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Don't Cry for Me Argentine Bondholders: the Second Circuit Decides NML Capital v Argentina

The US Court of Appeals for the Second Circuit has just released its decision in *NML Capital, Ltd. et al., v. The Republic of Argentina* (Docket No. 12-105(L)) (2d Circuit, October 26, 2012). This important decision arises from the contentious restructuring of Argentina's sovereign debt, and in particular Argentina's steadfast refusal to honor bonds whose holders have declined Argentina's exchange offers. In *NML*, the Second Circuit adopted a broad construction of the so-called *pari passu* clause, a provision that is virtually universal in sovereign debt instruments, and which has long been ill-defined. However, the Circuit Court raised major questions about the terms of the relief to be granted to the plaintiffs, and remanded the matter back to the District Court for further proceedings. The outcome of those further proceedings could have major repercussions, on, for example, the value of Argentina's debt and on the role of intermediaries in the payment streams with respect to such debt.

The Dispute

The plaintiffs in this case are holders of sovereign bonds issued by the Argentine Republic pursuant to a Fiscal Agency Agreement ("FAA") prior to Argentina's 2001 default ("FAA Bonds"). The plaintiffs' bonds are in default, and are the subject of federal court judgments, which are unsatisfied.

The FAA contains a *Pari Passu* Clause, which provides, in two sentences, as follows:

> *[1] The Securities will constitute … direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank pari passu and without any preference among themselves.*
>
> *[2] The payment obligation 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.…*

No payments have been made on the FAA Bonds since 2001.

In 2005 and again in 2010, Argentina made exchange offers to holders of FAA Bonds, pursuant to which bondholders who tendered FAA Bonds received new bonds ("Exchange Bonds"). As the result of the two exchange offers, approximately 91% of

the FAA Bonds were tendered, and the Exchange Bonds have been kept current by Argentina. The plaintiffs' FAA Bonds were not tendered into the exchange offer.

Argentina has made it clear that it does no intend to make any further payments on the plaintiffs' unexchanged FAA Bonds. For example, the prospectuses for both the 2005 and the 2010 exchange offers had language providing:

> *[FAA Bonds] that are in default and that are not tendered may remain in default indefinitely…Argentina does not expect to resume payments on any [FAA Bonds] that remain outstanding following the expiration of the [exchange offer]…there can be no assurance that [holders of unexchanged FAA Bonds] will receive any future payments or be able to collect through litigation.…*

Further, Argentina adopted legislation, referred to as the "Lock Law," that prohibited the Argentine state from making any arrangement to pay the unexchanged FAA Bonds: "*The national State shall be prohibited from conducting any type of in-court, out-of-court or private settlement with respect to [unexchanged FAA Bonds].*"

District Court Proceedings

The plaintiffs applied to the United States District Court for the Southern District of New York for a determination that Argentina's conduct in making full payment on the Exchange Bonds while making no payments on the FAA Bonds constituted a breach of the *Pari Passu* Clause. (The matter was referred to Judge Thomas Griesa, who has been assigned to hear all matters arising out of Argentina's 2001 default.) In a series of rulings running from December 2011 through March 2012, Judge Griesa agreed, holding that Argentina breached the *Pari Passu* Clause "*by lower[ing] the rank of [the plaintiffs'] bonds in violation of [the Pari Passu Clause] of the FAA when it made payments currently due under the Exchange Bonds, while persisting in its refusal to satisfy its payment obligations currently due under the [plaintiffs'] Bonds*" and through enactment of the Lock Law.

The District Court then issued the following injunction (the "Injunction"):

- *Whenever the Republic pays any amount due under terms of the bonds or other obligations issued pursuant to the Republic's 2005 or 2010 Exchange Offers … the Republic shall concurrently or in advance make a "Ratable Payment"… to [Plaintiffs]*
- *Such "Ratable Payment" … shall be an amount equal to the "Payment Percentage" … multiplied by the total amount currently due to [Plaintiffs].…*
- *Such "Payment Percentage" shall be the fraction calculated by dividing the amount actually paid or which the Republic intends to pay under the terms of the Exchange Bonds by the total amount then due under the terms of the Exchange Bonds.*

The District Court also prohibited Argentina from "*altering or amending the processes or specific transfer mechanisms by which it makes payments on the Exchange Bonds….*" Further, the District Court ordered Argentina to provide copies of its injunction "*to all parties involved, directly or indirectly, in advising upon, preparing, processing or facilitating any payment on the Exchange Bonds (collectively, 'Agents and Participants'),*" and further provided that "*such Agents and Participants shall be bound by the terms of this ORDER….*"

Argentina appealed, and the District Court suspended the effectiveness of its injunction pending the Second Circuit's disposition.

Appeal

Construction of the Pari Passu Clause

On appeal, Argentina argued that the District Court had misconstrued the *Pari Passu* Clause, which Argentina argued has been "*universally understood for over 50 years*" to provide bondholders only with protection from "*discriminatory legal ranking*" and the creation of unfavorable "*legal priorities*." However, the Second Circuit was "*unpersuaded*":

> *Instead, we conclude that in pairing the two sentences of its Pari Passu Clause, the FAA manifested an intention to protect bondholders from more than just formal subordination. The first sentence … prohibits Argentina, as bond issuer, from formally subordinating the bonds by issuing superior debt. The second sentence … prohibits Argentina, as bond payor, from paying on other bonds without paying on the FAA bonds, Thus, the two sentences of the Pari Passu Clause protect against different forms of discrimination: the issuance of other superior debt (first sentence) and the giving of priority to other payment obligations (second sentence). [citations omitted]*

The Second Circuit went on to say that the Pari Passu Clause was particularly important to holders of sovereign bonds:

> *When sovereigns default they do not enter bankruptcy proceedings where the legal rank of debt determines the order in which creditors will be paid, Instead, sovereigns can choose for themselves the order in which creditors will be paid. In this context, the [Pari Passu Clause] prevents Argentina as payor from discriminating against the FAA Bonds in favor of other unsubordinated, foreign bonds.*

Finally, the Second Circuit endorsed the District Court's determination that "*Argentina effectively has ranked its payment obligations to the plaintiffs below those of the exchange bondholders*." The Court went on to say that as the result of Argentina's refusal to pay the FAA Bonds, its announcements that it would not pay those bonds and the enactment of the Lock Law, "*we have little difficulty concluding that Argentina breached the Pari Passu Clause of the FAA*."

The Injunction

The Second Circuit then addressed the terms of the Injunction issued by the District Court. Argentina advanced many arguments against the terms and scope of the Injunction, all of which the Circuit Court again held to be "*unpersuasive*." One such argument was that the plaintiffs were limited solely to the "*contractually agreed upon remedy of acceleration*" of the FAA Bonds. In rejecting this argument, the Court held that, in the absence of limiting language in the FAA, "*the full panoply of appropriate remedies remains available*."

In addition, Argentina argued that the Injunction constituted a *de facto* attachment, and was thus prohibited by the Foreign Sovereign Immunities Act (*see* 28 USC §1609). The Court rejected this argument, holding that the Injunction can be complied with "*without the court's ever exercising dominion over sovereign property*."

However, the Circuit Court was concerned about at least two aspects of the Injunction. First, the Second Circuit pointed out that the "*ratable payment*" mechanism contained in the Injunction was unclear and appeared to be ambiguous, as it could be read to provide for vastly different scales of payment to FAA bondholders. Second, the Court stated that it was concerned that the application of the Injunction to "*pure intermediaries*" potentially violated the protections in favor of intermediaries provided for in UCC Article 4-A. The Court noted that "*Plaintiffs claim that the Injunctions do not encompass*

intermediaries, but they fail to offer a satisfactory explanation for why intermediary banks would not be considered 'indirect[ ] … facilitat[ors]' apparently covered by the Injunctions."

Accordingly, the Circuit Court remanded the case back to the District Court for additional proceedings with respect to the terms of the Injunction. Adopting an unusual procedural mechanism and recognizing that further appellate proceedings are inevitable, the Circuit Court provided that, once "*the District Court has conducted such proceedings, the mandate should automatically return to this Court and to our panel for further consideration of the merits of the remedy without need for a new notice of appeal.*"

What's Next?

On remand, District Court Judge Griesa will be required to substantially clarify and tighten up the provisions of the Injunction, both in terms of the mathematical formula for payments to holders of FAA Bonds and the difficult question as to how "*pure intermediaries*" are to be insulated.

Based on his past handling of Argentina-related cases, Judge Griesa is likely to move forward on these issues with relative speed. While hard to predict, a fair estimate is that Judge Griesa will issue a revised Injunction in the next two to three months.

Thereafter the appeal will be abbreviated. The brevity of the appeal is reflected by the Second Circuit's decision to remand using the procedure established by *United States v. Jacobson*, 15 F.3d 19, 22 (2d Cir. 1994), for supplementation of the record on appeal. Under *Jacobson*, the Second Circuit panel formally issues a mandate to the district court, but after the district court supplements the record, the mandate returns to the same panel without a new notice of appeal or necessarily a new round of briefs. Thus, after Judge Griesa clarifies and tightens the Injunction, the mandate will return to the same panel without the potential 30 days to file a notice of appeal and with appellate briefs likely limited to supplemental briefs addressing only the modified Injunction (consistent with the panel's statement that it will consider only "*the merits of the remedy*"). Assuming that Judge Griesa complies with the mandate in late 2012 or early 2013, the Second Circuit would likely issue its decision too late for any *certiorari* petition to be considered by the US Supreme Court in its current Term, with any petition becoming part of the "summer list" to be decided in the order list that issues shortly before or on the first Monday of October 2013.

Unless it can persuade Judge Griesa or the Second Circuit panel to change their minds, Argentina's options appear limited to seeking rehearing en banc now or after the return of the mandate or seeking review in the United States Supreme Court. Effective review would require a further stay pending appeal, which may be possible given that the application would be on behalf of a foreign state and that it might be supported by the United States. A stay pending appeal would buy time – perhaps until the first Monday in October, 2013 – but Supreme Court review of the Second Circuit's construction of the *Pari Passu* Clause would seem to be a stretch because that question is purely one of state (New York) law. The only federal question at issue on the appeal is whether the Injunction, which does not by its terms transfer the property interests of a foreign state, has the practical effect of requiring Argentina to transfer funds amounting to the balance of principal and interest owed to plaintiffs on the next occasion that it makes a payment on the Exchange Bonds in violation of Section 1609 of the Foreign Sovereign Immunities Act – thus effectively forcing Argentina to choose between defaulting on the Exchange Bonds or paying the accelerated FAA Bonds in full. Whatever the merits of that question, it is not the principal one presented by this appeal and its answer likely turns on the particulars of Judge Griesa's injunction.

Implications

As both the "how" and the "how much" that the final Injunction may require has been left to the District Court to determine, much uncertainty remains. The how much may be the easier of the two issues to resolve. The original District Court decision talked about a "Ratable Payment" and "Payment Percentage." Does this mean that the unexchanged FAA Bonds which have not matured are reinstated and made current? How will this apply to the unexchanged FAA Bonds which have matured? In both cases, the bonds are fully accelerated. If the totality of the unexchanged bonds constitute 10% of the total amount of *pari passu* debt outstanding, does that mean that the unexchanged bonds are now to receive 10% of any payment made to the Exchange Bonds? If the Exchange Bonds are currently being paid in full, does that mean that the unexchanged FAA Bonds should also be paid in full. The Court stated that:

> *… Argentina can pay all amounts owed to its exchange bondholders provided it does the same for its defaulted bondholders. Or it can decide to make partial payments to its exchange bondholders as long as it pays a proportionate amount to holders of the defaulted bonds. Neither of these options would violate the Injunctions.*

As a practical matter, any partial payment under the Exchange Bonds will result in a default of the Exchange Bonds, and the implication is that in order to avoid a default on the Exchange Bonds, the unexchanged bonds would have to be paid in full.

As to the "how," the Court of Appeals is quite concerned about how to apply the ruling to intermediary banks. According to the Court's recitation of the facts:

> *Under the indentures for the 2005 and 2010 Exchange Bonds, Argentina makes principal and interest payments to a trustee in Argentina that in turn makes an electronic funds transfer ('EFT') to US-registered exchange bondholders. The EFTs are made from the trustee's non-US bank to the registered holder's US bank, often routed through one or more intermediary banks.*

The Court also made clear that it was not invoking a "*sharing clause*" which would require holders of Exchange Bonds to share payments received by them with the plaintiffs. If the payment stream cannot be interfered with in the hands of intermediary banks because of the Court of Appeals' concern that such interference would violate the UCC, and payments cannot be clawed back from holders of Exchange Bonds under a sharing theory, it is quite unclear how flows would in fact be diverted in order to effectuate the holding of the Court.

The Court dismissed the relevance of this case to other sovereign issuers, stating that:

> *it is highly unlikely that in the future sovereigns will find themselves in Argentina's predicament. Collective action clauses – which effectively eliminate the possibility of 'holdout' litigation – have been included in 99% of the aggregate value of New York-law bonds issued since January 2005, including Argentina's 2005 and 2010 Exchange Bonds. Only 5 of 211 issuances under New York law during that period did not include collective action clauses, and all of those issuances came from a single nation, Jamaica.*

However, the Court was only looking at bonds issued since 2002, when Collective Action clauses were first introduced into New York law sovereign bonds and ignores the fact that there are billions of dollars of sovereign bonds outstanding that were issued prior to 2002 that are now subject to this interpretation of the *pari passu* clause.

The next few months should prove illuminating.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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