CHAPTER 3: Argentina and the Rebirth of the Holdout Problem

A Fundamental Tension

From a legal perspective, there are two noteworthy distinctions between corporate and sovereign debt. First, as already discussed, sovereign debt is mostly unenforceable. This is because sovereign immunity shields most public assets from creditors, even if they win a judgment against a defaulting government.[21] The debtor's property is either inside its own national borders (where the courts are loath to side with creditors against their own government), or enjoys the special protections that are provided for embassies, central bank funds, military installations and the like. Property used for commercial activity is more accessible, but since the wave of privatizations in the late 20th century, few governments have conducted much commercial business in their own name. Although sovereigns often waive immunities when they borrow abroad, courts sometimes interpret general waivers narrowly or even ignore them. Where the legal scope for enforcement is so limited, political pressures play an outsize role, adding to uncertainty about the outcome of any given case.

Second, although sovereign debt contracts are hard to enforce, they also last forever. Without bankruptcy, sovereign debt cannot be discharged to give the country a fresh start. In most cases, a determined creditor insisting on full repayment cannot be forced to restructure its bonds. At the same time, the combination of immunity and transactional technique that shields debtors from enforcement is imperfect. It relies on diverse national laws and contract provisions. When creditors try to attach external payment flows, the effectiveness of immunity as a shield depends on individual sovereigns' capacity to litigate and survive the loss of market access for potentially long stretches of time. This implies that creditors with the time, will and resources to pursue a country to the ends of the Earth can try to make life difficult for it in perpetuity, throwing obstacles in the way of its international trade and financial activity.

Arguably, the balance between these fundamental characteristics of sovereign debt—the fact that enforcement is difficult and unpredictable, but not absent altogether; and the fact that sovereigns cannot get a fresh start—has made orderly debt restructurings possible in the new era of bonded debt. Faced with the alternatives of accepting a reasonable take-it-or-leave-it debt exchange offer or the hard work and uncertainty of enforcement,

[21] E.g., see Weidemaier (forthcoming).

most creditors will accept the offer, particularly when the litigation prospects and secondary market values of defaulted instruments are further eroded by restructuring techniques (Bi, Chamon, and Zettelmeyer 2011). This calculus may not apply to specialized distressed debt funds—expert litigators—that have the patience, skill and deep pockets to exploit the loopholes in sovereign immunity—*provided* the sovereign's overall debt stock is reduced to make side payments possible. Sovereigns, in turn, will understand that in the presence of these loopholes, and given the non-dischargeability of debt, holdouts can be a permanent source of irritation and disruption. As a result, they will typically settle, and sometimes repay holdouts in full.

Since the revival of the sovereign bond market in the 1990s, the fundamental tension between the lack of enforcement and the lack of a fresh start has produced a regime where few creditors hold out. Those that do hold out do not fundamentally disrupt the restructuring process. With very few exceptions—most notably Argentina, where the authorities took a confrontational stance with creditors, largely for reasons of domestic political economy—all debt exchanges since the return of the emerging markets' sovereign bond market in the early 1990s have conformed to this pattern. As we argued in the previous section, some of these debt exchanges did not go far enough in reducing debt burdens. But they certainly constituted a "technology" for debt restructuring that minimized litigation and exclusion from sovereign debt markets.

The Return of the Holdout

Those creditors that refused Argentina's restructuring offers have been chasing it around the globe since 2001, using tactics that range from the exotic to the cartoonish. However, recent rulings in New York may give creditors the first broadly replicable remedy against sovereign debtors since the days of gunboat diplomacy a century ago (box 1). Relying on the "pari passu" clause in Argentina's fiscal agency agreement, a group of holdouts secured an order that bars Argentina from making payments on its restructured debt unless it pays holdouts proportionately ("ratably"). Under court orders, if the new bondholders get paid in full under the restructured contracts, holdouts are entitled to full payment under their original contracts.

Because versions of the pari passu clause are present in all sovereign bonds, the ratable payment order in New York has given creditors a way to intercept flows from a wide range of sovereigns to firms and official institutions. For the first time in decades, sovereign debt enforcement looks like a much more realistic prospect in a major financial jurisdiction. This is because cross-border payment flows remain ubiquitous and essential for most sovereigns. The pari passu remedy operates by inflicting collateral damage; that is, those creditors under performing debt contracts are blocked from receiving their payments, and payment and clearing systems and trustees are threatened with contempt of court if they help the debtor pay its performing bonds.[22] This forces the debtor to choose between repaying holdouts in full and defaulting on creditors within the reach of U.S. courts. The latter, in turn, would imply a loss of access to large segments of the international market, along with possibly interfering with trade-related payments.

In a world of well-coordinated creditors, giving creditors a powerful new enforcement tool might improve welfare. Creditors would enforce debt repayment when it is in their collective interest to do so. This would rule out "rogue debtor" behavior—that is, instances when countries repudiate their

[22] Although the creditors said that they were not trying to block payments to the IMF, the terms of the court orders appear to cover private and official payments in equal measure.

Box 1. NML Capital, Ltd. v. Argentina

Argentina defaulted on more than $80 billion in foreign bonds in 2001. Two debt exchanges and over a decade later, it has restructured 93 percent of this total. NML Capital, Ltd., is among the creditors that rejected Argentina's offers and sued for full payment. NML is an affiliate of Elliott Associates, which specializes in distressed sovereign debt litigation. Elliott's successful lawsuit against Peru a decade earlier, on the same theory it has since used against Argentina, was prominently cited to support SDRM.

Unlike Peru, Argentina has refused to settle with the holdouts, and it has chosen instead to pay the cost of moving its assets beyond its creditors' reach and to avoid new borrowing abroad, for fear of attachment.

By 2012, both the creditors and the courts were ready to escalate debt enforcement. In February, the U.S. federal judge in New York, who has presided over Argentina's debt litigation all these years, ruled that it had violated the pari passu clause in its old bonds with its protracted failure to pay, by enacting laws that impede settlement, and by making official statements of defiance—among other things. The court required Argentina to pay both its old and new bonds "ratably." The court later elaborated that ratable payments meant that Argentina must pay NML and its co-plaintiffs full principal and past-due interest (now $1.4 billion) whenever it makes the periodic coupon payment on the restructured bonds. The judge prohibited Argentina from rerouting payments on the new bonds, and threatened to sanction third parties that might help Argentina pay this debt but not NML. The threat covers trustees, clearinghouses and payment systems, even naming some located in Belgium, Luxembourg and the United Kingdom. The court effectively gave Argentina only two ways to comply: pay everyone, or default on everyone.

In October 2012, the U.S. Federal Appeals Court for the Second Circuit agreed that Argentina had violated the pari passu clause and must make ratable payments. It dismissed the U.S. executive branch's objections to the lower court's contract interpretation, its warnings that the remedy would impede future restructurings, and its claim that the court had violated the U.S. Foreign Sovereign Immunities Act by telling Argentina how to spend its treasury funds anywhere in the world.

In August 2013, the Second Circuit also affirmed the lower court's formula for ratable payment, and refused to limit up front the injunction's territorial reach, or its potential impact on third parties. The court was unpersuaded by the many submissions from the exchange bondholders and financial institutions potentially subject to sanctions. However, the injunction remains stayed (suspended) for now, to allow appeals to the U.S. Supreme Court. The stay may be at risk in the wake of Argentina's recent announcement that it would offer to swap its restructured New York bonds for domestic debt with payment streams beyond the reach of U.S. courts.

Argentina appealed to the U.S. Supreme Court in June 2013, asking it to review the holding that it may not service its new bonds unless it pays the plaintiffs ratably. France has filed a friend-of-the-court brief urging review, and stressing the consequences for debt restructuring and the Paris Club. In light of the August 2013 court decision, Argentina and other countries are likely to make other submissions to the Supreme Court. The Court is also likely to ask the U.S. government for its views.

debts or offer creditors a debt restructuring well below their capacity to pay. These have been rare in sovereign debt since World War II, much rarer than the opposite problem of overindebted countries that restructure too little too late, as argued in the previous chapter; however, ruling out rogue behavior entirely surely would be good news, particularly from the perspective of new borrowers with short track records. If, conversely, a debtor is genuinely unable to pay—or debt is inefficiently high, creating a debt overhang problem that weighs on growth and future capacity to pay—creditors could collectively agree to renegotiate debt contracts. Debtors would be discharged of past debt obligations through a change in the contract terms of each and every existing debt obligation.

In the absence of effective creditor coordination, however, the New York decisions could turn out to be a big problem. This is because they are likely to upset the delicate balance between imperfect enforcement and the nondischargeability of debt that has made ad hoc debt exchanges reasonably smooth in the past. Though sovereign debt remains nondischargeable, potential holdouts have been handed a much better enforcement technique than they had in the past: "third party enforcement" directed not at the sovereign itself but at those private parties on which the sovereign depends.

This will make successful debt exchanges harder to coordinate, even when they are in the joint interests of the debtor country and the creditors collectively. On one hand, the bargaining power of potential holdouts will be higher, making holdout strategies a more attractive proposition. One the other hand, creditors considering an exchange offer must weigh not only the proposed haircut but also the prospect of defending a lawsuit or, at a minimum, having their reduced payments interrupted by future holdouts. This means that even where litigation is unattractive to most creditors, participation is likely to become much less attractive.

As a result, exchange offers could fail for lack of participation even when they were collectively optimal, or they could result in much lighter haircuts than would be needed to restore debt sustainability. The country and most of its creditors, and perhaps even its neighbors and other victims of spillovers, could risk getting permanently stuck in debt purgatory.

No Easy Way Out

The opinions of the U.S. Court of Appeals mistakenly suggest that the court follows on the heels of a major shift in sovereign debt contracts that facilitates restructuring—the advent of collective action clauses (CACs)—which creates the space for more robust enforcement. In this view, the rise of CACs gets the debtor closer to a fresh start and justifies "rebalancing" in the direction of enforcement. However, whereas CACs can be helpful, they do not—at least in the variety that is most common in sovereign debt contracts today—eliminate holdouts in sovereign debt restructuring so as to make the pari passu remedy unimportant. Under the prevailing model of CACs, a supermajority of creditors in a single bond series may vote to amend the terms and bind the dissenting minority. However, creditors can and do target small series trading at a deep discount, where they can buy a blocking position with relative ease, hold out, and threaten to sue. For instance, more than half of all foreign-law bonds in the Greek debt restructuring failed to get the needed votes to amend the terms. These bonds are still being serviced according to the original terms.

Could exit consents offer a solution? Since Ecuador's 2000 restructuring, this has been a popular technique to deter holdouts in sovereign restructuring. When participating creditors exchange their old bonds for new ones, they are asked to vote to amend certain nonfinancial terms of the bond that may be altered by simple majority, with the result binding on all. In the early days of the tactic, it could be used to strip out a bond's terms concerning negative pledge, pari passu, listing, immunity and jurisdiction. Nonparticipants risked staying behind with an illiquid and potentially

Box 2. The *Assenagon* Case

CACs and exit consents both rely on majority rule. When a technique empowers a majority of bondholders to impose restructuring terms on dissenters, it raises the possibility of unfair treatment. Such fairness concerns have featured most prominently in U.K. court cases about the oppression of bondholder minorities. Taken to the extreme, this line of reasoning can block or severely limit the use of CACs and exit consents, and breathe new life into holdout strategies.

The High Court decision in *Assenagon Asset Management S.A. and Irish Bank Resolution Corporation Limited (Formerly Anglo Irish Bank Corporation Limited)* involved the use of exit consents in an Irish bank's restructuring and recapitalization exercise. Holders of Anglo-Irish bank bonds were invited to exchange their holdings for new ones at 20 cents on the euro. At the same time, they were asked to vote to give the Irish Bank Restructuring Corporation, which had taken over the bank, the right to redeem nonparticipating bonds at 1 cent on €1,000, effectively wiping out their value. The High Court deemed this oppressive and ruled for the fund challenging the transaction.

The judge appeared amenable to a softer version of exit consents, whereby nonparticipants are given value equivalent to that received by the participants. However, when the worst possible outcome for nonparticipation is getting the same terms as everyone else, the urgency of signing up for an exchange goes away.

worthless instrument. However, since the advent of CACs on a mass scale in 2003, important nonfinancial terms in sovereign bonds have generally migrated to the list of reserve matters that require supermajority amendment, along with financial terms. This means that blocking the removal of a pari passu clause through exit consents is now just as easy as blocking the change in the payment terms itself. In addition, a U.K. court's decision in 2012 potentially limits the use of exit consents in distressed exchanges (box 2).

This seems to leave only one approach to ad hoc debt restructuring that could avoid the new threat of third-part enforcement, albeit at a much higher risk of litigation by "mainstream" creditors. Rather than offering a debt exchange that would create incentives to hold out, debtors could simply default "ratably" on all creditors at once. For example, a debtor could announce a new payment stream equivalent to that which it would have offered in the form of a new debt preceding the New York decisions. By treating all creditors the same, this approach would sidestep the possibility of enforcement. But this comes at a high price, given that the debtor would plunge into a torrent of litigation and likely forgo any hope of a fresh start.

Pari Passu Is Not All

Even in the absence of legal and institutional reforms along the lines proposed in this report, the pari passu problem may well recede over the next decade or so (though only very gradually, given the typical maturities of sovereign bonds). Sovereigns and their creditors, including major trade associations, have adapted their contracts in response to litigation and other restructuring developments. There is some evidence that this adaptation process has already begun in response to New York court rulings. Hence, although recent legal developments are likely to pose problems for debt restructuring in the short and medium terms, their effect is likely to diminish over time.

However, this fact obscures a more significant structural problem, of which the pari passu saga is a symptom. With no clear path to enforcement or a fresh start, both sides in the sovereign debt restructuring game try to leverage contract provisions to win a given round. As the pari passu clause is gradually replaced, another technique will likely surface as a platform for recovery. All it will take is for one adventurous (or frustrated) court to interpret a contract term in an unconventional way for a brief period of time. In the next round, sovereigns might respond with more aggressive restructuring techniques. The same contractual flexibility that produces ingenious restructuring techniques lends itself to ingenious enforcement techniques, and so on.

Put differently, contracts as interpreted by judges have proven inadequate to mediate the tension between the lack of enforcement and the impossibility of discharge in sovereign debt. To the extent that contracts improve over time and leave less room for interpretation, this problem may recede. That said, experience suggests that this is at best an uncertain process that will take several decades—adaptation is a long and winding road littered with institutional problems, and is not at all certain to address interpretive shocks or result in more perfect contracts (Gulati and Scott 2013). Hence, a solution that is both durable and takes effects reasonably quickly will require policy action—whether to improve contracts in a more radical and coordinated fashion than adaptation would produce on its own, or to create statutory solutions that can complement existing contracts.