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Restructuring Sovereign Debt After *NML v. Argentina*

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Abstract

The decade and a half of litigation that followed Argentina's sovereign bond default in 2001 ended with a great disturbance in the Force. A new creditor weapon had been uncloaked: The prospect of a court injunction requiring the sovereign borrower to pay those creditors that decline to participate in a debt restructuring ratably with any payments made to those creditors that *do* provide the country with debt relief. For the first time holdouts succeeded in fashioning a weapon that could be used to injure their erstwhile fellow bondholders, not just the sovereign issuer. Is the availability of this new weapon limited to the aggravated facts of the Argentine default or has it now moved permanently into the creditors' arsenal? Only time (and future judicial decisions) will tell. In the meantime, however, sovereigns will occasionally find themselves in financial distress and their debts will occasionally need to be restructured. Venezuela already casts this chilly shadow over the sovereign debt market. If, in a galaxy not too far away, sovereign debt workouts are to have any chance of an orderly completion, a method must be found to neutralize this new weapon. Judging by the secondary market prices of different series of Venezuelan sovereign bonds, large amounts of money are being wagered that it cannot be done.

Restructuring Sovereign Debt
<u>After NML v. Argentina</u>

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Although it is relatively easy for a lender to get a court judgment against a defaulting sovereign (this is a sovereign's great vulnerability in comparison with a corporate debtor eligible for the protection of the bankruptcy court), it is often difficult for the creditor to enforce that judgment in light of the paucity of attachable assets outside of the sovereign debtor's own jurisdiction (this is a sovereign's great strength). A recognition of this state of affairs gives both sides an incentive to negotiate, rather than litigate, their way out of a sovereign debt problem.

NML v. Argentina[1] upset this strategic balance. For the first time, holdout creditors in a sovereign debt workout were given a new judicial remedy -- an injunction preventing the borrower from making payments to its other equally-ranking creditors without making a "ratable" payment to the holdouts.[2] The legal theory that purported to support the issuance of such an injunction focused on the *pari passu* clause in the bonds held by the holdout creditors. That provision, a boilerplate clause in cross-border debt instruments of both sovereign and corporate borrowers, promises to maintain the equal ranking of the obligation with the debtor's other senior external indebtedness. The U.S. federal courts sitting in New York interpreted such a promise by Argentina to maintain the equal *ranking* of its external debt instruments as justifying an injunction ordering Argentina to *pay* those instruments ratably with other debt.

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* Cleary Gottlieb Steen & Hamilton (New York) and Duke Law School, respectively. Thanks to Mark Weidemaier for comments and to Sofia Martos for assistance in the preparation of the table of *Pari Passu* Benchmarks.

1 *See* NML Capital, Ltd. v. Argentina, No. 08 Civ 6978 (TPG) (S.D.N.Y. Feb. 23, 2012); NML Capital, Ltd. v. Argentina, 699 F.3d 246, 264 (2d Cir. 2012); NML Capital, Ltd. v. Argentina, No. 08 Civ 6978 (TPG), 2012 U.S. Dist. LEXIS; 167272 (S.D.N.Y. Nov. 21, 2012); NML Capital, Ltd. v. Argentina, 727 F.3d 230 (2d Cir. 2013), *cert. denied* 134 S.Ct. 2819 (June 16, 2014).

2 In the Argentine case, the *pari passu* injunctions approved by the New York courts required Argentina to make a "ratable" payment to its holdout creditors whenever it made a payment on the new debt instruments (dubbed "*Exchange Bonds*") it had issued to those creditors that participated in the country's debt restructuring. As later interpreted by the District Court granting the injunctions, even payment of a coupon due under the Exchange Bonds triggered a requirement to make full payment of *all* amounts due under bonds held by holdouts. NML Capital, Ltd. v. Argentina, No. 08 Civ 6978 (TPG), 2012 U.S. Dist. LEXIS 167272 (S.D.N.Y. Nov. 21, 2012). In the face of these injunctions, Argentina felt compelled to default on its Exchange Bonds. *See* Kathy Gilsinan, *65 Words Just Caused Argentina's $29-Billion Default*, THE ATLANTIC, July 31, 2014, available at http://www.theatlantic.com/international/archive/2014/07/65-words-just-caused-argentinas-29-billion-default/375368/

As a matter of contract interpretation of the *pari passu* clause, the decision was certainly wrong. The largest trade association representing bondholders, underwriters, issuers and financial intermediaries felt compelled after the *NML* decision to promulgate model *pari passu* clauses for use in sovereign bonds that expressly disavow the court's ratable payment interpretation of the provision.[3] When issuers and investors take the trouble to revise their standard documents explicitly to disown an aberrant judicial interpretation of a boilerplate clause, it is pretty clear evidence that the market did *not* in fact understand the clause to mean what the judiciary *said* the market understood the clause to mean.[4] But the U.S. Supreme Court declined to review the *NML* holding and it remains the law in New York. It may be years before subsequent cases gradually narrow the *NML* decision to the peculiar facts of the Argentine case or the peculiar wording of the *pari passu* clause in the Argentine bonds (and it was peculiar). This process will resemble judicial tattoo removal; something that seemed like a good idea at the time must be gradually and painfully effaced years later.

Just What (Exactly) Did NML Hold?

The Second Circuit Court of Appeals considered the *pari passu* issue raised by the *NML* case three times: first in its October 26, 2012 decision responding to the District Court's grant of an injunction to the *NML* plaintiffs,[5] then again on August 23, 2013 after the District Court amended and explained the injunctions,[6] and finally on April 15, 2016 affirming the District Court's lifting of the injunctions.[7]

The 2012 Decision lays out the elements that the Second Circuit felt supported the District Court's finding that Argentina had violated its *pari passu* undertaking to the litigating bondholders. As explained by the Second Circuit, these elements were:

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[3] *See* International Capital Markets Association, Standard *Pari Passu* Provision For the Terms and Conditions of Sovereign Notes (August 2014), available at http://www.icmagroup.org/resources/Sovereign-Debt-Information/ .

[4] For details on the widespread changes to *pari passu* clauses used in the market, in the wake of the *NML v. Argentina* decision, see IMF, *Second Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts*, Progress Report Annex I (January 2017), available at http://www.imf.org/external/np/pp/eng/2017/122716.pdf (listing sovereign issuers that used the revised *pari passu* clauses during the period from October 1, 2014 to October 30, 2016); Stephen J. Choi, Mitu Gulati & Robert E. Scott, *Evolution or Intelligent Design: The Variation in Pari Passu Clauses* (2016 draft), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2827189 (reporting data on the revisions to *pari passu* clauses between June 1, 2011 and May 30, 2016); Lee C. Buchheit & Sofia D. Martos, *What to Do About Pari Passu*, J. INT'L BANKING AND FIN. L. (Sept. 2014) at 491.

[5] NML Capital, Ltd. v. Argentina, 699 F.3d 246, 264 (2d Cir. 2012) (The "2012 Decision").

[6] NML Capital, Ltd. v. Argentina, 727 F.3d 230 (2d Cir. 2013) (The "2013 Decision").

[7] NML Capital, Ltd. v. Argentina, No. 08 Civ 6978 (TPG) (April 22, 2016) (The "2016 Decision").

(i) Argentina had declared a moratorium on its bond indebtedness in 2001 and had renewed that moratorium annually in the intervening years.

(ii) No payments had been made for six years on Argentina's unrestructured bonds while the country had been making regular payments on the bonds it issued in connection with its debt restructuring program.

(iii) The prospectuses Argentina had issued in connection with those restructurings stated that Argentina had no intention of paying the non-tendered bonds.

(iv) Argentina had enacted legislation – the so-called "*Lock Law*" -- which specifically prohibited its officials from paying (or settling with) holders of non-tendered bonds.[8]

What the Second Circuit did *not* do, however, was clarify which of these elements, or which combination of these elements, would be sufficient to establish a *pari passu* violation. Indeed, the Second Circuit went out of its way to distance itself from the District Court's suggestion that a *pari passu* breach would occur whenever a sovereign paid one debt while defaulting on another. That, the court said, was an issue it need not decide.[9] Nor did the Second Circuit offer a view about whether a "legislative enactment" like the Lock Law, standing alone, could result in a breach of the *pari passu* provision. "We simply affirm", the Second Circuit said, "the district court's conclusion that Argentina's course of conduct did here."[10]

In the Second Circuit's 2013 Decision, Argentina's offending course of conduct was characterized in these terms (note the conjunctive "and" in the following sentence):

> As we have held, by defaulting on the [plaintiffs'] Bonds, enacting legislation specifically forbidding future payment on them, *and* continuing to pay interest on subsequently

8 699 F.3d. at 258-260.

9 *Id.* at 264, n.16.

10 *Id.*

> issued debt, Argentina breached its promise of equal treatment.[11]

The Second Circuit explicitly warned, however, that its decision in the Argentine case did not control the interpretation of *pari passu* clauses in other sovereign debt instruments.

> As we explicitly stated in our last opinion, we have not held that a sovereign debtor breaches its *pari passu* clause every time it pays one creditor and not another, or even every time it enacts a law disparately affecting a creditor's rights. We simply affirm the district court's conclusion that Argentina's extraordinary behavior was a violation of the particular *pari passu* clause found in the FAA.[12]

The question for future lawsuits is the one that the Second Circuit expressly left open in the *NML* case -- will a practice of making discriminatory payments on sovereign debt (paying some and not paying others), standing alone and without one or more aggravating factors such as passage of legislation similar to the Argentine Lock Law, be sufficient to establish a breach of a sovereign *pari passu* covenant? If the answer turns out to be yes, the *pari passu* risk will complicate sovereign debt workouts under New York law for many years to come because sovereigns invariably pay some creditors in a debt restructuring (such as the International Monetary Fund, other multilateral lenders and trade creditors) while restructuring others (bondholders, bilateral lenders etc.). If the answer turns out to be no, the shadow cast by the *NML* precedent may quickly dissipate because other sovereigns will presumably not fall into the trap of attempting to legislate a discriminatory treatment of holdout creditors, nor will they publicly consign holdout creditors to the outer darkness of perpetual payment default. Until the answer to this question is clarified by subsequent judicial decisions, however, the architects of future sovereign debt restructurings governed by New York law will need to address the possibility that holdouts may be able to wield the *pari passu* weapon after those restructurings have closed.

An important first step in this process occurred while this article was in the editing process. The United States District Court for the Southern District of New York (Judge Thomas P. Griesa) handed down a significant opinion in a case captioned *White Hawthorne, LLC, et al. v. The Republic of Argentina* (16-cv-1042 (TPG), Opinion dated December 22, 2016).

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[11] 727 F.3d. at 237 (italics added).

[12] *Id.* at 247.

The *White Hawthorne* decision involved complaints by certain creditors that had declined the Republic of Argentina's settlement offers in early 2016. The plaintiffs sought, among other things, "specific performance" of the *pari passu* clause in the Argentine bonds they held, arguing that Argentina was in continuing violation of that clause. The plaintiffs also sought money damages for this alleged violation of the *pari passu* clause. Argentina moved to dismiss the complaints.

In the spring of 2016, Judge Griesa lifted the *pari passu* injunctions he had previously imposed on Argentina in light of the efforts of the new administration in Argentina (which took office in December 2015) to settle its long-standing disputes with the country's holdout bondholders. As noted above, however, the decision to lift the injunctions did not clarify which elements of Argentina's prior behavior were necessary conditions for granting future *pari passu* injunctive relief.

Judge Griesa's December 22, 2016 Opinion in *White Hawthorne* contains just such a clarification. In particular, Judge Griesa held that "[n]onpayment on defaulted debt alone is insufficient to show breach of a *pari passu* clause."[13] Absent the aggravating factors (such as passage of the infamous Lock Law) that characterized the prior Argentine administration's approach to its holdout creditors, Judge Griesa found no continuing *pari passu* violation even though plaintiffs' bonds remained in default at a time when Argentina was paying (and settling with) other holders of similar bonds. *White Hawthorne* is, of course, only a District Court decision, albeit one from the same District Court and the same judge that granted the initial *pari passu* injunctions. Its fate on appeal (if there is an appeal) cannot now be predicted.

The manner in which the *NML* litigation was concluded in the spring of 2016 will only exacerbate the risk of holdout creditors seeking *pari passu* injunctions in future sovereign debt workouts. The new political administration that took office in Argentina in December 2015 did not attempt to hide the fact that the existence of *pari passu* injunctions in the *NML* case had effectively kept Argentina out of the capital markets and were a major factor inducing the country to settle claims dating back over 15 years.[14] On February 5, 2016, Argentina published a settlement offer directed at all holders of its defaulted bonds.[15] The offer

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[13] White Hawthorne, LLC et al., v. Republic of Argentina, 2016 WL 7441699 at *3.

[14] *Argentina's Debt: At Last*, THE ECONOMIST, March 5, 2016, available at http://www.economist.com/news/americas/21693786-agreement-victory-countrys-new-president-argentina-reaches-deal-its

[15] Available at http://www.economia.gob.ar/wp-content/uploads/2016/02/749772417-Propuesta-de-Settlement-Febrero-5-2016.pdf. *See* Daniel Bases & Sarah Marsh, *Argentina Offers $6.5 billion Cash Deal to End Debt Battle*, REUTERS, February 5, 2016, available at http://www.reuters.com/article/us-argentina-debt-idUSKCN0VE2L4. For the official offer and instructions, see

distinguished between those holders that had obtained a *pari passu* injunction from the New York court and those that did not. The financial terms of the offer were richer for bonds that benefitted from a *pari passu* injunction. Prospective holdouts in future sovereign debt restructurings will take from this the obvious lesson -- *pari passu* injunctions can force a sovereign to the settlement table and can significantly improve a creditor's recovery once the sovereign gets there.

<u>The Effect of the NML Precedent</u>

The prospect of a New York court issuing *NML*-style *pari passu* injunctions will have direct implications for future sovereign debt workouts.

<u>On future sovereign debt restructurings</u>. Not only have the holdouts' prospects for forcing a preferential settlement from the borrower greatly improved as a result of the *NML* decision, the prospects for the participating creditors ever getting paid on their restructured instruments have proportionally diminished. Absent a remedy of some sort, it is fanciful to think that even well-intentioned creditors in a future sovereign debt workout will write down or defer their claims against the sovereign debtor only to watch as holdout creditors attempt to interfere with payments on the restructured debt instruments issued in that transaction. So the question for the architects of those future sovereign debt workouts will come down to this -- how can the new instruments issued in a restructuring be insulated from *pari passu* claims by holdouts who decline to participate in the restructuring?

<u>On the settlement of future sovereign debt disputes</u>. Like jealousy, the ratable payment interpretation of a *pari passu* clause is "the green-eyed monster which doth mock / The meat it feeds on."[16] If the holdout creditor is entitled to a ratable payment whenever a payment is made to those who accepted the debtor's restructuring offer, presumably every other holder of a defaulted instrument containing a *pari passu* covenant is entitled to a ratable payment corresponding to any preferential recovery or settlement that the holdout itself may extract from the debtor. And if such a ratable payment is not forthcoming, the *NML* precedent suggests that those other lenders are entitled to an injunction running against the original holdout creditor and any financial intermediary that processes a payment to the holdout. Thus, if the holdout creditor asserting a claim under the *pari passu* clause prevails in its interpretation of that provision, it immediately exposes itself (and any preferential settlement it hopes to extract from the debtor) to similar claims of ratable payment by other lenders.

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http://www.economia.gob.ar/wp-content/uploads/2016/04/Argentina_Press_Release_with_Instructions.pdf

16 The quote is from William Shakespeare's *Othello*, Act 3, Scene 3.

An illustration. A holdout creditor persuades a court that the *pari passu* clause in its debt instrument entitles it to an injunction forbidding the borrower from paying its other creditors unless a ratable payment is made to the holdout. The strategy is successful: the debtor agrees to settle with the holdout at 70¢ on the dollar. At this point, every other holder of a defaulted debt instrument of that borrower, citing the *pari passu* clause in its debt instrument, is entitled -- under the same interpretation of *pari passu* -- to receive a ratable payment equal to 70% of what it is owed. The *NML* logic leads to the conclusion that an injunction should be issued against the borrower forbidding it to conclude a non-ratable settlement with the original holdout until other holders receive their ratable payments. The *pari passu* monster thus devours its own maker.[17]

Tactical Responses

Sovereign issuers and the sovereign bond market have attempted to respond to the *NML* decision in several ways. None have been entirely satisfactory.

Zero tolerance. One option is for the sovereign debtor to adopt a zero-tolerance policy with respect to holdout creditors in a future debt restructuring of New York law-governed bonds. This means, in practice, insisting that no part of the restructuring will proceed unless the required voting threshold for activation of the collective action clause in each affected bond has been reached.[18] Naturally, this is a two-edged sword. Although it undoubtedly ratchets up the peer pressure on all bondholders to act in a cooperative spirit, it also gives prospective holdouts who amass a blocking position in any single bond the ability to stop the entire restructuring in its tracks.

Keep payments outside of the United States. The issuer could attempt to engineer the payment streams on new bonds issued as part of a restructuring to keep those streams outside of the United States and beyond the reach of *NML*-type injunctions issued by U.S. courts. This may not be easy, particularly if the restructured instruments are denominated in U.S. dollars. At the very least it would require finding a trustee and paying agent that did not have (and did not expect in the future to open) an office in the United States, as well as a bond payment mechanism that did not involve the services of U.S.-based institutions. Investors would need to

17 A variation of this argument appeared when Argentina settled its long-running dispute with holders of its defaulted bonds in the spring of 2016. Some creditors argued that the sweeter settlement offer made to holders of bonds which had received a *pari passu* injunction was itself a breach of the *pari passu* clause in those bonds that did not benefit from such an injunction. See, *e.g.*, *Trinity Investments Limited v. Republic of Argentina*, Civ. Index 16-1436, Amended Complaint filed June 22, 2016 at paras 71-72; *Aurelius Cap. Master, Ltd. et. al v. Republic of Argentina*, 2d Cir. Index 16-0628-cv(L), Joint Brief for Plaintiffs-Appellants at 17-18 (March 14, 2016).

18 Belize embraced a zero tolerance policy in its debt restructuring of 2013, as did Grenada in its debt restructuring of November 2015. Both Belize and Grenada had only a single international bond outstanding, however, and this undoubtedly made zero tolerance an easier decision for the authorities.

understand and accept such novel payment machinery. If they do not, investors will exact a basis point penalty for the novelty of the structure.

Revised *pari passu* and CAC clauses. As noted above, the International Capital Markets Association (ICMA) has promulgated a revised model *pari passu* clause intended expressly to disavow the interpretation given that provision by the federal courts in the *NML* case.[19] ICMA simultaneously published a revised model collective action clause for use in sovereign bonds. This new CAC permits an issuer to "aggregate" the votes of holders of all series of its outstanding bonds, thus making it more difficult for a holdout to acquire a blocking position in a single series. Although these new clauses have received widespread support in the market since they were introduced in August 2014, they will not be of much help in neutralizing the risk of an *NML*-type injunction for many years. It will take a decade or more for existing bonds to mature and be replaced by new instruments containing the improved clauses.

Trust structures. In the wake of the *NML* decision, a number of sovereign borrowers have switched from issuing their bonds under fiscal agency structures (in which bondholders have individual enforcement rights) to trust structures (in which enforcement powers are largely concentrated in the hands of a trustee).[20] Enforcement by a trustee is pursued for the ratable benefit of all holders, thus frustrating the objective of a prospective holdout creditor.[21] Here again, however, it will take years before sovereign bonds mature and can be replaced by instruments issued under trust structures.

Strategic Options

If participants in a future sovereign debt restructuring demand (and they will) that the instruments they receive in connection with such a transaction be insulated from the risk of an *NML*-style *pari passu* injunction, we believe the architects of the transaction will have three strategic choices: (i) issue non-Benchmark (as defined below) debt instruments, (ii) frustrate the ability of a prospective holdout to obtain a *pari passu* injunction through a surgical use of exit consents or (iii) adopt the Cryonic Solution described below.

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19 *See* ICMA Clauses, *supra* note 3; *see also* Leland Goss, *NML v. Argentina: The Borrower, the Banker, and the Lawyer--Contract Reform at a Snail's Pace*, 9 CAP. MKTS. L. J. 287 (2014).

20 *See* IMF, *Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts*, *Progress Report* (Sept. 2015) at 10-13, available at https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Progress-Report-on-Inclusion-of-Enhanced-Contractual-Provisions-in-International-Sovereign-PP4983

21 *See* generally, Lee C. Buchheit & Sofia Martos, *Trust Indentures and Sovereign Bonds,* 31 J. OF INT'L BANKING AND FIN. L. 457, Sept. 2016.

Issuing Non-Benchmark Debt Instruments

Designing a sovereign debt restructuring to avoid the problem of *NML*-type injunctions will be a highly fact-specific exercise. The text of the relevant *pari passu* clause will be of crucial importance. These clauses promise that the borrower will maintain the *pari passu* (equal) ranking of the debt in question with a specified category of the borrower's other obligations. So, for example, the clause might promise equal ranking with the borrower's other "External Debt", or "Public External Debt" or "Indebtedness" or perhaps just "Obligations". The relevant category (which we will call the "*Benchmark*") is often a defined term in a debt instrument or in the related indenture, trust deed or fiscal agency agreement. Attached to this article is a schedule showing the *pari passu* Benchmark categories in recent sovereign bond issues.

Even under the broad interpretation of the *pari passu* clause accepted by the U.S. federal courts in the *NML* case, a holdout creditor will be entitled to an injunction only if the sovereign is attempting to make a non-ratable payment on an obligation falling within the category of Benchmark obligations in the relevant *pari passu* clause. So the threshold question in designing a restructuring is whether the sovereign can issue new debt instruments that fall outside of the relevant Benchmark.

For example, if the Benchmark is "External Debt" (defined as an obligation denominated in a currency other than the currency of the issuer), the sovereign might be able to issue a debt instrument denominated in local currency but couple it with a prepaid swap into foreign currency for those creditors electing to receive FX payments. The amounts due under the debt instrument would presumably be indexed to the exchange rate (otherwise the swap would be prohibitively expensive). The swap would undoubtedly add an element of expense and risk to the transaction. Perhaps the sovereign could arrange for its own central bank to write the swap contract in order to minimize costs and avoid injecting the credit risk of an unaffiliated third party into the transaction.

If the Benchmark defines a narrower category such as Publicly Issued External Indebtedness (that is, external debt in the form of bonds, notes or similar instruments that can be listed on exchanges), other options may present themselves. For example, the sovereign's own obligation could take the form of a loan agreement (a non-Benchmark debt instrument) lodged with a special purpose vehicle. The SPV would then issue to the ultimate investors some form of pass-through certificate entitling them to a share of the payments received by the SPV under the loan. Similar structures are routinely used in corporate borrowings where a higher rate of withholding tax is assessed on public debt instruments like bonds as opposed to loans. Thus, in the typical case, an SPV is established in a jurisdiction such as Luxembourg or Cyprus that has a tax treaty with the country in which the borrower is domiciled. The corporate borrower signs a loan agreement in favor of the SPV (on which withholding tax is assessed at the lower rate for loans) which in turn issues

Participation Certificates to investors (which trade in the market like bonds). The effect is to transform what is, for tax purposes, a loan to the borrower into a bond for the investor.

Naturally, if the Benchmark is a wider category such as a simple reference to "obligations," this technique becomes more difficult to implement.

<u>Exit Consents</u>

"Exit consents" refers to a technique by which holders of a debt instrument (*Old Bonds*) vote -- just before exchanging them for new instruments in a debt restructuring (*New Bonds*) -- to amend the terms of the Old Bonds in ways that make the Old Bonds more difficult to enforce by holdout creditors.[22] The amendment clause in a traditional New York law sovereign debt instrument requires unanimous creditor consent to changes to the payment terms of the instrument (amount, due dates, currency and so forth), but only 50% or 66⅔% creditor approval to all other modifications. The technique therefore involves identifying modifications to the non-payment terms of a debt instrument that will make the instrument less attractive to prospective holdout creditors.[23] Eliminating the acceleration remedy in the Old Bonds might be an example of a change that could be effected through an exit consent.

For sovereign debt instruments that do not contain collective action clauses[24] but follow the traditional New York law amendment approach (unanimous

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[22] *See* Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59 (2000).

[23] Although U.S. courts have generally upheld the validity of the exit consent technique in corporate bond restructurings (see *id*. at 70-78), two federal trial courts recently disapproved use of the technique in corporate debt restructurings. These trial courts found aggressive exit consents to be tantamount to an impairment of the payment terms of the Old Bonds. *See* Marblegate Asset Management v. Education Management Corp., Case No. 14 Civ. 8584(KPF), 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014); MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entm't Corp., No. 14-CV-7091 SAS, 2015 WL 221055 (S.D.N.Y. Jan. 15, 2015). Both of these cases involved indentures qualified under the Trust Indenture Act of 1939 (and the rulings are thus not strictly applicable to debt instruments issued by foreign sovereigns in the United States). Nevertheless, the analysis of when an exit consent will effectively undermine a creditor's right to payment (so as to require the unanimous consent of creditors under standard U.S. amendment clauses) may be relevant to the sovereign context. In both cases the exit consents in question were very aggressive, far more aggressive than those discussed in this article such as an exit consent to remove a *pari passu* covenant. On January 17, 2017, the Second Circuit Court of Appeals overruled the lower court's decision in the Marblegate case. The Second Circuit's 2-1 decision concluded that exit consents which may impair a bondholder's *practical* ability to recover its claim -- but which do not directly amend the core payment terms of the instrument -- do not violate the Trust Indenture Act. *See* Marblegate Asset Management v. Education Management Corp., 2017 WL 164318 (2d Cir).

[24] Exit consents can also sometimes be used effectively in a situation where the sovereign is worried that prospective holdouts may have acquired a position in a bond sufficient to block use of the collective action clause (typically 25%), but not sufficient to block amendments that require only a 50% or 66⅔ affirmative vote of holders. That said, developments in the sovereign debt market over the last 10

consent for changes to payment terms; 50% or 66⅔% for changes to everything else), exit consents might effectively neutralize the ability of holdout creditors to cause *pari passu* mischief after the debt restructuring closes. For example, depending on the precise wording of the amendment clause in the Old Bonds, an exit consent might (i) eliminate the *pari passu* clause in the Old Bonds altogether or (ii) clarify that the remedy for a breach of the *pari passu* clause in the Old Bonds is acceleration and money damages, *not* an equitable remedy such as an injunction or specific performance.

<u>The Cryonic[25] Solution</u>

In most sovereign debt restructurings carried out through an exchange of Old Bonds for New Bonds, the Old Bonds acquired in the exchange are promptly cancelled. Sometimes this is a contractual requirement of the terms and conditions of the Old Bonds themselves (although one susceptible to an exit consent modification) but normally it is done to ensure that the sovereign borrower's debt stock does not show as outstanding both the Old Bonds and the New Bonds. In situations in which the risk of post-closing *pari passu* injunctions cannot be convincingly neutralized by issuing non-Benchmark debt instruments in the restructuring or employing exit consents to prevent holdouts from obtaining *pari passu* injunctions, the third alternative may be a cryonic solution -- keeping the Old Bonds alive and lodged in a safe pair of hands.[26]

It would work something like this:

1. The sovereign debtor implements its restructuring through a conventional exchange offer.

2. The Old Bonds that the sovereign receives back in connection with that exchange are *not* canceled. Those bonds are lodged with a trustee (the "*Custodian Trustee*") and any recoveries under the Old Bonds are pledged as

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years have narrowed the scope for the use of exit consents in bonds containing collective action clauses. Following the G-10 promulgation of a model collective action clause for sovereign bonds in 2002, drafters of CACs began to expand the list of CAC "Reserve Matter" amendments (requiring a 75% approval) to include changes to non-payment provisions of the agreement such as the *pari passu* clause, events of default, governing law and waiver of immunity. For details, see Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract*, 84 WASH U. L. Q. 1627 (2006).

25 The process of freezing and storing dead bodies under the assumption that they may be reanimated in the future.

26 The practice of canceling bonds acquired in an exchange offer for a sovereign debt restructuring has other undesirable consequences. Once the Old Bonds acquired in the exchange are canceled, the only bonds that remain outstanding are, by definition, held by holdouts. It thus becomes much easier to obtain the required percentage of holders to accelerate the instrument after the restructuring closes, or -- in the case of bonds issued under trust structures -- to instruct the trustee to enforce the instruments.

security for the New Bonds issued to participating creditors in the exchange.

3. In connection with the exchange offer, participating creditors expressly agree that:

    - the Custodian Trustee holding the Old Bonds shall take no action to enforce the Old Bonds against the issuer (the participating creditors will look to their New Bonds for legal remedies);

    - the Custodian Trustee, in respect of the Old Bonds it is holding, shall not vote in favor of an acceleration of those instruments (most modern sovereign bonds require holders of at least 25% of the instruments to accelerate);

    - in the event a holdout creditor seeks a recovery under its Old Bonds that exceeds the amounts received by participating creditors under the New Bonds, the Custodian Trustee is instructed to assert a claim against the holdout for a ratable payment based on the *pari passu* clause in the Old Bonds the Custodian Trustee is holding; and

    - any amounts recovered by the Custodian Trustee under the Old Bonds will be applied toward amounts falling due under the New Bonds and will, dollar for dollar, discharge the issuer's payment obligations under the New Bonds.

If a holdout creditor succeeds in obtaining an *NML*-style *pari passu* injunction preventing the sovereign borrower from making payments on its New Bonds without making ratable payments on its Old Bonds, the issuer might decide to cease making direct payments on its New Bonds in favor of making partial payments on its Old Bonds. (The size of this partial payment would be set at a level sufficient to cover current debt service on the New Bonds.) The lion's share of that partial payment on the Old Bonds, of course, would go to the Custodian Trustee holding the Old Bonds acquired in the exchange. The Custodian Trustee would then apply those funds to amounts falling due under the New Bonds. The result? The New Bonds will be kept current; the Old Bonds in the hands of the holdouts will be partially paid.

But, some may ask, won't a U.S. judge, bent upon applying pressure on the sovereign to settle with its holdout creditors, merely look through a cryonic structure to find that the sovereign had devised an indirect way of paying the holders of its New Bonds in full? And if a judge were to be so disposed, might she not issue an *NML*-style injunction to require ratable payment of Old Bond holdouts whenever the sovereign wishes to make even an indirect payment on its New Bonds? The answer is no, for two reasons.

First, the payments that the holders of the New Bonds would receive in a Cryonic Solution would represent recoveries as pledgees of the collateral (the Old Bonds) securing the New Bonds. Had the sovereign given a mortgage over an office building in Manhattan to secure the New Bonds and the holders of those instruments received payment through a foreclosure on that mortgage, this might raise questions under the sovereign borrower's negative pledge clause but it would not implicate the sovereign's *pari passu* covenant.[27]

Second, much of what allowed the *NML* plaintiffs to succeed in their *pari passu* argument against Argentina was the temporal gap between the time when Argentina's other creditors accepted the country's restructuring offer (in 2005 and 2010), and the point at which the *pari passu* claim was asserted against the payments being made on the New Bonds issued in connection with those restructurings. This gap allowed the *NML* plaintiffs to argue that their erstwhile colleagues who accepted the restructuring (i) had long ago permanently surrendered their claims under the Old Bonds and were now holding only the reduced claim represented by the Exchange Bonds and (ii) in their capacity as holders of New Bonds, had long been enjoying full payment while the holdout owners of the Old Bonds had received absolutely nothing. The emotional appeal of this argument completely dissipates when, in a Cryonic Solution, every holder of the Old Bonds (holdouts as well as creditors accepting the restructuring) receives a ratable share of the payment made on that instrument. If the holders of the New Bonds wish to treat that payment as fully satisfying their voluntarily reduced claim (represented by the New Bonds), that is their choice. Dick and Jane are each owed $10 by the same borrower under instruments containing *pari passu* clauses. Dick and Jane are each paid $5 by the borrower. Jane agrees that she will treat that $5 payment as fully satisfying her original claim for $10. Dick is not so generous. He insists on retaining his claim for the residual $5. May Dick now argue that he is entitled to an injunction preventing Jane from receiving her $5 unless Dick is paid his full $10? We do not think so. These are precisely the economics and legal relationships inherent in a Cryonic Solution.

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27 In addition, many *pari passu* covenants in sovereign bonds and loans only promise to maintain a ranking equal to the sovereign's other "unsecured, unsubordinated" obligations. As secured debt instruments, the New Bonds issued in a Cryonic Solution would fall outside of the Benchmark category of a clause worded in this way. Even under the logic of the *NML* decisions, a holder of those bonds would therefore not have a contractual basis to seek an *NML*-style ratable payment injunction.

Making even partial payments to creditors that did not join the restructuring could be distasteful for the issuer. Having this option available, however, would give the issuer a mechanism by which it could continue to pay its New Bonds (indirectly) even in the face of a *pari passu* injunction, thus depriving the injunction holder of its principal weapon to induce a preferential recovery. Creditors asked to accept New Bonds in the restructuring could also take some comfort in the fact that the issuer would have a method of keeping them current without the issuer facing the *truly* distasteful prospect of paying holdouts in full.

A secondary objective of the Cryonic Solution is to position the Custodian Trustee holding the Old Bonds (acting on behalf of all holders who participated in the debt restructuring) to make a *pari passu* claim against a holdout that succeeded in extracting a preferential settlement from the issuer in respect of its untendered bonds. This effectively turns the *pari passu* weapon against the holdouts in a sovereign debt restructuring and serves much the same function as a "most favored creditor" undertaking in a debt restructuring.[28] As with all such restrictions, however, the issuer both gains and loses. It gains by deflating the hopes of prospective holdouts that preferential recoveries will be achievable after the main restructuring closes. That realization should reduce the absolute number of holdouts. But the issuer may lose some of its tactical flexibility to settle with diehard holdouts on terms that are better than those offered in the main restructuring,[29] perhaps resulting in a decade-long standoff similar to the Argentina experience.

A tertiary objective of the Cryonic Solution is to make it more difficult for holdouts to accelerate the Old Bonds after the exchange offer closes and, in the case of bonds issued under a U.S. trust indenture, to instruct the indenture trustee to commence an enforcement action in respect of the bonds. Both of those steps typically require the affirmative vote of holders of 25% of the bonds of a particular series. Old Bonds held by the Custodian Trustee would be debarred from joining in any such vote or instruction.

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28 For a discussion of these types of clauses, see Allen & Overy (Global Intelligence Unit), *The Pari Passu Clause and the Argentine Case* pp. 8-9 (December 2012), available at http://www.allenovery.com/SiteCollectionDocuments/The%20pari%20passu%20clause%20and%20the%20Argentine%20case.pdf. The most notorious clause of this kind was the "*Rights Upon Future Offerings*" provision embedded in Argentina's Exchange Bonds. *See* Joseph Cotterill, *Raising the RUFO in Argentine Bonds*, FT ALPHAVILLE, March 6, 2013, available at http://ftalphaville.ft.com/2013/03/06/1411442/raising-the-rufo-in-argentine-bonds/

29 Under a Cryonic Solution approach, the Custodian Trustee could only pursue a claim against settling holdouts if those holdouts had previously persuaded the court that the relevant *pari passu* clause in the Old Bonds required ratable payment of Old Bonds and New Bonds. In other words, a holdout could avoid the risk of a *pari passu* claim being asserted against it by the Custodian Trustee by not itself pursuing a *pari passu* claim for ratable payment against the holders of the New Bonds. By leaving the *pari passu* sword sheathed, the holdout avoids the risk that it might itself eventually feel the bite of that same blade.

The effect of a Cryonic Solution is to maintain the Old Bonds as vital legal instruments for the purpose of enforcing the *pari passu* covenant in those bonds (assuming the covenant is interpreted to require ratable payment of equally ranking debt). The arrangement also discourages the prospective holdout creditor from asserting a ratable payment interpretation of the *pari passu* covenant in its bonds because, if successful, that interpretation arms the trustee holding the Old Bonds to deploy the same interpretation against a holdout that succeeds in extracting a preferential settlement from the debtor.

Illustration

For purposes of illustration, assume a Republic of Ruritania debt restructuring involving a debt stock comprised of --

- six U.S. dollar, New York law-governed Republic bonds with collective action clauses that permit amendments with the approval of holders of 75% of outstanding principal (the "CAC Bonds"), and

- six U.S. dollar, New York law-governed Republic bonds with traditional U.S.-style amendment clauses that require unanimous consent for changes to payment terms but the approval of holders of only 50% of the principal of the bonds for all other changes (the "Conventional Bonds").

Assume further that prospective holdout creditors have acquired positions in two of the CAC Bonds, and two of the Conventional Bonds, equal to 25% of outstanding principal.

How would the Ruritanian authorities reassure creditors willing to participate in the restructuring that the New Bonds they receive in exchange for their Old Bonds will not become the object of NML-type *pari passu* injunctions?

1. For the Conventional Bonds, the authorities could embed an exit consent in the exchange offer removing altogether the *pari passu* provision in the old Conventional Bonds. If holders of more than 50% of the outstanding principal of the Conventional Bonds participated in the exchange offer, this exit consent would become effective. Any untendered Conventional Bonds would still exist, they just could not be used to support the issuance of a *pari passu* injunction after the closing of the exchange.

2. For the four series of CAC Bonds in which prospective holdouts have *not* acquired a 25% blocking position, the authorities could rely on the collective action clauses to force an exchange of all the bonds in each of those series, thus eliminating the possibility of holdouts in those series.

3. For the two series of CAC Bonds in which prospective holdouts have acquired a 25% blocking position, the relevant collective action clauses probably set the level of creditor consent needed to amend the *pari passu* provision at the same 75% threshold needed for other amendments, so an exit consent strategy will not be possible. The authorities must therefore fall back on a Cryonic Solution for these series (and for any of the other series of CAC Bonds for which the 75% voting threshold had not been reached), keeping tendered Old Bonds alive and lodged with a Custodian Trustee under instructions of the kind outlined above. Because the authorities are unlikely to know in advance whether they will in fact reach the 75% voting threshold for any particular series, the transaction will probably need to anticipate a Cryonic Solution for all CAC Bonds from the outset. If the 75% voting threshold is reached for a series, of course, the collective action clause will be triggered and the Old Bonds of that series can be canceled at the closing of the exchange.

Naturally, these mechanisms require majority (in the case of the Conventional Bonds) and supermajority (in the case of CAC Bonds) creditor approval of the terms of the debt restructuring before they can be implemented. Their purpose is to protect the creditors (by definition, a majority of creditors) that elect to participate in the exchange offer against the risk of post-closing interference by holdouts of the kind suffered by the holders of Argentina's Exchange Bonds.

Conclusion

Until the scope of the Second Circuit's decisions in the *NML* case are fully clarified, the architects of sovereign debt restructurings under New York law will need to find some way of assuring those creditors who elect to participate in a restructuring that payments under the New Bonds they receive in the workout will not later become the object of an *NML*-style *pari passu* injunction. If such an assurance cannot be given, the prospects for a successful debt restructuring will be diminished.

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Pari Passu Benchmarks in Recent Sovereign Bonds

The chart below summarizes the *pari passu* Benchmarks in a subset of sovereign bonds issued between October 26, 2012 (the date of the Second Circuit's 2012 Decision upholding the issuance of *pari passu* injunctions) and July 1, 2016.

Benchmark	**Defined / Not Defined**	**Issuer**
"Public Debt"	Defined	Belize
"External Debt"	Defined	Paraguay
"External Indebtedness"	Defined	Mongolia Turkey Israel Sri Lanka Pakistan Jamaica Ecuador Colombia
"Public External Indebtedness"	Defined	Costa Rica Honduras Bolivia
"Public External Debt"	Defined	Dominican Republic
public external indebtedness	Not defined	Mexico
"Indebtedness"	Defined	Panama
obligations	Not defined	Serbia Ukraine Ivory Coast Rwanda Morocco Nigeria Armenia Croatia Kenya Senegal
general obligations	Not defined	Italy
borrowed money	Not defined	Greece
public foreign debt	Defined	Uruguay