The pari passu clause in sovereign debt instruments: developments in recent litigation

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1. Introduction

The pari passu clause is a standard clause in public or private international unsecured debt obligations (syndicated loan agreements and bond issuances). To understand the pari passu clause, it is first necessary to understand the meaning of the short Latin phrase “pari passu”. Literally, this means “with equal step”, from *pari*, ablative of *par*, “equal” and *passu*, ablative of *passus*, “step”. That is to say, pari passu refers to things that are in same situation, things that rank equally. This notwithstanding, the pari passu clause, as brilliantly noted by Buchheit (2000), “is short, obscure and sports a bit of Latin; all characteristics that lawyers find endearing”.

In 1900, an opinion was given that “[t]here is no special virtue in the words ‘pari passu’, ‘equally’ would have the same effect or any other words showing that the [bonds] were intended to stand on the same level footing without preference or priority among themselves...” (Palmer (1900)). However, more recently, the pari passu clause has been described as a harmless relic of historical evolution (Gulati and Scott (2012)).

The reason why the pari passu clause returned to the limelight is a lawsuit that is currently taking place in New York against Argentina (*NML Ltd. v Republic of Argentina*) which is basically the background of this paper on the interpretation of the pari passu clause.

This lawsuit has resulted in some important developments that are worth analysing, namely: (i) the real meaning and the novel interpretation of the pari passu clause; and (ii) the remedies recently proposed by the New York District Court for the enforcement of the clause, which pose a real threat to the future of sovereign debt restructuring – and especially to New York’s future as an international financial centre. This paper will focus only on substantial aspects of the interpretation of the clause and will not address the details of the judicial processes.

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2. The ad hoc scenario and the use of contractual sweeteners

Currently, there is no statutory regime to deal with a sovereign in distress. We are thus left with two main options. One is the use of collective action clauses (CACs), provided that such clauses have already been included in the bonds. The other option is to use an exchange offer, which is a voluntary process whereby the bondholders accept a "new" bond in exchange for the "original" or "old" instrument. The most pertinent aspect of an exchange offer is that the new bond will usually offer less attractive financial and legal terms.

Sometimes, exchange offers incorporate so-called legal or financial "sweeteners" to increase the rate of bondholders' participation in the offer; or are combined with the use of exit consents,[2] which have been used in a number of restructurings (eg those of Ecuador in 2000, Uruguay in 2003 and the Dominican Republic in 2005). These sweeteners can be seen as an ad hoc approach to addressing the lack of a formal insolvency-like regime to force bondholders to accept a restructuring exercise. Some examples of these contractual sweeteners include mandatory prepayment clauses or mandatory restatement of principal clauses, ie clauses that can be included in the new terms of the bonds when the exchange offer is launched, with the aim of convincing the bondholders that they will continue to be protected, either by a reduction in the outstanding stock of debt (ie via mandatory prepayment clauses) or by a reinstatement of the accepted face value reduction in the event of a new default (mandatory restatement of principal clauses). Still others include the use of credit-linked notes (eg as in Argentina 2005); a guarantee (eg as in Seychelles in 2010, where a guarantee was provided by the African Development Bank); the use of a principal defeasance (eg as mooted in an early stage of the Greek PSI); or the use of collateral (eg as in the Brady Plan).

One kind of sweetener that is of particular relevance to the interpretation of the pari passu clause in the ongoing Argentine litigation is the "most favoured creditor clause" (MFCC), as used by Argentina in 2005 (Olivares-Caminal (2009a)). Say a sovereign – after an initial exchange offer – decides to enter into a repurchase, a new exchange offer, or to enter into a *settlement* (pertinent here) on better terms than the exchange offer made to the original bondholders. Including an MFCC in the new terms of the bond being issued as a result of the exchange offer means that the "more beneficial" terms subsequently offered will also be extended to those that that accepted the initial exchange offer. This is usually intended to show that an exchange offer is definitive and, in the event that there is a holdout creditor, the sovereign is not willing to enter into any kind of settlement agreement with more beneficial terms. Why? Because if it enters into a settlement to put an end to

[2] Exit consent is the technique by which holders of bonds who decide to accept an exchange offer, at the moment of accepting said offer, grant their consent to be represented by a third party to amend certain non-payment terms of the (old) bonds that are being exchanged. By using the exit consent technique, the exchange offer is conditioned to a minimum threshold of creditors' acceptance and the amendments to the terms are performed once the required majority to amend the terms has been obtained. Some of these amendments include delisting the bonds, reinstating sovereign immunity provisions or changing the governing law of the bonds. By means of these amendments, the (old) bonds subject to the exchange offer become less attractive (in legal and financial terms), forcing a greater number of bondholders to accept the exchange offer. Hence, if holdout bondholders do not accept the exchange offer, they will end up holding an impaired bond without some of the original contractual protections.

ongoing litigation and pays the holdouts 100% of the value of the claim, then bondholders who accepted a reduction in the face value of the original or old bonds will be entitled to that same treatment. When Argentina included an MFCC in the prospectus with a view to enhancing the degree of investor participation, it forgot to include the word "settlement", rendering the MFCC inadequate since it failed to protect bondholders who accepted the 2005 exchange offer from the possibility that a separate settlement might be reached with a holdout creditor. As result of this gaffe, Argentina passed what is known as a "Lock Law" which prevents the Argentine government from reopening the exchange process or making any kind of court, out-of-court or private transaction or settlement with respect to the bonds that were subject to the exchange offer.

The cases of Pakistan (1999), Ukraine (1999), Ecuador (2000), Uruguay (2003), Argentina (2005–10) and Belize (2006) can be used to evaluate whether such exchange offers work. These six different countries have been selected because they serve as an adequate sample of different types of restructuring episodes, including a pre-emptive debt reprofiling, default (with and without nominal value reductions) and the use of CACs and exit consents. In all these cases, the degree of participation in the exchange offers, which means the rate of acceptance, was above 90% (Ukraine 95%, Ecuador 97%, Pakistan 99%, Uruguay 93%, Argentina 93% after two rounds of exchanges, and Belize 97%) (Olivares-Caminal (2009b)).

Despite the fact that these exchange offers did not achieve 100% participation, none of them experienced the degree of belligerent litigation that has been witnessed in the Argentina case. Argentina's experience is slightly different because it followed a coercive approach and took more than 36 months to launch an exchange offer. In addition, it touches upon another clause, which is the pari passu clause – a clause that even now causes legal professionals to disagree as to its meaning or purpose and even origin.

3. Understanding the pari passu clause

A pari passu clause included in sovereign bond issuances usually reads that the bonds rank pari passu with each other and with other unsecured (payment) obligations of the issuer.[3] This can be read as "equal among equals" and that bondholders are in the same ranking as other unsecured creditors.

From a close reading of the clause, it can be argued that it has two elements: (i) an internal element, ie that the bonds will rank pari passu with each other; and (ii) an external element, ie that the bonds will rank pari passu with other unsecured (present or future) indebtedness of the issuer.

Sometimes the term "payment" is included before "obligations", which adds nothing since we are talking about a bond – which cannot be anything other than a payment obligation. As Wood (2003) noted, adding "payment" means nothing,

[3] The pari passu clause included in Argentina's 1994 Fiscal Agency Agreement (Clause 1(c)) reads as follows: "The Securities will constitute [...] direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank pari passu and without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness (as defined in this Agreement)."

while rank means rank. It does not mean "will pay", nor does it mean "will give equal treatment to creditors". "If a clause adopts a variant such as rank pari passu in priority of payment, then the result should be the same."

3.1. The (in)famous Elliott case

The meaning of the pari passu clause in the sovereign debt context was first discussed in the *Elliott* case, which was brought by Elliott Associates LP against Peru. The peculiarity of this case was the lack of assets to attach in the United States when the claimants sought to enforce a payment obligation. This forced the claimant to resort to the courts of Belgium, Canada, England, Germany, Luxembourg and the Netherlands to seek enforcement of the decision.

In September 2000, Elliott obtained a restraining order from a Brussels Court of Appeals prohibiting Chase Manhattan (the financial agent) and Euroclear from paying interest on the Republic of Peru's Brady bonds (approximately USD 80 million that was due on October 2000). The Brussels Court of Appeals resolution stated that "[t]*he basic agreement regulating the reimbursement of the Peruvian foreign debt, also indicates that the different creditors enjoy a 'pari passu clause', which has as a result that the debt should be paid down equally towards all creditors in proportion to their claim*."

Confronted by the judicial order not to make any payment, Peru faced default on restructured bonds totalling USD 3,837 million. In response, the country attempted to create a trust to make twice-yearly payments of interest due on the Brady bonds in order to keep servicing interest due and to avoid disrupting the flow of funds. Shortly after, however, Peru decided not to implement the trust structure because payments were curtailed through Euroclear, as well as through the Depository Trust Company (DTC) as result of attachment orders in different states in the United States. The only window that was left open – albeit temporarily – was to make the payments through Clearstream (Olivares-Caminal (2012)). This would have implied that only those bondholders holding an account with Clearstream would be paid or that bondholders not holding an account with Clearstream should open an account there (which implied an additional cost and several practical difficulties for Peru). As it was, it was only a matter of time before Elliott obtained a restraining order in Luxembourg (where Clearstream is headquartered).

This scenario forced Peru to reach an agreement with Elliott in order to avoid a new default on its recently restructured debt under the auspices of the Brady Plan. The final settlement agreement implied a payment in the total amount of USD 58.45 million. In the end, after the settlement, Peru was able to pay the due interest in time, avoiding a new default. The decision of the Brussels Court of Appeals that forced the parties to reach a settlement was based on the violation of the principle of equal treatment of creditors under the pari passu clause. The Belgian court mistakenly opened a door that permanently changed sovereign debt practices, as is explained below.

3.2. The ongoing Argentine litigation

Most practitioners and legal scholars thought that it would be just a matter of time until a New York court passed an interpretation of the pari passu clause. As a side note, it is worth pointing out that the Belgian court had to interpret the *pari passu* clause not under Belgian law but under New York law. The interpretation of the pari passu clause under New York law by experts in New York law finally occurred in the wake of the current Argentine litigation (*NML Ltd. v Republic of Argentina*). The first great surprise occurred when the District Court ruled that "*it is declared, adjudged and decreed that the Republic* [of Argentina] *violates Paragraph 1(c) of the FAA whenever it lowers the rank of its payment obligations … including (and without limitation) by relegating NML's bonds to a non-paying class …*". The salient point here is to understand why NML's bonds have been relegated to a non-paying class. The answer to this is the Lock Law. This is why the District Court finds that there has been a form of subordination. It says: "… that the Republic lowered the rank of NML's bonds in violation of Paragraph 1(c) of the FAA when it enacted [the Lock law]".

In the Argentine restructuring case, the bonds that were restructured did not include CACs. Argentina was unable to use exit consents because, in one of the bond series, bondholders managed to get a blocking holding curtailing any possible amendments to the non-payment terms. Therefore, Argentina had to resort to the MFCC. After the above-mentioned gaffe in the drafting of the MFCC (forgetting to include the word "settlement"), the government then passed the Lock Law to persuade bondholders who were in the process of tendering their original or old bonds that Argentina would not settle with holdouts. Otherwise, holding out might have eventually paid off.

However, it was the Lock Law that provided a basis for judging that there had been an alteration in the legal ranking. For, by means of the Lock Law, Argentina opened the way for an interpretation of the pari passu clause in the narrow or payment interpretation and not in the broad payment interpretation as in the Belgian case. Why? Because now there was a basis for subordination. It can be argued that Argentina *formally* subordinated a class of creditors lowering holdouts to a non-performing class by means of the Lock Law. In addition, in its US Securities and Exchange Commission filings (Form 18K, which is an annual report), Argentina has stated that holdouts are a category separate from its regular debt-holders and that since 2005 it has "not [been] in a legal … position to pay" that category. Emphasis should be put on the "*legal position*", which can be read as an indirect acknowledgment by Argentina that holdout creditors are a different category created by law. In this line of thinking, Buchheit (1991) noted that "*you can do pretty much whatever you want in discriminating among creditors (in terms of who gets paid and who does not) but do not try to justify your behavior by taking steps that purport to establish a legal basis for discrimination*". This is precisely what happened in the case of Argentina.

More worrying is that now, when the New York courts were faced with the need to interpret the pari passu clause, we find ourselves in the same position that we were in the year 2000 with the Belgian courts. The District Court found that: "*Argentina lowered the rank of the plaintiff bonds in two ways: when it made payments currently due under the exchange bonds while persisting in its refusal to satisfy its payment obligations currently due under the bonds; and when it enacted the Lock Law.*" This clearly denotes that it is not just the actual subordination but something else.

The decision of the District Court was appealed to the US Court of Appeals for the Second Circuit. Surprisingly, the Court of Appeals understood that "*… in pairing the two sentences of its Pari Passu Clause, the FAA manifested an intention to protect bondholders from more than just formal subordination*". Again, as the District Court found, it is not just the actual subordination (which took place as result of the Lock Law) but something else.

According to the Court of Appeals, the pari passu clause protects against: (i) "the issuance of other superior debt (first sentence)";[4] and (ii) "the giving of priority to other payment obligations (second sentence)".[5] This confirms the broad interpretation of the pari passu clause along similar lines to the Belgian court's opinion and that as result of this we might be witnessing the opening of a Pandora's box. This means that the courts can order: (i) the debtor not to pay other debts of equal rank without making a rateable payment under the debt benefiting from the clause; (ii) other creditors: (a) not to accept a payment from the debtor unless the pari passu-protected lender receives a rateable payment; or, (b) if they have knowingly received and accepted a non-rateable payment, they are answerable to the pari passu-protected creditor for a rateable share of the funds; and (iii) a financial intermediary (eg a fiscal agent or a bond clearing system) can be ordered to freeze any non-rateable payment received from the debtor and to turn over to the pari passu-protected creditor its rateable share of the funds (Buchheit and Pam (2004)).

In January 2012 the District Court issued a temporary restraining order enjoining Argentina from altering the payment process (including the use of different firms or other vehicles). In addition, in February 2012, the same court issued an injunctive relief order requesting that, each time that a payment is made on exchanged bonds, the same fraction of the amount due on them should be paid to holdouts. The latter decision is based on principles of equitable relief, given that Argentina had formally made clear its intention not to pay. Since Argentina might refuse to comply with the injunctive order, the District Court extended its applicability not only to Argentina but also to its officers, agents, servants, employees and attorneys as well as other persons who are in active concert or participation with them. The injunctive order expressly prohibited Argentina's agents from aiding and abetting any further violation of the order by the court.[6] This clearly falls under point (iii) in the previous paragraph. These procedural orders (ie the temporary restraining order and the injunctive relief order) are currently under scrutiny by the Court of Appeals.

3.3. A serious threat to New York as a leading financial centre for sovereign debt

The broad interpretation of the pari passu clause will affect New York as an international financial centre because sovereign issuers will fear that it opens the way to litigation on such clauses. In addition, the injunctive relief order enjoining other parties (ie financial intermediaries) has several operational ramifications that threaten to impair the functioning of the payment systems. On the other hand, if the injunctive order is reversed by the Court of Appeals, creditors' enforcement

[4] The first sentence of the pari passu clause included in the Argentine bonds reads: "… shall at all times rank pari passu and without any preference among themselves".

[5] The second sentence of the pari passu clause included in the Argentine bonds reads: "… shall at all times rank at least equally with all its other present and future unsecured and unsubordinated [e]xternal [i]ndebtedness".

[6] This conflicts with another norm that states that intermediaries cannot be affected (Art. 4-A of the UCC).

rights will be affected. In both scenarios, New York stands to lose as an international financial centre, particularly in the sovereign debt arena.

To follow this line of thinking, it is worth noting that in the 1990s, in the *Pravin* and *Elliott* cases, the Court of Appeals for the Second Circuit was faced with balancing two important considerations, namely: (i) granting US-resident bondholders scope to pursue the repayment of their credit, although this would limit the chances of achieving a debt restructuring under the auspices of the IMF; and (ii) disallowing such claims because they would prejudice New York's status as a financial centre. Both issues were important for US foreign policy. For the Court of Appeals, however, the priority lay with the protection of investors and the sanctity of contracts.

4. Concluding remarks

The broad interpretation of the pari passu clause is a very delicate issue because we are opening a Pandora's box without knowing what might emerge. If we consider the aftermath of the *Elliott* case, which was the first time that there was a broad interpretation, and despite the fact that it was by a less authoritative court (many of the sovereign debt issuances are governed by New York law), there were several developments: the sovereign debt restructuring mechanism proposal of the IMF; the private sector reaction, ie the use of CACs and exit consent; increased NGO activism clamouring for debt forgiveness; increased investment by distressed debt funds; "vulture" repudiation by means of legislation in the United States and the United Kingdom; the erroneous re-emergence of the odious debt principle and its mutation into the debts of odious regimes and illegitimate debts; and an increased aggressiveness on the part of debtors and creditors.

As indicated above, this will seriously affect the future of the sovereign debt market in New York. The harm has been done; one way or another, there will be damage.

The interpretation of the pari passu clause in the pre-Argentine litigation was incorrect. It was based on the Belgian court's interpretation of the pari passu clause in the broad sense. Post-Argentine litigation, the interpretation could have been based on the correct reading of the clause based on an actual breach of it due to the ranking or narrow form as a result of the legal subordination from the Lock Law. Unfortunately this was not the case. This was a great missed opportunity, and it will trigger a new round of litigation.

As Olivares-Caminal (2009a,c) and Gulati and Scott (2012) noted, the clause has little or no meaning in the sovereign debt context. However, it is a boilerplate and boilerplates are sticky. After the decision of the Second Circuit Court of Appeals it will become even stickier. Looking forward, it is the task of lawyers – as guardians of the purity of language in contracts – to clearly state whether the pari passu clause should read as "rank" or "rateable payment" instead of the not very clear Latin phrase "pari passu". In the meantime, there are still many contracts with Frankenstein-like pari passu clauses that will be litigated.

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