THE EVOLUTION OF MODERN SOVEREIGN DEBT LITIGATION: VULTURES, ALTER EGOS, AND OTHER LEGAL FAUNA

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I

INTRODUCTION: THE LACK OF BANKRUPTCY PROTECTIONS FOR SOVEREIGNS

The recent global financial crisis vividly displayed the legal protections available in nonsovereign insolvencies. To use a prominent example in the United States, the massive Chrysler Corporation—whose $49 billion in revenue in 2007 was greater than the GDP of more than half the world's nations[1]—was able to leverage the threat of declaring bankruptcy to extract economic concessions from its commercial lenders, bondholders, employees, and other creditors (with significant financial and political support from the U.S. Administration).[2] Once Chrysler negotiated the terms of a sale with the majority of its creditors, it entered bankruptcy with a prepackaged petition, and, shortly thereafter, a new Chrysler entity emerged from the process as a going concern, no longer burdened by billions of dollars of debt.[3] Although a minority of creditors challenged the Chrysler sale as a draconian invalidation of their contract rights, those efforts failed under the debtor-friendly rules of Chapter 11.[4]

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1. The 35 Largest U.S. Private Companies, http://money.cnn.com/galleries/2008/fortune/0805/gallery.private_companies.fortune/4.html (last visited Nov. 24, 2009); WORLD BANK, World Development Indicators database, *Gross domestic product 2007* (revised Sept. 10, 2008).

2. *See* Bill Vlasic & David E. Sanger, *Debtholders v. U.S. Over Chrysler Deal*, N.Y. TIMES, Apr. 22, 2009, at B1; Bill Vlasic, *Holdouts Jeopardize Plan for Chrysler,* N.Y. TIMES, Apr. 28, 2009, at B1.

3. Michael J. de la Merced & Micheline Maynard, *Fiat Deal with Chrysler Seals Swift 42-Day Overhaul*, N.Y. TIMES, June 10, 2009, at B4.

4. *See In re* Chrysler, LLC, 576 F.3d at 108.

As the Chrysler case illustrates—as would other recent examples, such as GM, Nortel, and the like—the safe harbor of insolvency law is a potent tool for private debtors who cannot afford to pay their creditors. Even before formally declaring bankruptcy, sophisticated parties can exploit creditor fears of judicial contract reformation to obtain voluntary liability reduction. Once a private company or individual enters bankruptcy, debt service and litigation against the debtor is automatically stayed pending the completion of a mandatory restructuring plan.[5] Bankruptcy rules also allow for a post-insolvency market for "superpriority" (debtor-in-possession) financing, which the debtor can access to jumpstart its reorganization.

In contrast to distressed private debtors, it is axiomatic that there are no bankruptcy protections for financially impaired sovereign states, though such a system has been advocated for since at least the time of Adam Smith.[6] When a state cannot pay its debts, its only recourse is to enter voluntary negotiations with its creditors, which today are a miscellany of private and public entities with disparate agendas.[7] Unlike the bankruptcy process for private debtors, participation in a sovereign debt workout is optional, and creditors may choose to opt out by bringing lawsuits on the face value of defaulted debt in order to obtain judgments, and try to execute on them.

Although distressed sovereign debtors cannot use the shield of bankruptcy law to prevent creditor litigation, rules concerning foreign sovereign immunity have emerged as a rough, sometimes inadequate, proxy for insolvency laws. There are two categories of sovereign-immunity protections for foreign states: (1) immunity from suit and (2) immunity from execution. Protections concerning immunity from *suit* derive from the international principle that a sovereign should not be made to suffer the indignity of being haled into court against its will.[8] Immunity from *execution* provisions stem from long-standing concerns about the disruptions and political ramifications that can result from the seizure of a foreign state's property.[9] Under the modern, "restrictive" theory

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5. *See* 11 U.S.C. § 362 (2006).

6. *See* Charles Seavey, *The Anomalous Lack of an International Bankruptcy Court*, 244 BERKELEY J. INT'L L. 499, 499 (2006) (citing ADAM SMITH, THE WEALTH OF NATIONS 468 (Edwin Cannan ed., Methuen and Co. 2000) (1776) ("When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both the least dishonourable to the debtor, and least hurtful to the creditor.")). More recently, there have been sporadic movements to create a bankruptcy analogue for sovereigns under the auspices of an international organization such as the IMF. *See, e.g.*, Anne O. Krueger, *A New Approach to Sovereign Debt Restructuring*, INTERNATIONAL MONETARY FUND, Washington, D.C. (Apr. 2002); International Monetary Fund, *The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations* (Nov. 27, 2002). To date, none of these proposals has garnered significant momentum.

7. *See* Nouriel Roubini & Brad Setser, *The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions and the Argentine Episode*, 1 J. RESTRUCTURING FINANCE 173 (2004).

8. *See, e.g.*, The Schooner Exchange v. M'Faddon, 11 U.S. 116, 144 (1812).

9. Conn. Bank of Commerce v. Republic of Congo, 309 F.3d 240, 256 (5th Cir. 2002) ("[T]he international community viewed execution against a foreign state's property as a greater affront to its sovereignty than merely permitting jurisdiction over the merits of an action.").

of sovereign immunity—codified in some jurisdictions by national laws, such as the Foreign Sovereign Immunities Act (FSIA) in the United States—a foreign state's immunity is subject to various exceptions, the extent of which are often at the heart of sovereign-litigation disputes.[10] In a manner somewhat analogous to the way bankruptcy law provides the backdrop to negotiations between an insolvent private debtor and its creditors, the case law that has developed interpreting the scope of foreign sovereign immunity provides the background set of rules that inform the parties to a sovereign debt restructuring.

This article examines the progression of sovereign debt case law as displayed by the succession of litigation strategies employed by professional suers of defaulted sovereign states. These plaintiffs are often referred to as "vulture funds" because their strategy is to buy sovereign debt instruments when a country is most vulnerable, which enables the funds to purchase the debt at a deep discount from its face value and attempt to enforce the full claims. This business plan necessarily depends on the lack of bankruptcy protection for sovereigns, but it is constrained by the sovereign-immunity rules that national legislatures have enacted and national courts have elaborated to protect the vultures' targets from some of their attacks.

In section II of this article, we provide some historical context for the emergence of investors specializing in speculation in sovereign debt litigation. In section III, we examine the first phase of vulture-fund suits against foreign sovereigns, which was dominated by litigation over the champerty defense—an English common-law doctrine that precluded the purchase of debt with the intent and purpose to sue upon it. In section IV, we look at the post-champerty phase of sovereign debt litigation, when some plaintiffs advanced a novel theory of *pari passu* as a "nuclear device" in their efforts to enforce judgments against sovereigns. In section V, we come to the present phase, with an increased focus on litigation over the "commercial activity" exception to execution immunity. We end with some concluding thoughts on the state of sovereign debt litigation.

II

BACKGROUND OF MODERN SOVEREIGN DEBT LITIGATION: THE SECONDARY DEBT MARKET AND ECONOMIC CRISES IN LATIN AMERICA AND ELSEWHERE

Modern sovereign debt litigation was born from the rise of the secondary debt market and the attendant opportunities for arbitrage, which, in turn, gave life to an industry of professional suers of foreign states.[11] The business plan of these entities is to purchase sovereign debt on the secondary market when it is being traded at a discount from its face value—often significantly so—because a

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10. Even under the "restrictive" theory of sovereign immunity, a foreign state's property was completely immune from execution. However, national laws have partially lifted this absolute immunity. *See* JOSEPH W. DELLAPENNA, SUING FOREIGN GOVERNMENTS AND THEIR CORPORATIONS (Transnational Publishers 2d ed. 2003).

11. *See* Alon Seveg, *Investment: When Countries go Bust: Proposals for Debtor and Creditor Resolution*, 3 ASPER REV. INT'L BUS. & TRADE L. 25 (2003).

country is so financially distressed that its debt is near or in default. The vulture funds take advantage of the lack of bankruptcy protection for foreign states by suing the financially distressed state and urging courts to take an expansive view of the exceptions to sovereign immunity.[12] In doing so, the vulture funds' managers speculate that they will be able to reap profits either by obtaining judgments and executing against nonimmune property of the state or by extracting profitable settlements because their lawsuits may have a significant nuisance value for the sovereign defendant.[13] This strategy is possible in the first place only because foreign states lack the bankruptcy protections available to private debtors—if foreign states had such protections, litigation would be automatically stayed and a tribunal would impose a mandatory "haircut" on the creditors' claims.

The historical event that provided the impetus for the first wave of lawsuits by professional suers of states was the Latin American debt crisis of the early 1980s.[14] Throughout the 1970s, international commercial banks were flooded with petro-dollars from the Middle East as a result of skyrocketing oil prices.[15] The banks used the influx of deposits to extend commercial loans to Latin American countries that were hungry for capital.[16] A subsequent rise in interest rates and a global recession resulted in a string of defaults on these loans, starting with Mexico in 1982.[17] Facilitated by the United States–led Brady Plan, distressed sovereign loans became available on the market.[18] Until this event, private sovereign debt was held primarily by large institutions, whose economic and political interests were oriented towards achieving a voluntary workout with the nation-debtor.[19] The same was not true of market speculators, who

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12. As explained by Lee Buchheit, two features of conventional financing documents used in the United States have contributed to vulture creditor activity: (1) the conventional amendment clauses in U.S.-style bonds and syndicated loans traditionally did not permit amendments to the payment terms of those instruments without the consent of every holder, and (2) U.S.-style trust indentures explicitly reserve to each individual creditor the right to sue for its share of a missed payment. *See* Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1331–32 (2002); Lee C. Buchheit & Elizabeth Karpinski, *Grenada's Innovations*, 20 J. INT'L BANKING L. & REG. 227, 230 (2006). The development of collective-action clauses (CACs) in sovereign debt investments beginning in 2003 has helped put a damper on some of this activity, and will do so to a greater extent in the future, but it does not affect litigation under debt incurred at earlier periods before CACs came into play.

13. *See* Jonathan C. Lippert, Note, *Vulture Funds: The Reason Why Congolese Debt May Force a Revision of the Foreign Sovereign Immunities Act*, 21 N.Y. INT'L L. REV. 1, 1, 27 (2008).

14. *See* Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L.J. 1043 (2004).

15. *See* HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION (2004).

16. *Id.*

17. *Id.*

18. Under the Brady Plan, the U.S. government allowed commercial banks to swap loans to distressed sovereigns for Treasury-backed bonds, and the securitized sovereign debt was in turn offered to the public. *See* Philip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructurings*, 64 FORDHAM L. REV. 2701, 2708 (1996).

19. *See* Samuel E. Goldman, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring*, 5 UCLA J. INT'L L. & FOREIGN AFF. 159 (2000).

purchased the rights to the impaired debt at a discount, and then rejected the voluntary restructuring process negotiated between the Latin American governments and the vast majority of their creditors.[20] These funds then brought suit against the states to enforce the face value of the claims, plus interest.

Following the broad Latin American crisis of the 1980s, new opportunities for vulture-creditor activity arose from debt defaults by the war-torn Democratic Republic of Congo (DR Congo)[21] and the economic collapse in Argentina in 2001.[22] The DR Congo's debt was primarily commercial loans similar to the defaulted Latin American debt from the 1980s, while Argentina had directly accessed the public markets through global bond issuances throughout the 1990s. As these countries approached and entered default, vulture funds once again purchased discounted claims on the secondary market and launched a new wave of aggressive litigation campaigns.[23]

The market availability of their defaulted debt explains the recurring role of Latin American and African countries as defendants in modern sovereign debt litigation. Beginning in earnest in the mid-1990s, and actively continuing through the present, professional plaintiffs instituted suits against these foreign states in the United States and elsewhere. The progression of modern sovereign debt litigation is linked to the successes and failures of the legal strategies employed by these professional plaintiffs in obtaining judgments against the states and trying to collect on them.

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20. *Id.*

21. In the late 1980s and early 1990s, weak oil prices and a growing public sector combined to drive up the DR Congo's debt to unsustainable levels. ABDELRAHMI BESSAHA ET AL., REPUBLIC OF CONGO: SELECTED ISSUES 12 (Int'l Monetary Fund, Country Report No. 07/206, June 2007), *available at* http://www.imf.org/external/pubs/ft/scr/2007/cr07206.pdf. The country's ensuing civil war exacerbated the DR Congo's debt burden. *Id.* at 14.

22. "The collapse of the Argentine economy . . . was one of the most spectacular in modern history." Paul Blustein, *And The Money Kept Rolling In (And Out): Wall Street, The IMF, and the Bankrupting of Argentina* 1 (Public Affairs 2005). Beginning in 1998, the Argentine Republic experienced an economic recession—later depression—which reached its nadir at the end of 2001 and beginning of 2002. *See* CONG. RESEARCH SERV., ARGENTINA'S SOVEREIGN DEBT RESTRUCTURING, Pub. No. RL32637, at 1 (2004). Argentina was hit especially hard by a sudden halt to capital inflows after the East Asian crisis of 1997 and the Russian default in August 1998. Guillermo A. Calvo & Ernesto Talvi, *Sudden Stop, Financial Factors, and Economic Collapse in Latin America: Learning from Argentina and Chile*, *in* THE WASHINGTON CONSENSUS RECONSIDERED: TOWARDS A NEW GLOBAL GOVERNANCE 119, 134–48 (Narcis Serra & Joseph E. Stiglitz eds., 2008). In addition, demand from its primary trading partner, Brazil, fell sharply after Brazil devalued its currency in 1999, and Argentina's exports became relatively more expensive due to a steep drop in commodity prices. Joseph E. Stiglitz, *Argentina, Short-Changed: Why the Nation that Followed the Rules Fell to Pieces*, WASH. POST, May 12, 2002, at B1. Interest rate increases by the U.S. Federal Reserve, designed to slow down the United States economy, also had a drastic impact on Argentina and its dollar-pegged currency at a time when Argentina's economy was contracting. Mark Weisbrot & Dean Baker, *What Happened to Argentina?*, CTR. FOR ECON. & POL'Y RESEARCH (Jan. 31, 2002), http://www.cepr.net/documents/publications/argentina_2002_01_31.htm.

23. *See, e.g.*, Patrick Bolton & David A. Skeel, Jr., *Redesigning the International Lender of Last Resort*, 6 CHI. J. INT'L L. 177, 192–93 (2005) (discussing creditor attempts to seize Argentina's U.S.-based assets, including military assets and payments to its embassy).

III

EARLY YEARS: THE CHAMPERTY DEFENSE

As sovereign debt litigation came to the fore in the United States following the Latin American crisis of the 1980s, the sovereign-immunity defense from *suit* was often unavailable to the sovereign defendants, either because the states had waived such immunity in the debt contract or due to the application of the "commercial activity" exception. Under the FSIA, waiver of immunity from suit can either be explicit—which it often is, under transnational sovereign debt instruments—or implicit.[24] Under the statute's "commercial activity" exception to suit, the sovereign state's presumption of immunity can be overcome even in the absence of a waiver when

> the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.[25]

Arguably, any activity conducted by a sovereign state is noncommercial in some sense. But in *Republic of Argentina v. Weltover, Inc.*,[26] the Supreme Court held that, when a foreign state issues "garden variety" public debt in the U.S. market, it is engaging in commercial activity here regardless of the activity's purpose, and the state may thus be sued based upon that act.[27] This decision essentially foreclosed the sovereign-immunity defense to suit for countries that had accessed the U.S. debt markets and had agreed to repayment in the United States.[28]

Notwithstanding the foreign states' lack of a sovereign-immunity defense to suit, early lawsuits brought by professional creditor-plaintiffs were frequently found to be both procedurally and substantively flawed, even without reference to sovereign-immunity principles. A suit brought against Panama by a precursor to Elliott Associates—which would become one of the most prolific litigants

24. "An express waiver under section 1605(a)(1) must give a clear, complete, unambiguous, and unmistakable manifestation of the sovereign's intent to waive its immunity." *See* Aquamar S.A. v. Del Monte Fresh Produce N.A., Inc., 179 F.3d 1279, 1292 (11th Cir. 1999) (quotation omitted). "Courts have found implied waiver where a foreign state has filed a responsive pleading without raising the defense of sovereign immunity . . . [and] where the state has agreed to arbitrate or to adopt a particular choice of law." World Wide Minerals, Ltd. v. Republic of Kazakhstan, 296 F.3d 1154, 1162 (D.C. Cir. 2002).

25. 28 U.S.C. § 1605(a)(2) (2006). This exception to suit is broader than the FSIA's commercial-activity exception to execution, which applies in the stricter circumstances when property of the foreign state is in the United States and being "used for" a commercial activity in the United States. 28 U.S.C. § 1610(a) (2006); *see, e.g.*, Conn. Bank of Commerce v. Republic of Congo, 309 F.3d 240, 255 ("Congress used the more specific phrase 'used for a commercial activity' in [Section 1610] rather than the less specific phrase 'in connection with a commercial activity' used in Section 1605.").

26. 504 U.S. 607 (1992).

27. *Id.* at 617.

28. In another significant early decision, the Second Circuit also rejected the common-law "act of state" defense to nonpayment of sovereign debt. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 522–23 (2d Cir. 1985).

against foreign states—was dismissed based upon the fund's failure to disclose its principal.[29] Vulture funds tend to be secretive about their investors, which is not surprising, given the political distastefulness of seeking to reap profits at the expense of indebted, and typically very poor, countries and their citizenry.[30] Yet knowing the identity of one's litigation adversary is a matter of fundamental fairness and is invariably essential to defending against claims and establishing affirmative defenses. In *Water Street*, Judge Baer found the plaintiff's steadfast refusal to disclose its ultimate human owners to be unacceptable, and he dismissed the case outright.[31]

A suit based on nonperforming Brazilian debt brought by members of the Dart family—who would also come to figure prominently as professional plaintiffs in sovereign debt litigation—was also short-circuited notwithstanding the existence of U.S. jurisdiction.[32] In the midst of the Latin American crisis of the 1980s, Brazil restructured its debt with its commercial lenders pursuant to a Multi-Year Deposit Facility Agreement (MYDFA). The Darts bought a significant amount of MYDFA debt at a deep discount on the secondary market—so much so that they became one of Brazil's largest foreign creditors.[33] When Brazil later sought to restructure its MYDFA debt under the Brady Plan, the Darts held out and brought suit in the Southern District of New York. The district court held, however, that the plaintiffs could not accelerate principal under the MYDFA's contractual terms, which required at least fifty percent of the creditors to vote for acceleration.[34]

The most potent defense asserted by foreign states in these early cases was champerty. Had the courts broadly accepted this defense asserted by foreign

29. Water Street Bank & Trust, Ltd. v. Republic of Panama, No. 94 Civ. 2609 (HB), 1995 WL 51160 (S.D.N.Y. Feb. 8, 1995).

30. *See, e.g.*, Gordon Brown, The Chancellor of the Exchequer and IMF Governor for the U.K., Financing A World Fit For Children, Speech at the United Nations General Assembly Special Session on Children (May 10, 2002), *available at* http://www.hm-treasury.gov.uk./newsroom_and_speeches/press/2002/press_46_02.cfm ("We particularly condemn the perversity where Vulture Funds purchase debt at a reduced price and make a profit from suing the debtor country to recover the full amount owed—a morally outrageous outcome."); John B. Taylor, Under Secretary Of Treasury For International Affairs, Sovereign Debt Restructuring: A U.S. Perspective, Remarks at the Conference on Sovereign Debt Workouts: Hopes And Hazards? (Apr. 2, 2002), *available at* http://www.treas.gov/press/releases/po2056.htm.

31. Water Street Bank & Trust, Ltd. v. Republic of Panama, 1995 WL 51160, at *1; *See* Elliott Assocs. v. Republic of Peru, 961 F. Supp. 82, 86–87 (S.D.N.Y. 1997) (allowing discovery of the principals and management of plaintiff).

32. CIBC Bank & Trust Co. (Cayman), Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105 (S.D.N.Y. 1995).

33. *See* Agasha Mugasha, *Solutions for Developing-Country External Debt: Insolvency or Forgiveness?*, 13 L. & BUS. REV. AM. 89 (2007).

34. The plaintiff had alleged that Brazilian officials had ordered Banco do Brasil, S.A., to hold an amount of MYDFA debt greater than the Darts' share, specifically to prevent the family from accelerating the principal. Another nonjurisdictional issue raised in some of the earlier cases was the court's discretion to stay suits against a financially distressed sovereign to permit consensual debt restructuring to take place. Such stays would not be permitted to last indefinitely, but courts would retain the ability to impose them for appropriate periods. Pravin Banker Assocs., Ltd. v. Banco Popular Del Peru, 109 F.3d 850, 855 (2d Cir. 1997).

state-defendants, it could effectively have ended the industry of speculating in sovereign debt litigation. Champerty, originated in English common law and later adopted by state legislatures, forbids as an abuse of process the purchase of debt with the intent, and for the purpose of, bringing a lawsuit.[35] The defense had a natural application to the claims brought by vulture funds against foreign states since the funds' strategy necessarily anticipated litigation following the purchase of nonperforming debt.

In *Elliott Associates, L.P. v. Republic of Peru*,[36] the U.S. District Court for the Southern District of New York held that champerty barred claims brought by Elliott Associates on nonperforming debt of the Republic of Peru.[37] The district court allowed Peru to conduct discovery of Elliott in connection with its champerty defense, and the court's opinion detailed the facts surrounding the formation of Elliott's sovereign debt litigation strategy, which it found ran afoul of the champerty rule.[38] But in a game-changing decision, the Second Circuit reversed the district court,[39] holding that if the suer's intent in purchasing the discounted debt was to be paid in full or *otherwise* to sue, such intent did not meet champerty's intent requirement. The Court of Appeals found Elliott's intent to sue on the debt was "contingent" even though "Elliott knew Peru would not, under the circumstances, pay in full."[40] The Second Circuit's narrow reading of the champerty defense was accepted by other courts, as by the D.C. District Court in *Turkmani v. Republic of Bolivia*,[41] and saved the business of speculating in defaulted sovereign debt from what would otherwise have been a major setback.

Despite the Second Circuit's ruling in *Elliott Associates*, some residual uncertainty remained concerning the application of the champerty defense in New York state courts.[42] Not willing to leave the fate of its business model to judicial chance, vulture funds apparently lobbied the New York state legislature to amend the law by statute.[43] And on August 17, 2004, the New York state legislature amended N.Y. Judiciary Law 489 to effectively eliminate the defense of champerty as to any debt purchases or assignments having a value of more than $500,000.

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35. *See generally* Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?,* 30 AM. BUS. L.J. 485, 486–89 (1992).

36. 12 F. Supp. 2d 328 (S.D.N.Y. 1998).

37. Elliott had rejected Peru's Brady exchange offer, which closed in March 1997, and was achieved based on Peru's verbal promise not to provide any extra benefits to holdout creditors. Sönke Häseler, *Individual Enforcement Rights in International Sovereign Bonds* (German Working Papers in L. & Econ., Paper No. 17, 2008), *available at* http://www.bepress.com/gwp/default/vol2008/iss1/art17.

38. 12 F. Supp. 2d at 333–35; *but see* Elliott Associates, L.P. v. Republic of Panama, 975 F. Supp. 332 (S.D.N.Y 1997); Banque de Gestion Privee-SIB v. Republica de Paraguay, 787 F. Supp. 53 (S.D.N.Y. 1992).

39. 194 F.3d 363 (2d Cir. 1998).

40. *Id.* at 379.

41. 193 F. Supp. 2d 165 (D.D.C. 2002).

42. *See, e.g.*, Bluebird Partners, L.P. v. First Fidelity Bank, N.A., 94 N.Y.S.2d 726, 736 (N.Y. 2000).

43. *See* Memorandum in Support, New York State Assembly, Bill Number: A7244C.

IV

SECOND PHASE: *PARI PASSU*

With the defeat of the champerty defense, the path was clear for litigants to purchase defaulted sovereign debt, to reject the sovereign's voluntary restructuring process, and to obtain judgments at the obligation's face value. The paper judgments were just that, however, and plaintiffs still faced a high hurdle in executing on foreign state property. The focus of sovereign debt litigation thus quickly turned to judgment enforcement against the debtor states.

Judgment creditors apparently recognized from the outset that scanning the globe for nonimmune, executable property of a foreign state could prove to be an expensive and fruitless exercise. As an alternate to this pursuit, vulture funds invented what they believed could be a devastating enforcement device—an expansive application of the *pari passu* clause contained in many sovereign debt instruments.[44] The *pari passu* provision is a standard clause in cross-border lending agreements that contains a borrower's promise to ensure that the obligation will always rank equally in right of payment with all of the borrower's other unsubordinated debts.[45] The international financial markets long understood the clause to protect a lender against the risk of legal subordination in favor of another similarly situated creditor.[46]

In 2000, Elliott sought to enforce its judgment against Peru—the same judgment that the Second Circuit had held was not precluded by champerty—by advancing a novel interpretation of the *pari passu* clause. Elliott argued that not only was Peru barred from legally subordinating its loan debt under the agreement's *pari passu* clause, but the same provision precluded Peru from paying other creditors (such as holders of restructured debt) without also paying it pro rata as a judgment creditor on the defaulted contract. Elliott succeeded ex parte on this argument in the Brussels Court of Appeals in Belgium and blocked a payment that Peru was to make to the holders of its

44. *See generally* Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869 (2003).

45. "In a loan agreement, the *pari passu* clause is often drafted as follows: 'The payment obligations of the borrower under this Agreement rank at least *pari passu* with all its other present and future unsecured obligations.' In an international securities issue, the *pari passu* clause is usually found in the 'status' or 'ranking' condition and is often drafted as follows: 'The bonds and the coupons are direct, unconditional and unsecured obligations of the issuer and rank and will rank at least *pari passu*, without any preference among themselves, with all other outstanding, unsecured and unsubordinated obligations of the issuer, present and future.'" Financial Markets Law Committee, Issue 79—*Pari Passu Clauses* (Mar. 2005).

46. Modern commercial bank loans and bonds for purely domestic lending to corporate borrowers do not usually contain any form of *pari passu* representation or covenant. *See* Buchheit & Pam, *supra* note 44. Presumably, this reflects the lenders' confidence that U.S. law (1) does not permit an involuntary subordination of an existing creditor and (2) calls for a ratable payout in bankruptcy of all similarly-situated creditors within each class to the extent of available assets. *Id.*

restructured debt via Euroclear[47] on the theory that it violated the *pari passu* provision in Peru's defaulted debt.[48] Peru quickly settled with Elliott, which realized a significant return on its original investment.

Not surprisingly, Elliott and others were encouraged by the result against Peru in Belgium and brought other enforcement actions based on the same *pari passu* theory. In *Red Mountain Finance v. Democratic Republic of Congo*,[49] a U.S. district court in California appeared to reject the *pari passu* theory as such, but, for unexplained reasons, nonetheless enjoined the DR Congo from making any payments on its "External Indebtedness" (as defined in the credit agreement) without making a proportionate payment to Red Mountain.[50] Like Peru, the DR Congo ultimately settled the case. In *LNC Investments v. Nicaragua*,[51] plaintiffs once again asserted this theory in Belgium and obtained an ex parte order blocking Nicaragua's payment on certain bonds that were to be made by Euroclear. Unlike Peru and DR Congo, though, Nicaragua appealed.

The tide began to turn against Elliott's *pari passu* strategy in *Kensington International Ltd. v. Republic of Congo.*[52] In *Kensington*, an affiliate controlled by Elliott sought the same result in London that Elliott had achieved in Belgium. But the English court denied Kensington's attempt to restrain the Congo from paying its other creditors without paying it pro rata based on Elliott's *pari passu* theory.[53] The English trial judge recognized the claim as "novel" and "unprecedented," although he ultimately denied—and the appellate court affirmed—the injunction attempt on equitable grounds, including the plaintiff's failure to identify who it was or how much it had paid for its debt.

Elliott's *pari passu* strategy was dealt another severe blow when the Brussels Court of Appeals, this time with the benefit of an adversary presentation, reversed course in *LNC Investments v. Nicaragua* and held that, irrespective of the construction of the contractual *pari passu* clause, that clause could not be invoked against Euroclear (the settlement agent under Nicaragua's indemnity bonds) since Euroclear was not a party to the contract under which the *pari*

47. Euroclear is a financial intermediary based in Brussels, which settles domestic and international securities transactions. *See* https://www.euroclear.com/site/public/EB.

48. *See* Elliott Assocs., L.P., General Docket No. 2000/QR192. 12 (Ct. App. of Brussels, 8th Chamber, Sept. 26, 2000) ("It also appears from the basic agreement that governs the repayment of the foreign debt of Peru that the various creditors benefit from a *pari passu* clause that in effect provides that the debt must be repaid pro rata among all creditors. This seems to lead to the conclusion that, upon an interest payment, no creditor can be deprived of its proportionate share.").

49. Case No. CV 00-0164 R, 2000 WL 34479543 (C.D. Cal. Nov. 29, 2000). The case was heard by Judge Real, one of the most often reversed judges in the Ninth Circuit. *See* Carol J. Williams, *Critics Want to Bench Judge Manuel L. Real*, L.A. TIMES, Aug. 16, 2009.

50. *See* Buchheit & Pam, *supra* note 44, at 881.

51. Commercial Court of Brussels, Sept. 11, 2003.

52. [2003] EWHC (Comm) (Eng.).

53. *See id.*

passu clause arose.[54] By this time, Belgian legislators had also taken notice that Elliott's *pari passu* campaign, and the Belgian courts' unpredictability on the issue, might undermine Belgium's place in the world financial markets. The Belgian Parliament thus instituted a law shielding Euroclear from injunctions.[55]

In the District Court for the Southern District of New York, Elliott and other creditors suggested that they might pursue the *pari passu* theory in their lawsuits against Argentina pending before that court. Both the United States government and the Clearing House Association of New York Banks filed amici statements opposing Elliott's *pari passu* interpretation, but the New York federal court ultimately declined to address the issue, ruling that the case was not ripe for review.[56] Perhaps in light of these statements, nothing further has been heard of the *pari passu* argument in more recent court proceedings.[57]

For whatever reason, the Elliott *pari passu* strategy seems to have receded from the forefront of creditor enforcement strategies. Managers of vulture funds may have sensed that the political and legal climates were aligning towards a conclusive defeat of the theory. Without the ability to freeze the debtor–foreign state's payments to other creditors via *pari passu*, plaintiffs were forced to concentrate on trying to directly execute against foreign state property, which has animated the current phase of sovereign debt litigation.

V

CURRENT PHASE: EXECUTION LITIGATION

Limits on execution against a foreign state's property, however, present a significant obstacle for litigants that hold judgments against foreign states. The exception to execution immunity that professional litigants against foreign states have most frequently raised is the "commercial activity" exception. Under the FSIA, this exception provides that a creditor may execute against a foreign state's property to the extent that the property is in the United States and "used for" a commercial activity in the United States.[58]

Early cases interpreting the commercial-activity exception to execution immunity focused on whether the nature of property was such as inherently to make its use the support and maintenance of governmental functions of the sovereign. To the extent that a foreign state's property was for the benefit of the government's sovereign activities, courts found the commercial-activity

54. Republic of Nicaragua v. LNC Invs. & Euroclear Bank, S.A., No. 2003/KR/334 (Court of Appeals of Brussels, 9th Chamber, Mar. 19, 2004).

55. *See* Belgian Law 1119201, art. 15.

56. Transcript of Conference Before Judge Thomas P. Griesa, at 9, Applestein v. Republic of Argentina and Province of Buenos Aires, No. 02 CV-1773 (TPG), 2010 U.S. Dist. LEXIS 14083 (S.D.N.Y. Jan. 15, 2004).

57. Very recently, for the first time since 2004, *pari passu* has reared its head again in a new attempt by Elliott to argue that an Argentine law enacted in 2005 to regulate exchange offers for defaulted debt violated the *pari passu* clause. How this effort will fare remains to be seen.

58. 28 U.S.C. § 1610(a) (2006).

exception inapplicable. In *LNC Investments, Inc. v. Republic of Nicaragua*,[59] a vulture creditor sought an attachment in New York of taxes collected and paid by American and Continental Airlines to Nicaragua. The court held that because taxation is a uniquely governmental activity in which private persons cannot and do not engage, the tax obligations were noncommercial property and thus immune under Section 1610(a).[60]

A milestone in execution litigation against sovereigns that refined the approach to the commercial-activity exception to execution immunity was the Fifth Circuit's decision in *Connecticut Bank of Commerce v. Republic of Congo*.[61] The Fifth Circuit placed particular emphasis on the statutory phrase "used for" under Section 1610(a) of the FSIA, which provides that a foreign state's property must be "used for" a commercial activity in the United States in order to be subject to execution. By inserting the phrase "used for," the Fifth Circuit said Congress had made clear its intent that "[w]hat matters under the statute is not how [the foreign state] made its money, but how it spends it."[62] The Fifth Circuit thus held that the relevant inquiry concerning the tax and royalty obligations at issue was not only the property's nature, but also whether and how the assets had been "used" by the state.[63] The Fifth Circuit affirmed the centrality of the "use" analysis in *Walker International Holdings Ltd. v. Republic of Congo*, when it held that purported property of the Congo could not be attached when there was no evidence of how the property had been "used," let alone any evidence that it had been used for a commercial activity in the United States.[64] The Second and Ninth Circuits followed the Fifth Circuit's lead, which confirmed that the "used for" commercial-activity exception was a narrow one.[65]

59. No. 96 Civ. 6360 (JFK), 2000 WL 745550 (S.D.N.Y. June 8, 2000).

60. *See* Liberian Eastern Timber Corp. v. Republic of Liberia, 650 F. Supp. 73, 77–78 (S.D.N.Y. 1986) (denying attachment of tax obligations because "[t]he levy and collection of taxes intended to serve as revenues for the support and maintenance of governmental functions are an exercise of powers particular to a sovereign").

61. 309 F.3d 240.

62. *Id.* at 253.

63. *Id.* at 256–58.

64. 395 F.3d 229, 236 (5th Cir. 2004) ("While these funds could indeed be used for other commercial purposes, such as debt service, Walker does not make this assertion.") (citation omitted).

65. *See* EM, Ltd. v. Republic of Argentina, 473 F.3d 463, 481 n.19 (2d Cir. 2007), cert. denied, 128 S. Ct. 109 (2007); Af-Cap, Inc. v. Chevron Overseas (Congo), Ltd., 475 F.3d 1080, 1091 (9th Cir. 2007) ("[P]roperty is 'used for a commercial activity in the United States' when the property in question is put into action, put into service, availed or employed for a commercial activity, not *in connection* with a commercial activity or *in relation* to a commercial activity.") (emphasis in original); Ministry of Def. & Support for the Armed Servs. of the Islamic Republic of Iran v. Cubic Def. Sys., Inc., 495 F.3d 1024, 1037 (9th Cir. 2007) ("Because repatriation into a ministry's budget does not constitute commercial activity, we hold that the . . . [property] is not subject to attachment under § 1610(a)."); Colella v. Republic of Argentina, No. C 07-80084 (WHA), 2007 WL 1545204, at *6 (N.D. Cal. May 29, 2007) (noting that the Argentine equivalent of Air Force One was only "used for" transporting the President of Argentina, and that "[s]ervice and maintenance do not convert the airplane into an implement used in commerce any more than filling its tanks with jet fuel would be considered a commercial use"). Other litigation under §1610 has focused on the requirement that the foreign state's property be used

Not only are judgment creditors faced with a narrow exception to immunity for the foreign state's property under these decisions, but also, in any event, insolvent sovereign debtors rarely have even arguably attachable assets in jurisdictions where execution is possible. Judgment creditors have thus, more recently, turned their sights to property of agencies or instrumentalities of the state—which may be more likely than the state itself to maintain assets outside of their home jurisdiction—and have argued that the property of those entities should be available to satisfy judgments of the state. Plaintiffs must nonetheless grapple with the Supreme Court's decision in *First National City Bank v. Banco Para El Comercio Exterior De Cuba* (*Bancec)*, which held that agencies or instrumentalities of a state are entitled to a presumption of legal status independent from that of the state itself.[66] To overcome that presumption, plaintiffs must sue the entity, serve it, obtain jurisdiction over it under the FSIA, and meet the exacting standards of *Bancec* and its progeny for disregarding its separate status. And when attempting to reach property held by a foreign state's central bank, creditors face an even higher bar because central banks are afforded heightened protections under the FSIA.[67]

Some judgment creditors have made creative arguments in attempting to evade *Bancec*'s application—for instance, by arguing that the foreign state had a direct ownership interest in the property held by the agency or instrumentality. But such efforts have mostly failed. In *EM Ltd. v. Republic of Argentina*,[68] entities controlled by Elliott and the Dart family sought to block a payment by Argentina's central bank to the IMF and attach reserves held by the bank at the Federal Reserve Bank of New York. The funds argued that because Argentina had authorized its central bank to pay back the IMF on its behalf, Argentina acquired a property interest in the central bank's reserves. The Second Circuit disagreed and held that it saw

> no reason why the presumption of separateness required by *Bancec* . . . should not apply here to shield the [reserves] from attachment. . . . We reject plaintiffs' effort to circumvent *Bancec* . . . by characterizing [Argentina's] ability and willingness to control BCRA as a transfer of property rights sufficient to give the Republic an attachable interest in [the central bank's reserves.][69]

The court further recognized that funds used to repay the IMF were not "used for a commercial activity" since only sovereigns can borrow from the IMF and pay it back, and the targeted funds at issue had not in any event been used

"*in the United States*." *See* Af-Cap, Inc. v. Republic of Congo, 383 F.3d 361 (5th Cir. 2004) (a foreign state's interest was located in the United States because the garnishee was located here), *but see* FG Hemisphere Assocs., LLC v. République du Congo, 455 F.3d 575, 589–90 (5th Cir. 2006) (the interest at issue in *Af-Cap* was *not* in the United States when the garnishee was no longer located here).

66. 462 U.S. 611, 626 (1983).

67. 28 U.S.C. § 1611 (2006); LNC Invs., Inc. v. Republic of Nicaragua, 115 F. Supp. 2d 358, 362–63 (S.D.N.Y. 2000), *aff'd sub nom.*, LNC Invs., Inc. v. Banco Central De Nicaragua, 228 F.3d 423 (2d Cir. 2000).

68. 473 F.3d 463.

69. *Id.* at 479.

for Argentina's repayment.[70] And, although it did not need to reach the issue, the Second Circuit also noted the heightened protections given to central-bank funds under the FSIA.[71]

Most recently, various vultures—led by Aurelius Capital Partners, LP (Aurelius), a recent fund created by former Elliott portfolio managers—sought to execute on social security funds of Argentine citizens that had been invested in New York by private pension fund managers.[72] In December 2008, the Argentine Congress enacted legislation to restructure the hybrid public–private Argentine national social-security system by returning it to a single, unified system under the management of Argentina's public social-security administration. The district court granted motions for execution on the social-security funds managed by the private managers in New York based on the plaintiffs' premise that the new Argentine legislation made these funds attachable property of the state because the Argentine law transferred responsibility for administering them to Argentina's public social security agency. The Second Circuit reversed and vacated the orders because the funds had not been used *by the state* for a commercial activity in the United States.[73] In this context, the Court of Appeals concluded,

> As we read 'used for a commercial activity,' we hold that a sovereign's mere transfer to a governmental entity of legal control over an asset does not qualify the property as being 'used for a commercial activity.' A contrary conclusion would essentially nullify the Act's commercial activity requirement in cases involving attachment and execution of a foreign state's property.[74]

On the heels of the Second Circuit's rejection of its attempt to execute against Argentine social security funds in the United States, Aurelius then tried to execute against Argentine social security funds maintained in custodial accounts *in Argentina*.[75] The district court rejected this second execution attempt under the FSIA because the purported foreign state property was neither "in the United States" nor "used for a commercial activity in the United

70. *See id.* at 481–85.

71. *Id.* at 485–86 (citing LNC Invs., 115 F. Supp. 2d 358). In *EM*, *supra* note 68, the Second Circuit noted that plaintiffs had purposely declined to argue that the central bank was the alter ego of the state proper under the standards set forth by *Bancec*. *Id.* at 480–81. Nevertheless, while the appeal was pending, the same plaintiffs filed a new alter ego action against Argentina and its central bank and simultaneously sought to attach the same funds at issue in *EM* based upon the alter ego theory. The district court recently granted plaintiffs' alter ego application, and the appeal of that decision is now pending. EM, Ltd. v. Republic of Argentina, No. 03 Civ. 2507 (TPG), 2010 WL 1404119 (S.D.N.Y. April 7, 2010), *appeal docketed*, 10-1487 (CON) (2d Cir. Apr. 21, 2010).

72. Aurelius Capital Partners, L.P. v. Republic of Argentina, 584 F.3d 120 (2d Cir. 2009), *cert denied* 130 S. Ct. 1691 (2010).

73. *Id.* at 131 ("[B]efore the retirement and pension funds at issue could be subject to attachment, the funds *in the hands of the Republic* must have been 'used for a commercial activity.'") (emphasis in original).

74. *Id.* Based on this finding under Section 1610(a), the Second Circuit concluded that it need not address whether the funds were also immune from attachment because they were to be managed under the new law by a presumptively separate agency or instrumentality of Argentina.

75. *See* Aurelius Capital Partners, LP v. Republic of Argentina, No. 07 Civ. 2715 (TPG), 2010 WL 768874 (S.D.N.Y. Mar. 5, 2010).

States."[76] In vacating the district court's stay pending appeal, the Second Circuit also held that plaintiffs were unlikely to "succeed on the merits of a claim that the custodial accounts at issue are being used for a commercial activity in the United States," and plaintiffs subsequently withdrew their appeal of the district court's ruling.[77]

VI

CONCLUSION

The case law interpreting the scope of sovereign immunity has often developed in response to the various litigation paths that professional plaintiffs have undertaken. In effect, sovereign debt litigation has begun to resemble a chess match: a move by a vulture is blocked or countered, and a new move or theory comes into vogue as another avenue to try to increase the chances of recovery. Unfortunately, for the state defendant, this is not a game; the vulture's portfolio may be diversified, and it may believe that it only needs an occasional big win to recoup its costs of carry-and-litigation expense. For the state however, what is at issue is not a litigation gamble, but the economic and social welfare of its citizens. Eventually, something other than litigation may be the answer to sovereign debt defaults. But until that day comes, if it ever does, judicial decisions of the kind described in this article will provide the framework for how states and their creditors attempt to deal with these problems.

76. *Id.* at *4.

77. Motion Order, Aurelius Capital Partners, LP v. Republic of Argentina, 10-837-cv (CON) (2d Cir. Mar. 24, 2010), *appeal withdrawn*, Apr. 9, 2010.