

Second Circuit Adheres Strictly to the Rules of Contract in Sovereign Debt Restructurings

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In a measured opinion hewing closely to **standard principles of contract interpretation**, the United States Court of Appeals for the Second Circuit in *NML Capital, Ltd. v. Republic of Argentina*, No. 12-105, slip op. (2d Cir. Oct. 26, 2012), rejected the notion that a **sovereign may issue bonds governed by New York state law and subject to the jurisdiction of the state's courts**, and then restructure those bonds in a manner that violates New York state law.

The Second Circuit held in *NML Capital* that Argentina violated an equal treatment provision (part of a *pari passu* clause) requiring Argentina to rank bonds “at least equally” with other forms of External Indebtedness through “the combination of Argentina’s executive declarations and legislative enactments.” The court held that bonds issued in Argentina’s 2005 and 2010 restructuring (the “Exchange Bonds”) qualify as External Indebtedness, and to remedy the violation, the court ordered that Argentina make ratable payments to holders of defaulted bonds whenever Argentina makes payment on Exchange Bonds. In addition, the Second Circuit also held that the enforcement of the equal treatment provision did not violate the **Foreign Sovereign Immunities Act (FSIA)**.

The Second Circuit also ruled that the district court’s judgments do not have the practical effect of enabling a single creditor to thwart sovereign restructurings. The court found that Argentina has the capacity to pay all of its obligations under the defaulted bonds and the Exchange Bonds, and therefore its ruling does not impact holders of Exchange Bonds unless Argentina chooses to not pay holders of defaulted debt.

Background of Bond Issuance and Restructuring

Argentina began issuing bonds in 1994 pursuant to a Fiscal Agency Agreement (FAA) governed by New York law and enforceable in “any state or federal court in The City of New York.” *NML Capital*, slip op. at 9. Argentina defaulted on its sovereign debt in 2001. At the time of default, Argentina owed approximately \$80 billion in principal and interest payments on its public external debt, including bonds issued pursuant to the FAA.

Argentina restructured the FAA bonds through two rounds of exchange offerings in 2005 and 2010 at a rate of 25 to 29 cents on the dollar. Argentina induced the bondholders to participate in the exchange offerings by effectively promising that holdouts from the restructuring would never receive

any payment on their FAA bonds. The government of Argentina codified this warning with the passage of the “Lock Law,” which prohibited the state from making any payment to holdouts. In light of this threat, the aggregate participation rate of the restructurings in 2005 and 2010 was 91 percent.

The District Court Enforces the *Pari Passu* Clause

The holdout bondholders have pursued their legal rights against Argentina for several years in the courts of the United States and elsewhere. The dissident bondholders brought a legal action in the District Court for the Southern District of New York to enforce the *pari passu* clause in the bonds, including specific performance of the equal treatment provision. The clause states that:

[t]he Securities will constitute . . . direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times 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*

NML Capital, slip op. at 4-5 (emphasis in original). In its opinion, the Second Circuit refers to the clause in its entirety as the *pari passu* clause, and the second sentence of the *pari passu* clause as the “equal treatment provision.”

The district court entered summary judgment for the holdouts and held that Argentina violated the equal treatment provision by persisting in its refusal to pay the holdouts while paying the holders of the new Exchange Bonds (who held External Indebtedness under the terms of the FAA), and by enacting the Lock Law. To remedy this violation, the district court ordered specific performance of the equal treatment provision and enjoined Argentina and third parties who may assist Argentina from making payment on the Exchange Bonds without also making payment to the holdouts.

The Second Circuit Upholds the District Court’s Decision Using Basic Principles of Contract Law

The Second Circuit affirmed the lower court’s decision on appeal, although it remanded for the district court to clarify the scope and effect of its order of specific performance and its injunction. The Second Circuit first addressed whether Argentina had violated the equal treatment provision when the country issued and then honored new bonds in exchange for the old.

To the Second Circuit, this issue of the *pari passu* clause presented a “simple question of contract interpretation” as “a bond is a contract.” *NML Capital*, slip op. at 16. On the other hand, Argentina argued that the clause was essentially meaningless because a *pari passu* clause could only be effective where there is a hierarchy of payments that could be legally enforced in a bankruptcy regime, and in the case of bonds issued by a sovereign, no such insolvency scheme applied. The court rejected this interpretation of the *pari passu* clause because, under one of the time-honored principles of contract law, “[a] contract should not be interpreted in such a way as would leave one of its provisions substantially without force or effect.” *Id.* at 17-18.

In addition, the court found that Argentina’s position failed “to give effect to the difference between

the two sentences of the *pari passu* clause.” To give full effect to both sentences, the court reasoned that the sentences must “protect against different forms of discrimination.” *Id.* at 18. The first sentence of the *pari passu* clause must be read to prohibit Argentina, as bond issuer, from “formally subordinating the bonds by issuing superior debt,” and the second clause prohibits Argentina, as bond issuer, “from paying on other bonds without paying on the FAA Bonds.” *Id.*

Moreover, the Second Circuit reasoned, the court’s reading of the second sentence “makes good sense in the context of sovereign debt.” A sovereign, unlike an individual or a corporate entity, cannot be forced into bankruptcy proceedings where the legal ranking protected by the first sentence determines the order in which creditors will be paid. *Id.* at 19. Therefore, the Second Circuit concluded, the equal treatment provision is a bargained-for protection for bondholders that “prevent[] Argentina as payor from discriminating against the FAA Bonds in favor of other unsubordinated, foreign bonds.” *Id.*

Applying this interpretation to the *pari passu* clause, the Second Circuit found that the “record amply supports a finding” that Argentina violated the equal treatment provision by “effectively [ranking] its payment obligations to the [holdouts] below those of the exchange bondholders.” *Id.* Five items of record in particular showed that the equal treatment provision had been violated: (1) Argentina had made no payments to the holdouts in the six years since the 2005 restructuring, while simultaneously making payments on the new Exchange Bonds; (2) Argentina had renewed its moratorium on payment of the FAA bonds each year since the default; (3) Argentina declared in the restructuring prospectus for 2005 and 2010 that it had no intention of resuming payment on the FAA bonds; (4) Argentina stated in SEC filings that it is not in a legal position to pay the FAA bonds and had reclassified them as a separate category distinct from its regular debt; and (5) Argentina had enacted the Lock Law prohibiting Argentina’s local courts from giving full effect to judgments obtained by the holdouts while allowing, were a default to occur on the Exchange Bonds, its courts to recognize judgments obtained by the exchange bondholders.

In light of the litany of executive and legislative acts contrary to the *pari passu* clause, the Second Circuit had “little difficulty concluding” Argentina was in breach of its contract with the bondholders. *Id.* at 20.

Addressing the threshold immunity issue, the court ruled that the FSIA did not bar injunctions or specific performance because that relief did not amount to an exercise of dominion or control over sovereign property. Generally speaking, the FSIA provides certain limitations on a court in the United States from attaching, arresting, or executing on assets located in the United States that belong to a foreign sovereign. Here, the district court did not need to seize any property of Argentina to give effect to its ruling. Instead, the court could simply order that the sovereign pay the holdouts ratably with the holders of External Indebtedness.

On Remand to the District Court

While the Second Circuit affirmed the district court’s decision, the appellate court instructed the district court to address the manner and calculation of repayment and the application of the injunctions issued on third parties and intermediary banks. *NML Capital*, slip op. at 28 and 29. On November 21, 2012, the district court issued a clarification order that, as to the payment formula, all \$1.33 billion in principal and interest owed to the holdouts was currently due, and that Argentina must pay 100 percent of that amount if it paid 100 percent of any amount due to the exchange bondholders. As to the scope of the injunctions, which apply to parties “in active concert or participation” with Argentina, the district court clarified that the injunctions were to have a broad

scope while not affecting those immune as a matter of law such as intermediate banks under Article 4A of the UCC. Importantly, the district court confirmed that the indenture trustee was subject to the injunctions.

Argentina has appealed this latest ruling by the district court, and on November 28, 2012, obtained a stay pending that appeal. The Second Circuit set February 27, 2013, as the hearing date for oral arguments on Argentina's appeal. The bondholders who accepted the exchange offers have sought and obtained leave to intervene and be heard in the latest appeal, and will support Argentina's position.

Implications of the Second Circuit's Decision on Future Sovereign Debt Restructurings

Some of the implications of the Second Circuit's decision are clear, and others will develop over time. On the one hand, the Second Circuit was careful to limit the scope of its decision to "Argentina's course of conduct," expressly stating it did "not decide . . . whether 'legislative enactment' alone could result in a breach of the Equal Treatment Provision" or whether "any non-payment that is coupled with payment on other debt breaches the Equal Treatment Provision." *Id.* at 27 n.16 (emphasis in original). In this regard, the Second Circuit sent a clear signal that its decision should not apply in a rote fashion to any sovereign debt restructuring.

On the other hand, two principles underlying the decision would appear to have broad application to future sovereign debt restructurings. The Second Circuit began its analysis noting that a "bond is a contract" and that the dispute between Argentina and the holdouts legally amounted to no more than standard state-law questions of contract interpretation. *NML Capital*, slip op. at 16. Framing the dispute in this manner proved to be outcome determinative, as the language of the bonds and rules of contract are quite clear and well-known.

Still, the Second Circuit noted that "it is highly unlikely that in the future sovereigns will find themselves in Argentina's predicament" because "[c]ollective action clauses - which effectively eliminate the possibility of 'holdout' litigation - have been included in 99 percent of the aggregate value of New York-law bonds issued since January 2005, including Argentina's 2005 and 2010 Exchange Bonds." *NML Capital*, slip op. at 27.

The clear and perhaps unsurprising lesson is that New York courts are bound to interpret bonds as they would any other contract, even if the issuer is a sovereign or some other unique entity. Accordingly, prospective issuers under New York law are well advised to carefully consider their options when drafting and negotiating bond indentures, such as the inclusion of collective action and other prophylactic clauses, in order avoid disputes that could complicate a refinancing or restructuring, and lead to time-consuming and expensive litigation. Conversely, prospective buyers of sovereign debt will scrutinize indentures with a view towards protecting their interests in future restructurings.

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National Law Review, Volume II, Number 360

Source URL: <https://natlawreview.com/article/second-circuit-adheres-strictly-to-rules-contract-sovereign-debt-restructurings>

