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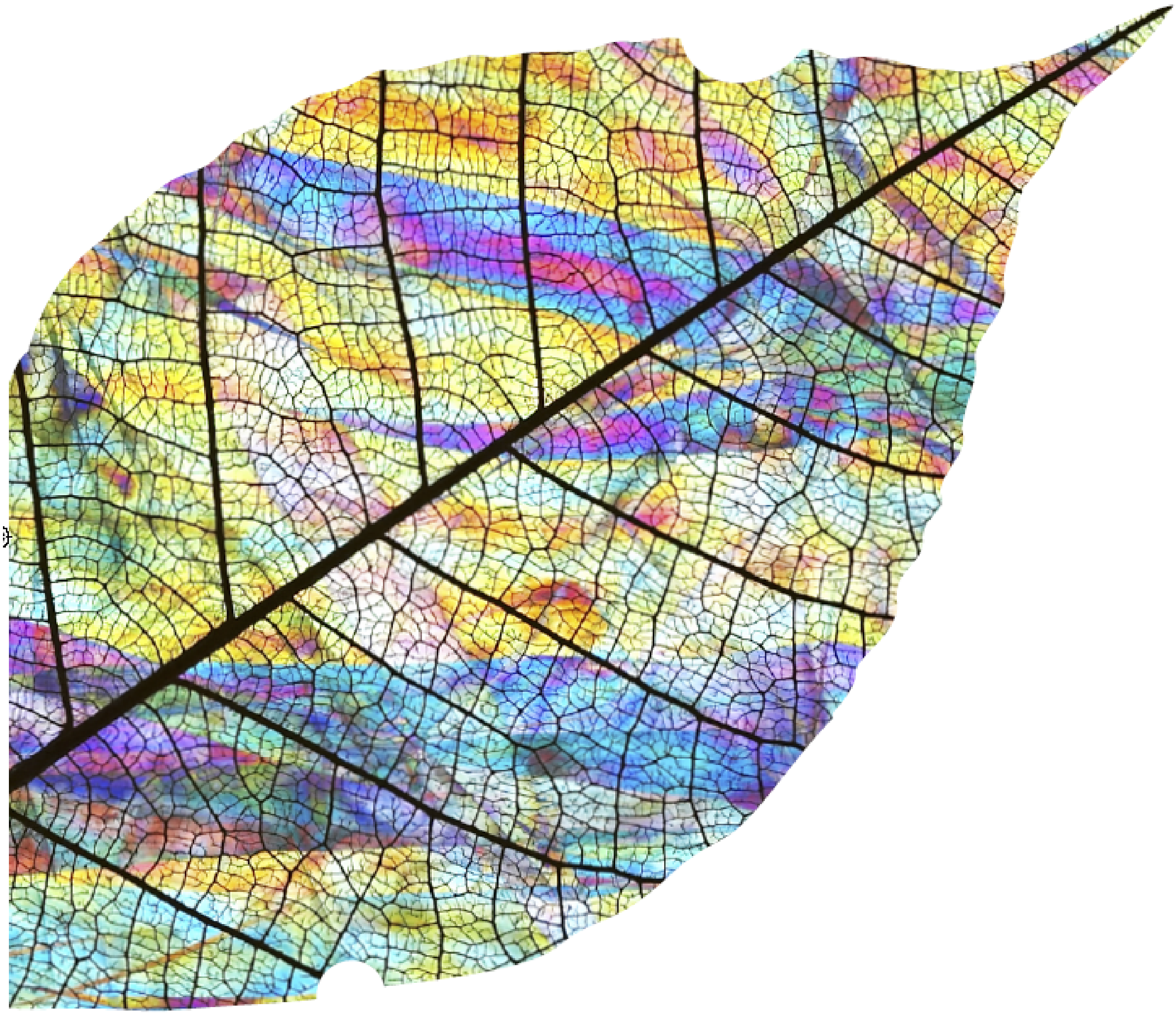

The *pari passu* clause and the Argentine case

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Executive summary

The case of *NML Capital Ltd v Argentina* decided by a U.S. Federal court of appeals in New York in October 2012 held that Argentina violated a standard *pari passu* clause in its old unrestructured bonds and therefore Argentina was ordered not to make any payments on new bonds unless it made a rateable payment to the holders of the old bonds. The new bonds had been exchanged for most of the old bonds in 2005 and 2010 pursuant to the restructuring of Argentina's foreign debt.

The court held that the reasons for the violation were a combination, amongst other things, of a statute passed by Argentina preventing Argentina from paying the holders of the old bonds as holdouts, declarations by Argentina that it would not pay the holdouts and the persistent non-payment of the holdouts for six years.

The *pari passu* clause typically provides that the bond debt will rank *pari passu* with other debt or, in the case of sovereigns, other external debt. It is a standard provision in international sovereign and private sector bonds.

One of the reasons the case is important is because of the consequences of adopting one of the two main competing interpretations of *pari passu* clauses, the narrow interpretation and the wide interpretation. The narrow interpretation holds that there is a breach of the *pari passu* clause only if the debtor subordinates the protected debt by some legal or mandatory measure which changes the legal ranking. The wide interpretation holds that once a debtor is in fact insolvent or in payment default, it cannot actually pay any of its debts without a rateable payment of other debts within the scope of the *pari passu* clause.

The narrow interpretation, which accords with the mainstream market understanding of the clause, does not normally give rise to problems: the clause is treated as boilerplate because sovereigns very rarely change the ranking of their obligations by specific statutes. The wide interpretation, however, would prevent sovereigns and indeed other corporate or bank debtors from making any unequal payments when they are in fact insolvent or even just in any kind of payment default. This could inhibit payments to preferred creditors such as multilaterals or to creditors where it is desirable in the interests of stability of the markets or of the protection of a corporate debtor's business.

It is unclear which interpretation the court sided with although it held that Argentina's overall course of conduct was sufficient to allow the court to reach its decision. In doing so the wider interpretation seems to be the preferred one but not with sufficient discussion of the issues and clarity of principle and policy. Accordingly, there is uncertainty as to what the court intended and the possibility of de-stabilizing litigation.

Although the decision is a decision on bonds governed by New York law, a decision by a senior court in New York might influence courts elsewhere and could, in any event, affect bonds not governed by New York law.

If the wider interpretation were adopted, then this could have disruptive implications for work-outs and the resolution of financial difficulties in the case of sovereign debtors and private sector debtors. The use of collective action clauses could mitigate the problem of holdout creditors but the protections would not be comprehensive.

The case is also important because, instead of just leaving the creditor to its ordinary remedies for a default, the court made a tough order compelling Argentina to make rateable payments to the creditor if Argentina paid the new bonds.

Some commentators have said that the cases is to be welcomed because the ruling strengthens creditors rights against a sovereign state which is able but unwilling to pay and that the ruling delivers a message to the more aggressive defaulting states that the courts can get tough. Our view, however, is that the case needs also to be viewed outside the saga of the Argentina litigation and in the wider context of the debt markets. A *pari passu* clause is standard in virtually all major international bonds and bank syndicated credits so that the amounts involved probably run into trillions of dollars or the equivalent. In our view, the wider interpretation suggested by the New York courts is contrary to the intentions of the parties and would therefore create considerable instability in financial markets. It would give individual creditors the possibility of very unexpected events of default. It would effectively give individual creditors a veto right during restructuring negotiations because inevitably during restructurings, both corporates and sovereigns have to be able to keep making some payments in order to keep going and it is desirable in the interests of a rescue that they should, e.g. payments to employees and trade payments and rent in the case of corporates and essential payments in the case of sovereign states.

The debate on the ambit of the *pari passu* clause has been running since around 2001 following a case in Belgium. It is highly desirable that U.S. courts, as the custodians of one of the most important legal systems in the world used as a public utility in relation to very large financial contracts, should settle this issue with clarity, certainty and regard for the operations of the debt markets as a whole. It is our view, that the public interest would be served if such a settlement were to be made in favour of the narrow interpretation. The wider interpretation of equality of payment would have unintended consequences and would destabilise the vast debt market where the *pari passu* clauses are prevalent. Clauses requiring equality of payment are extremely rare in financial practice and are, in our view, not contemplated by the standard *pari passu* clause. If parties wish to insert clauses about equality of payments, as opposed to legal ranking, it is open to them to do so.

Purpose of this paper

This paper deals with the implications of the case of *NML Capital Ltd v Argentina* decided by the U.S. Federal Court of Appeals for the Second Circuit in New York on 26 October 2012. The case was on appeal from the district court in the Southern District of New York and is likely to be further appealed.

Although the decision applies specifically to sovereign debt contracts governed by New York law, it could have an impact on bondholders whose debt is not governed by New York law if the sovereign has also issued bonds which are governed by New York Law. The decision also could have major implications for bonds issued by corporates, banks and others and might influence courts in other jurisdictions.

What the case decided

The plaintiff hedge fund held Argentinean bonds issued since 1994 – these are called the old bonds. In 2005 and 2010 Argentina restructured most of the old bonds by making an exchange offer for new bonds which were worth about 25% of the old bonds. Eventually about 91% of the holders of the old bonds accepted the offers but the plaintiffs did not accept and were therefore holdouts.

Argentina refused to pay the holders of the old bonds and instead in 2005 passed a law, known as the Lock Law, declaring that the state was prohibited from paying these holdout old bonds. Argentina also passed budget laws imposing a moratorium on the holdout bonds. The Lock Law was intended to encourage holdouts to participate in the exchange since otherwise holdouts would not be paid. If holdouts were paid immediately, then they would have priority over those who had accepted the new bonds and in addition the holdouts would receive 100% of the nominal amount of the old bonds, even though in many cases they presumably paid much less for their bonds in the market. The crucial point however is that Argentina passed a statute so that the non-payment of the holdouts was made mandatory by law.

The court held that the Lock Law, the moratorium legislation, various declarations and filings by Argentina and the persistent non-payment of the holdouts together constituted a violation of the *pari passu* clause in the old bonds. The court did not clarify whether any of these factors on its own was enough but rather that the whole course of conduct of Argentina was sufficient.

The *pari passu* clause in the old bonds follows one of the variant formulations found in bond issues and 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 …

External Indebtedness was defined as obligations payable in non-Argentine currency.

The court said that there was a difference between the two sentences because otherwise the drafting would be repetitious. Apart from the fact that some drafting often is repetitious, (usually for emphasis) the two sentences cover different situations which in our view were not the situations suggested by the court. The first sentence relates to ranking amongst the bonds of that particular issue. The second sentence relates to the ranking of these bonds with other external indebtedness. In other words, as is standard in bond issues, the bonds are to rank equally amongst themselves and are also to rank equally with other external debt.

In terms of remedies for the breach, the court could just have left the plaintiffs NML Capital with an event of default and their rights as an unsecured creditor. In the specific context this would have left the plaintiffs with little more than yet another event of default to add to their existing non-payment event of default. Instead, the court imposed a remedy which gave real teeth to the order. The court by injunctions ordered Argentina to specifically perform the *pari passu* obligation, that is, whenever Argentina pays the new bonds, it must make a rateable payment on the old bonds. Failure to do so would presumably be a contempt of court. The injunctions provide that whenever Argentina pays any amount due under the terms of the new bonds, it must concurrently or in advance pay plaintiffs the same fraction of the amount due to them on the old bonds. To give effect to this, Argentina was ordered not to alter the bank payment processes and at the time of the payment Argentina must certify to the court that it has satisfied its obligations.

Various reasons were given for this draconian order but the background is the weakness of the legal position of creditors of sovereigns. Creditors of a sovereign cannot normally claim domestic assets of the state by attachment since we believe that most, if not all, states, prohibit attachment of domestic assets by unpaid creditors and in addition, it can be difficult for unpaid creditors to attach external assets, primarily because the most important external assets, such as the foreign reserves, are held by a separate legal entity, such as the central bank, which is not liable for the debts of the state.

If the violation was purely the Lock Law, then any court order should have been directed at the Lock Law. But instead, the court ordered what was substantially rateable payment so that the order treated the clause as if it required rateable payment. The effect of the order was that a breach would presumably put Argentina (and the other parties to whom the judgement was addressed) into contempt of court so that non-payment of a debt was being backed by a remedy which goes beyond ordinary creditor remedies against defaulting debtors.

The court also held that the injunctions did not violate Argentina's immunities under the Foreign Sovereign Immunities Act of 1976 because the injunctions did not attach any property of Argentina. In practice, sovereign bonds governed by external law typically contain a wide waiver of immunity.

The case was sent back to the district court on two technical matters, namely how the injunctions applied to banks and other pure intermediaries who process payments to bondholders and also how the rateable formula worked.

The practical result of the case for Argentina is that, if Argentina pays the holders of the new bonds, it must pay a rateable amount to the holders of the old bonds. If Argentina does not pay the new bonds, then it does not have to pay the old bonds but presumably non-payment of the new bonds will be an event of default under the terms of the new bonds.

The new bonds are paid to a trustee for the bondholders located in Argentina, presumably to ensure that the proceeds are not attachable in Argentina and so can reach the new bondholders.

Why is the case important?

The case is important because there are two interpretations of the *pari passu* clause with dramatically different results. The narrow interpretation would not usually have significant consequences in the sovereign context. The wider interpretation would have major consequences, not only for sovereign bonds, but also for bank and corporate bonds and could lead to defaults and major problems in company and sovereign rescues and bail-outs. It could be disruptive and destabilising.

These wider consequences arise because the *pari passu* clause is, in various formulations, a standard clause in international bond issues and syndicated credits. Thus most *pari passu* clauses in sovereign bonds and also in sovereign restructured bonds, such as the new Greek bonds, contain a *pari passu* clause similar in form to that in the case of Argentina. The main difference in the drafting of *pari passu* clauses, whether public sector or private sector, relates to the debt which must rank *pari passu*. In bond issues, it would be relatively unusual for the clause to cover all other debt: thus, in the case of sovereign bonds, it is often limited to external debt and in the case of bank, corporate and many sovereign bonds, it is also sometimes further limited to other bonds and like tradable debt instruments. These generalisations are also true of restructured sovereign bonds, i.e. the *pari passu* clause typically relates to external debt in the form of tradable securities.

In the case of bank term loans, such as international syndicated credits, the *pari passu* clause generally applies to all debt without limitation, although in the case of sovereign bank loans it may be limited to external debt, which has a detailed definition.

Both sovereign states and large corporations, as well as banks, enter into syndicated credits from banks. The clause is not just limited to bond issues. The amounts outstanding worldwide must be extremely large.

A *pari passu* clause would be unusual in sovereign bonds governed by the local law of the issuing sovereign state. Typically these bonds do not have covenants, events of default, jurisdiction clauses or waivers of immunity. Thus, most of the debt of eurozone countries is governed by the local law of the issuing sovereign and does not have a *pari passu* clause or indeed other typical protections found in bonds governed by an external system of law, such as English or New York law.

What are the main interpretations?

The narrow interpretation of the clause holds that the clause merely requires that the obligations within the clause legally rank *pari passu*, that is, there is no mandatory prior debt and no mandatory legal subordination of the *pari passu* debt. According to this interpretation, the debtor can *in fact* discriminate between creditors so long as there is no mandatory law creating discrimination and no legally obligatory ladder of priorities subordinating the protected debt. The *pari passu* clause is therefore a statement of the legal position in the case of competition between creditors and does not prevent a debtor from actually discriminating by paying one creditor but not others. The fact that the clause relates only to legal ranking is signalled by the use of the verb "rank".

The wider interpretation holds that the clause means that, when the debtor is insolvent or even if just in payment default, it must then pay all its creditors rateably, regardless of whether there is a mandatory insolvency priority ladder imposed by the law. This interprets the use of the term "rank" as actually meaning "pay".

It is considered well-settled that, in the context of bank or corporate bonds, the *pari passu* clause is to be interpreted narrowly, i.e. that the bonds legally rank equally on insolvency proceedings with other unsecured debt. It does not mean that a corporate debtor could not, once it is in fact insolvent or in payment default, pay some unsecured creditors ahead of others, e.g. it could still pay the rent, pay utilities or royalties or the telephone bill or the milk bill without violating the clause.

Because bankruptcy statutes almost invariably provide for a ladder of priorities between unsecured creditors, there is commonly a qualification in corporate loan agreements and bonds that the undertaking does not apply where the law otherwise provides. Thus, bankruptcy statutes typically provide for the unsecured priority of certain wages, certain taxes, sometimes depositors in the case of banks, usually insolvency administration expenses and sometimes new rescue loans made after the commencement of the insolvency.

Because sovereign states cannot be liquidated (there is no international bankruptcy regime for sovereign states), some commentators take the view that the clause must mean something different in the case of sovereign states. However, the language is exactly the same as the corporate language and there seems no reason to impose a different interpretation.

Although priorities in the case of sovereign states are not an order of priority out of realised proceeds of liquidated assets, a de facto priority is achieved by varying the dates of maturity of debts. For example, if a sovereign state is insolvent but pays a creditor who is due on Monday but not another creditor who is due on Tuesday because there is not enough left after payment of Monday's creditor, then effectively Monday's creditor ranks ahead of Tuesday's creditor.

The narrow interpretation of a clause does not have much bite because it is very uncommon for states to vary the ranking by statute. But the clause is not meaningless because states can pass statutes which subordinate one creditor below others or give priority to one set of creditors. A state could, for example, provide that, where debts are due at the same time, one set of creditors will be paid before the other, resulting in discrimination. In addition, sovereign states in the past have provided for the allocation of revenues to one set of creditors (but without creating a security interest), thereby potentially violating a *pari passu* clause.

If the wider interpretation were to prevail, then a sovereign state would violate the clause if it paid some creditors without paying the others who are within the scope of the clause, e.g. external bond indebtedness. Hence a very wide clause catching all creditors or even just foreign currency creditors may inhibit foreign currency payments to the multilaterals or to official creditors or to trade suppliers or to a government's foreign diplomatic missions, or, in the case of a comprehensive clause, local currency payments to nurses, civil servants, the judiciary, the police and soldiers.

Analysis in light of drafting practice

If the clause applied to all payments after a corporation is insolvent (and much more so after a payment default), then one would have expected negotiators to exclude salaries, the rent, public utilities and other essential payments. These are payments which have to be made if the corporation is not to immediately stop business which nobody wants. In our experience, negotiators never do ask for these exclusions because the clause only applies to legal ranking, not equality of payments.

Similarly, banks which have *pari passu* clauses in their bond issues and bank credits, do not exclude obligations to pay retail deposits or trade letters of credit or indeed any other essential payments which are necessary for them to continue in business while negotiations go on if they are in financial difficulties. The reason must be that nobody has ever interpreted the clause to apply to equality of payment, but only to ranking by law.

In the case of sovereigns, one would have expected negotiators to exclude payments to the IMF, to the World Bank, payments of short term treasury notes, payments to diplomatic accounts for the rent, payments to nurses, civil servants and the military. Even if the covenants were limited to external debt, one would expect somebody at some time to ask for these exceptions, particularly in view of the immense attention to detail paid by lawyers to the drafting in very large transactions. Wide *pari passu* clause are common in bank loans to sovereigns. We are not aware of requests to modify the clause in this way.

If a court could get a court order blocking payments unless all debt was paid equally, then one would have expected it to be standard over the last few decades in our memory for exceptions to have been requested. The fact that this has not happened is conclusive evidence that the parties intend the clause to relate to legal ranking, not equality of payment.

Most favoured debt clauses

It is possible to negotiate a clause which provides that payments must be made rateably, not just that they must legally rank equally. These are called "most favoured debt" clauses and have appeared in sovereign restructuring agreements for commercial bank debt. These clauses provide that, if any other debt eligible for a rescheduling is paid more quickly, then the borrower must repay the rescheduled date rateably. In other words, if the borrower pays holdouts, it also has to repay the rescheduled debt and the clause is therefore a disincentive to payment of holdouts. Typically the clause then excludes certain categories of debt so that they can be paid in priority, e.g. amounts owed to the IMF and other multilaterals, trade debt, small claims and certain other agreed categories.

Theoretically parties could modify the standard *pari passu* clause so as to require rateable payments but such a clause would be complicated and intricate because it would have to specify in advance exactly what debts could be paid when the company or sovereign was in difficulties. For example, should the company be able to pay the rent to prevent forfeiture of its premises, should it be able to pay utilities, should it be able to pay on long-term supply contracts in order to maintain them? What debt should a sovereign be able to pay so as to maintain its status as a performing debtor? It is believed that the markets would consider it impracticable to draft most favoured debt clauses in ordinary bonds, even for sovereigns, and it is therefore only in highly negotiated bank restructuring agreements that one tends to find most favoured debt clauses.

As it is, clauses which relate to equality of payments are extremely rare in our experience.

For the sake of completeness, we would mention other equality clauses as follows:

– The agreed minutes of the Paris Club usually contain a comparability requirement stating that the sovereign debtor will accord all categories of official creditors, including creditor countries not participating in the Paris Club, and private sector creditors, treatment that is no more favourable than that accorded to the Paris Club creditors for credits of comparable maturity. The effect of this clause is that the sovereign debtor is not permitted to give other governments or private bondholders more favourable terms, e.g. by shorter maturities.

- A pro rata sharing clause in commercial bank syndications provides that, if any bank receives a greater proportion of its share, e.g. by set-off, it must pay the excess to the agent bank who redistributes to the banks pro rata. This clause does not appear in sovereign or corporate bonds, but if these bonds are constituted by a trustee with a trust deed, then it is commonly provided that, after a default, the trustee will distribute receipts pro rata to the bondholders. In the Greek debt reorganisation, there was a pro rata sharing clause in the Co-Financing Agreement between Greece, the trustee for the bondholders and EFSF to address equality issues.
- A negative pledge provides that the debtor will not create or permit to subsist any security interest over its assets, subject to exceptions. The clause is very limited in typical bond issues. By contrast, the *pari passu* clause regulates only the ranking between unsecured debt.
- Events of default may also have an equality motive, e.g. cross-default clauses whereby a default towards one creditor is treated as a default to all creditors.

Which interpretation did the New York court select in the Argentina case?

The main problem with the Second Circuit judgment is that it is not clear whether the appeal court upheld the narrow interpretation or the wider interpretation. The court held that a combination of the actions of Argentina were enough. These included executive-declared moratoriums on payments on the old bonds which had been renewed each year, the fact that Argentina had not made a single payment on the old bonds for six years while timely servicing the new bonds, that Argentina enacted the Lock Law and that Argentina had stated in the prospectuses for the new bonds that it had no intention of making any payments on the old bonds and classified the old bonds as a separate category from the new bonds in its SEC filings.

The court did not say whether a single discriminatory non-payment would be enough or whether a law was required or what the threshold was, so that in effect the court did not use the opportunity to express a clear and unambiguous view on the competing interpretations. But there are some statements in the case which seemed supportive of the wider interpretation.

If the court had adopted the narrow interpretation, i.e. that there had to be a change in legal ranking, the case would have much less significance because Argentina could reasonably be said to violate the clause by virtue of the Lock Law and the statutory moratorium. The Lock Law and the statutory moratorium by law prevented the holdout creditors from being paid at all while other creditors were paid and therefore ranked the priority of the old bonds below that of the new bonds. If the decision was limited in this way, then its implications would not be particularly significant because indebted sovereign states rarely pass laws similar to the Lock Law changing the priority ranking of bond creditors. Insolvent states usually impose moratoriums by non-statutory declaration and state that they will not pay holdout creditors in a prospectus for the exchange without passing a mandatory law to this effect.

If on the other hand the wider interpretation is followed, then there would be serious implications as further discussed below.

What did the New York court decide about the IMF preferred status?

The IMF has always insisted that obligations owed by sovereigns to the IMF must be kept current even though other official creditors and private sector creditors are rescheduled. The effect of this is that the IMF has a preferred status de facto and this has been universally recognised by other creditors, even though there is no legal rule to that effect.

The Second Circuit did not rule on whether payments to the IMF would breach a *pari passu* clause and noted that the plaintiffs had not argued that Argentina's preferential payments to the IMF could similarly entitle the plaintiff to rateable payments. That issue was also left completely open. The issue would therefore presumably remain open for other multilaterals which claim preferred status.

Technically the impact of an adverse decision on multilaterals might be restricted by reason of the fact that the decision applies only to obligations governed by New York law. In addition, there is a view that IMF standbys are not strict legal obligations.

What would an English court decide?

We are not aware of any conclusive English case deciding the meaning of the *pari passu* clause. However, we believe that the weight of informed opinion is that English law would uphold the narrow interpretation on the ground of the intent of the parties and on the ground that, if the parties meant to require a debtor to pay equally instead of representing that payments would rank equally, then they would say so and also draft a conventional most favoured debt clause. As mentioned, most favoured debt clauses are complicated and would therefore not be suitable for normal bond issues.

Variants of the *pari passu* clause have been considered in old cases but the most recent authority *Kensington International Ltd v The Republic of the Congo*, 16 April 2003 (unreported but approved by the Court of Appeal) decided in similar circumstances that the court did not have to decide the meaning of the *pari passu* clause in defaulted bank debt owed by the Congo because, whatever it meant, the court was not prepared to grant an injunction to restrain payments in alleged breach of the clause.

The narrow interpretation of the *pari passu* clause received endorsement in England by the Financial Markets Law Committee (FMLC). The FMLC is an independent committee established and sponsored by the Bank of England "to identify issues of legal uncertainty, or misunderstanding, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed". The FMLC also acts as "a bridge to the judiciary to help UK courts remain up-to-date with developments in financial markets practice". In its March 2005 report "*Analysis of the role, use and meaning of pari passu clauses in sovereign debt obligations as a matter of English law*" the FMLC concluded that "*…the payment interpretation* [what is here referred to as the "wide interpretation"] *of the pari passu clause is unsupportable as a matter of English law except where the clause is very clearly drafted to achieve this effect*".

Hence, while the matter has not been decided, we think it likely that an English court would uphold the narrow interpretation, i.e. require a change in legal ranking. This is because this is believed to be the mainstream market view of the meaning of the clause, because the clause is generally regarded as boilerplate without great force and because, if the parties wanted to convert the clause into a forceful and far-reaching equal payment on most favoured debt clause, then this would have to be expressly stated.

If the court did find a violation we doubt that an English court would order injunctions against a foreign sovereign state requiring it to make rateable payments except perhaps in very severe circumstances. In the Congo case, the court left the creditor to its normal rights as a creditor, i.e. event of default, acceleration and whatever creditor recoveries were available against the sovereign (even though these remedies might be very weak in practice).

However, an English court might well decide that a statute such as the Lock Law was a contravention of the *pari passu* clause, although it would still be open to the English court to decide that a law prohibiting payment is not a priority law discriminating between creditors but rather a law that prohibits payment altogether.

There has been other inconclusive case law in Belgium and California.

Role of the governing law

The decision is explicitly decided under New York law and so should apply to debt obligations governed by New York law. The decision could be further limited to sovereign *pari passu* clauses and not *pari passu* clauses in bank and corporate bonds, for example, but this seems unlikely.

Nevertheless, *pari passu* clauses in New York law bonds could lead to an order preventing discriminatory payments on bonds governed by another system of law. For example, if an issuer has bonds governed by New York law containing a *pari passu* clause and also bonds governed by another system of law, such as English law, then a New York court could require the issuer to make rateable payments on the New York bonds if the issuer pays the English law bonds. This is in essence what has happened in this case, as some of the new bonds issued by Argentina are governed by English law.

Further, if, say, an English law bond is litigated in the U.S. courts and the U.S. court finds that under English law there is a violation of the *pari passu* clause, then the New York court could apply its own draconian remedies by ordering the issuer not to pay other bonds unless it makes a rateable payment on the English law bonds. This is because remedies are typically decided by the law of the enforcing court, not the governing law. There are many bonds and syndicated bank credits which provide for the jurisdiction of both the English and New York courts and also, in common with other jurisdictions, U.S. courts have long-arm jurisdictional rules.

The two dominant systems of governing law used for international bonds and syndicated credits are New York and English law, although some international credits are contracted under other leading systems of law, such as Swiss, German or Japanese law. There are regional trends in the governing law most frequently chosen by sovereign and private sector issuers.

For example, in the eurozone most of the public debt of eurozone sovereigns is governed by their own law. For those which issue international bonds, most are governed by English law although there are smaller amounts governed by other legal systems, but not usually New York law. EFSF loans to troubled countries in the eurozone have typically been governed by English law.

Other jurisdictions may be influenced by the interpretation of a senior court in the U.S.

It follows therefore that creditors or debtors with bonds or loan contracts governed by another system of law could be drawn in by the New York decision. In addition, there might be continued litigation on the clause around the world which could have destabilising effects.

What would be the implications of a wider interpretation?

Apart from the question of restriction to the governing law, if the wider interpretation is adopted, then the potential implications could include the following:

– Corporate and bank issuers would be in breach if they made discriminatory payments once they were in fact insolvent or in payment default and there was competition between creditors. For example, a bank could not pay depositors or other unsecured creditors as part of a rescue, nor could it repay emergency central bank last resort money without violating the clause. Companies could not similarly pay the rent to preserve leases of premises, or trade suppliers to preserve contracts, or utilities, without a breach. It could therefore be much more difficult to conduct a work-out out-of-court. Most financial difficulties are resolved by out-of-court measures.

– Sovereign states would be in breach if they paid some unsecured creditors covered by the clause without paying the bond creditors. This might, for example, affect trade payments, payments of short-term debt, payments to retail bondholders, diplomatic payments, payments to multilaterals and payments to holdouts. However, there is an argument that IMF stand-bys are not legally binding and therefore outside the scope of contract debts covered by the *pari passu* clause. In the eurozone context, the wider interpretation might impact on preferred payments to the EFSF and the ESM. It could impact on payments to the ECB.

– If a debtor actually makes a prohibited payment, this could be an event of default which could lead to cross-defaults. Creditors often do not call events of default but a single creditor might threaten to do so or actually do so to destabilise work-out negotiations and to put pressure on other creditors or to crystallise a credit event under credit default swaps. The events of default would be very unexpected if the incorrect interpretation of the clause is adopted.

– During negotiations for a restructuring, a holdout creditor might veto a legitimate payment by a debtor and thereby disrupt negotiations and acquire disproportionate power to get a full payout at the expense of other creditors. It is very rare that general creditors negotiating a workout want the debtor to stop paying anybody at all and just seize up. For example, a corporate debtor may want to pay the rent to preserve its premises or to pay utilities or to pay salaries or long-term contracts, or royalties to preserve its assets in the interests of an ongoing business supported by the general body of creditors. In the case of sovereigns, it is rarely desirable that the sovereign should simply stop paying all claims during the course of work-out negotiations but the degree of restriction on sovereigns would depend on the scope of the *pari passu* clause, e.g. whether it applied only to external tradable debt (typical of bond issues), thus permitting the sovereign to continue to pay its civil service, its teachers etc. But *pari passu* clauses in sovereign bank loans are wider and in the case of currency unions, as the eurozone, the distinction between internal and external debt may have disappeared. In any event, single holdouts could have much more veto power during negotiations because they can threaten to apply for a court order compelling rateable payment, which is usually not feasible, unless somebody pays them to go away. It is not conducive to stability to convert a harmless clause to a weapon in the hands of hold-outs.

– The fact that holdouts can compel full payment may incentivise them to holdout from an exchange offer.

– After an exchange, the payment of holdouts in full could be at the expense of the restructured bondholders. Hence, the finality of the restructuring might be more in question.

– The payment of holdouts is contrary to equality because they get 100%, often at the expense of those who agreed to a restructuring.

– Disparity between the two great legal "public utilities" – English and New York law – could lead to undesirable arbitrage and destabilizing forum-shopping and litigation.

– Even if an English court came to a different interpretation (which is considered likely), a New York ruling could impact on English law bonds, as in the case of Argentina where some of the new bonds are governed by English law.

– The use of collective action clauses could mitigate the problem of holdout creditors. The main element of collective action clauses provides that minorities are bound by decision of the majority (typically two-thirds or 75%) so that, if the majority decide to accept an exchange of bonds, then the minority are also bound to accept the exchange. The result is that holdout creditors can no longer holdout. Although collective action clauses are now widespread in sovereign bonds, this does not cover existing bonds without collective action clauses nor does it prevent situations where creditors buy a blocking minority of bonds of a particular issue. In fact, at present, very few collective action clauses do contain aggregation clauses allowing overall majorities across all issues to bind a single dissenting minority in one issue. The result is that holdout creditors can buy-out a blocking holding in a small issue and thereby torpedo the whole process. One effect is that the resolution of sovereign bankruptcies misses the essential element of a corporate judicial reorganisation on the lines of chapter 11, which is that all creditors are bound by the plan. In addition, in some countries, notably the United States, legislation prevents collective action clauses which change the terms of payment in the case of corporate bonds but not sovereign bonds.

– U.S. courts might, in the case of sovereigns, order specific performance by means of injunctions preventing discriminatory payments, with the penalty of contempt of court if not complied with.

– Markets would be advised to make it clear what they mean by the *pari passu* clause for the future and to introduce appropriate qualifications. This would not of course cover existing situations.

We do not consider the impact on credit default swaps, nor do we review issues of choice of governing law and jurisdiction.

What are the implications of a narrow interpretation?

The potential implications of a narrow interpretation would include the following:

– Sovereign and private sector debtors can continue to make priority or discriminatory payments as part of a rescue and can continue to pay holdout creditors without violating the clause, unless otherwise prohibited. Preference and insolvency laws apply to private sector debtors. Insolvency laws usually provide for a total moratorium on payments by a debtor once proceedings have commenced. Preference laws typically require creditors who have received a preferential payment to disgorge it.

– Insolvent sovereign debtors should not pass statutes declining to pay holdout creditors in order to incentivise them. In practice, statements that holdouts will not be paid have often been sufficient. Of course holdouts know that a state can change its mind and even disapply a law (as Argentina did when it settled with creditors in 2010).

– Sovereigns should take special care not to give effect to preferred status arrangements in statute or equivalent measures if they wish to avoid a violation of the *pari passu* clause.

– There should be no impact on the preferred status of the IMF and other multilaterals. Under the narrow interpretation, it should not be a breach of the *pari passu* clause where multilaterals decline to be rescheduled at a time when other official and private sector creditors are rescheduled.

– There should be no impact on discrimination in favour of bailout creditors providing bailout funds to eurozone countries, provided that there is no legal measure subordinating credits.

– Creditors should consider making it clear what the *pari passu* clause means and also introduce appropriate qualifications.

What should happen next?

– Courts should restrict the *pari passu* clause to what it is intended to mean, i.e. legal ranking. This clause is standard worldwide in sovereign bonds and in international corporate and bank bonds. The amounts involved are probably several trillion. A wrong and unexpected interpretation would have implications which are impossible to predict.

– Participants should continue in any event to monitor the situation.

– Care should be taken by sovereign states to ensure that statutes do not rank sovereign debt or create a preferred status senior to bondholders or banks that have the benefit of *pari passu* clauses.

References

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