Ct of App of Bruxelles, 26 Sept 2000
[9] Buchheit and Pam, The Pari Passu Clause in Sovereign Debt Instruments, 53 Emory Law Journal 869, 2004, especially the section headed "Tom, Dick and Harry in Brussels"
[10] *Kensington International Ltd v Republic of Congo,* 16 April 2003, [2003] EWHC 2331

interpreting commercial documents, and that approach supports the traditional, more limited construction of these clauses. They may be directed to more limited aims, such as avoiding the sort of involuntary subordination which can occur in the Philippines (and could, until recently, occur in Spain).

Uncertainty will remain, however, and in the United Kingdom the general view is that strengthened collective action clauses will provide the best way forward. In the past such clauses have often been ineffective because one or more hold-out creditors could obtain a blocking position (usually 25 per cent) of a particular series of bonds, and so reduce the prospect of a successful restructuring plan. The single-limb aggregated voting mechanism counts votes across several series of bonds. In that way it obviates the need for support from the requisite majority of each series. In August 2014 the International Capital Markets Association published a standard model CAC with some variant forms, including one for single-limb voting.

The validity of such a clause has been upheld by the English court in the *Redwood Master Fund* case.[11] The judge said, "By signing up at the outset, each lender submits to the decision of the majority of lenders at important forks in the road". This precedent is likely to be followed, provided that there is no misrepresentation, oppression or bad faith. That proviso is necessary because no CAC will be treated as "conferring on the majority an unfettered power to act arbitrarily, capriciously or oppressively."

Stronger CACs are of course a way of avoiding problems on future bond issues. They cannot be imposed on holders of bonds already issued on different terms. Lee Buchheit of Cleary Gottlieb, who has huge experience in this field, has estimated that even if there is an immediate general adoption of stronger CACs, it will take a decade or more before all the sovereign bonds now in issue (whose total value, after deducting recent issues with stronger CACs, may be of the order of $900 billion) have been redeemed.[12] In the meantime early indications in the United Kingdom are that stronger CACs will not significantly affect the pricing or rating of new bond issues.[13]

In this short paper I have referred to several sources, but in closing I must acknowledge that easily my most important source has been research by members and

[11] *Redwood Master Fund Ltd v TD Bank Europe Ltd* [2012] EWHC 2090 (Ch), paras 98 and (on oppression)
[12] Buchheit, Sovereign Debt Restructurings: Recent Developments and Future Prospects, 2015
[13] FMLC Survey, 2015

staff of the Financial Markets Law Committee, which I have the honour to chair. A very recent publication[14] brings together four papers produced between March 2005 and last April by a succession of distinguished working parties. These papers have been an invaluable guide to me, but any errors or omissions are my own.

[14] FMLC, Issues of Legal Uncertainty Arising in the Context of Sovereign Debt, May 2015