"Don't Borrow From Me Argentina" The Aftermath of the Largest Sovereign Default in International Finance

MARIANO SOTO GAJARDO[*]

> *"We are going to take the bull by the horns. We are going to speak of the foreign debt. First, I announce that the Argentine state will suspend payment on the foreign debt."*

(Inauguration speech of President Adolfo Rodriguez Saá, December 24, 2001)

INTRODUCTION

This is the story of a country that has learned how not to honour its contractual obligations. A country that has behaved opportunistically in restructuring its debt. A country that has claimed to negotiate in good faith with its creditors when its efforts to do so have been dubious to say the least. A country that has exploited every legal mechanism available to prevent its creditors from recovering their claims in court. This is the story of Argentina and its most recent sovereign debt restructuring.

Argentina has a long history of defaulting on its obligations. After selling bonds listed on the London Stock Exchange in the early 1820s, the country defaulted on the bonds just a few years later and did not settle with the bondholders until

[*] LL.B. Universidad de Chile. LL.M. The University of Chicago and the London School of Economics & Political Science.

1857.[1] Argentina defaulted on its obligations again in 1890, causing a financial panic in England as Argentina's primary creditor, Baring Brothers, experienced a liquidity crisis as a result of Argentina's default.[2] In 1956, Argentina's threatened default led to the creation of the Paris Club, an informal association established by creditor countries to act in a co-ordinated way in the rescheduling of debts due to them by developing countries.[3] In 1982, Argentina, together with other Latin American countries, experienced a financial crisis that led it to suspend interest payments on all foreign debt and to engage in complex negotiations with private and multilateral lenders.[4] Most recently, in 2001, in the midst of political chaos and social unrest, Argentina declared the largest and potentially most complex default to date.[5]

By the end of 2001, when Argentina decided to take the "bull by the horns" and declared the moratorium on its foreign debt, it faced the mother of all sovereign bond restructurings as the country defaulted on more bonds, in more jurisdictions and in more currencies than any other economy in history. All of these complexities, coupled with the absence of a regulatory framework guiding sovereign debt workouts, guaranteed that Argentina's restructuring would face extremely difficult creditor coordination issues as well as intense holdout litigation, a problem widely

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[1] See Carlos Marichal, *A Century of Debt Crisis in Latin America,* at p. 14, 34-35, 55-60, 59 t.2 (1989).

[2] Id. at p. 149-159.

[3] For a good account of the origins of the Paris Club see http://www.clubdeparis.org/sections/qui-sommes-nous/48-description-du-club-de/switchLanguage/en. Last visited on 07.01.2008.

[4] See Ernst Oliveri, *Latin American Debt and the Politics of International Finance,* at p. 163-203 (1992). See also Robert Delvin, *Debt and Crisis in Latin America, The Supply Side of the Story,* at p. 181-235 (1989).

[5] Arturo Porzecanski, *From Rogue Creditors to Rogue Debtors: Implication of Argentina's Default,* Chi. J. Int' L.(2005) at p. 317.

perceived as the biggest threat to orderly restructurings. Interestingly, however, the core lessons from Argentina's restructuring have not been about the costs created by holdout litigation. Rather, what is striking about the Argentinean case is that, notwithstanding this threat, Argentina acted opportunistically by taking advantage of its sovereign status and the lack of a transnational legal framework to deal with sovereign workouts.

With the expectation of engaging in good faith negotiations with Argentina, key bondholder groups and committees from around the world representing about 75 per cent. of bonds held outside Argentina, formed the Global Committee of Argentine Bondholders, a legitimate counterparty for an expeditious and consensual restructuring of the country's debt, but Argentinean authorities opted to ignore it. Despite the fact that its public finances were recovering from the depths of the economic crisis, Argentina behaved aggressively throughout the negotiations with the bondholders and made the poorest offer the world has ever seen. Creditors who did not accept the offer and instead decided to commence proceedings against Argentina have had little or no success. The litigation by bondholders in the US, Italy and Germany has not yet yielded any actual returns for bondholders, and Argentina has shown no interest in proposing a settlement to bring such litigation to an end.

Argentina's restructuring demonstrates that the proposals advanced by legal scholars and policy makers to improve sovereign debt workouts have paid too much attention on improving collective decision-making mechanisms among creditors, but too little on developing a creditor-debtor framework to structure the bargaining process and its outcome, and providing creditors sufficient power to make such a framework effective. In this sense, innovative legal techniques such as collective action clauses and aggregation mechanisms are not sufficient to deal with rogue debtors[6] such as Argentina, as Argentina's strategy was to achieve a restructuring "no matter what", even if less than half of its creditors had blessed the proposal. The Argentinean case further shows that the international financial system lacks a legal framework necessary to provide creditors with access to relevant information in a timely fashion to allow them to have a full picture of a defaulting sovereign's financial position at the time a restructuring takes place.

The following paper consists of four parts. The first part briefly discusses creditor coordination problems as the main focus of sovereign debt restructuring. Although not directly related to Argentina's restructuring, it provides the background necessary to understand the current regime with respect to sovereign debt workouts. The second part examines Argentina's restructuring exercise. It provides an account of the best practices followed by countries when restructuring their debts and compares such practices with the approach adopted by Argentina after its default in 2001. This section contains both an analysis of procedural and substantive issues arising out of Argentina's restructuring and analyses how, under the current regime, countries with significant leverage like Argentina can easily jeopardize a swift and orderly workout. The third part provides a brief overview on

[6] I borrow the terminology from Porzecanski, *supra* note 5.

the immunities granted to foreign countries and their instrumentalities in jurisdictions such as England and the US, and then reviews the multi-jurisdictional litigation commenced against Argentina as a consequence of its default. This section puts a special emphasis on the difficulties creditors have faced in enforcing judgements against Argentina and on the defences raised by this country in such proceedings. The last part provides concluding observations and advances a few suggestions on how to avoid new episodes inspired by the Argentinean experience.

I

"CREDITOR COORDINATION" PROBLEMS AS THE MAIN FOCUS OF SOVEREIGN DEBT RESTRUCTURING

From a legal standpoint, the most fundamental difference between defaults arising out of corporate debt and those in the sovereign context lies in the limited legal ability of creditors to enforce debt contracts against countries.[7] It has been suggested that it is hard to force a government to pay against its will, since most of the assets that could be used for repayment purposes (including tax revenues) are located inside the country.[8] Moreover, when it comes to assets located outside a country's own territory, although several jurisdictions have relaxed the traditional sovereign immunity barriers that used to protect foreign nations from judicial

[7] M. Gulati and G. Triantis, *Contracts Without Law: Sovereign Versus Corporate Debt*, Duke Law School Working Paper Series, Paper 89 (2007), at p. 11. Available at http://lsr.nellco.org/cgi/viewcontent.cgi?article=1089&context=duke/fs

[8] F. Sturzenegger & J Zettelmeyer, *Has the Legal Threat to Sovereign Debt Restructuring Become Real?*, at p. 9.

claims,[9] countries still remain largely litigation-proof with respect to enforcement of judgements.[10] As a consequence of this insulation, sovereigns have an important bargaining strength at the time of repayment, a strength that has led some to argue that it is willingness to pay rather than ability to pay which is a defining characteristic of sovereign debt.[11] Accordingly, its been said that sovereign defaults can be acts of political will, a discretion exercised whenever the national government decides that the tax burden and administrative costs of debt service are intolerable, and that the burden of payment (political as well as economic) outweighs the costs of default.[12]

Given the limited legal recourse available to creditors to enforce their contractual rights following a country's default, lenders have generally opted to negotiate, rather than to litigate, their way out of sovereign debt problems.[13] However, while in the case of corporate debtors several measures have been adopted in various jurisdictions to facilitate such bargaining processes,[14] no similar

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[9] See part III below.

[10] M. Gulati and G. Triantis, *supra* note 7.

[11] J. Eaton and M. Gersovitz, *Debt With Potential Repudiation: Theoretical and Empirical Analysis,* Review of Economic Studies, Vol. 48 (1981) at p. 289-309.

[12] W. Bratton and G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, Georgetown University Law Center, (2003) at p. 12. Available at http://ssrn.com/abstract=387880

[13] L. Buchheit and M. Gulati, *Exit Consents in Sovereign Bonds Exchanges*, UCLA L. Rev. 59 (2000) at p. 60.

[14] Typically, those rules shield the distressed debtor and its assets from maverick creditor litigation, at least for some time, to permit the formulation and negotiation of a plan; protect creditors from abusive behaviour by the troubled debtor; impose a plan that has been approved by the majority creditors and judicially confirmed on dissenting creditors; and equally important, provide for the fate of the defaulting debtor when consensus is not at hand. See Andrés de la Cruz, *Sovereign Debt*

set of rules yet exist to deal with sovereign debtors and their creditors, including foreign private creditors.[15] The lack of parallelism between the development of restructuring mechanisms applicable to private debtors and those applicable to sovereign debtors has been explained by asserting that a country in distress can neither surrender its sovereignty by submitting to a binding process to facilitate the restructuring of its liabilities, nor can it cease to exist should a restructuring plan fail.[16] By understanding these differences, the need for a legal framework for the restructuring of sovereign debt can be justified on the grounds that such a mechanism can help to achieve an orderly, swift and fair outcome for all parties, particularly where issues of creditor coordination arise and litigation against the sovereign is highly unlikely or not possible.[17]

Due to the lack of a regulatory framework guiding sovereign debt restructurings, legal scholars have tried to explore the problems that arise out of current workouts,[18] and to advance possible solutions to overcome such shortcomings. Interestingly, of the many issues that emerge in sovereign debt

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Restructurings, in *Cross Border Debt Restructurings, Innovative Approaches for Creditors, Corporates, and Sovereigns,* Esteban C. Buljevich ed. (2005) at 317.

[15]Id.

[16]Id.

[17] See generally Mitu Gulati & George Triantis, *Contracts Without Law: Sovereign Versus Corporate Debt,* Duke Law School Working Paper Series (2007).

[18] S. Schwarcz has identified the following problems in sovereign debt restructurings: (1) the holdout or collective action problem; (2) the moral hazard problem; and (3) the taxpayer problem. See S. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach,* Cornell Law Review (1999-2000) at p. 957. For a systematic analysis of the three problems see S. Schwarcz, *"Idiot's Guide to Sovereign Debt Restructuring"*, Emory Law Journal (2005) at p. 1189.

restructurings its the so-called "collective action problem" that has captured by far the greatest attention of all.

In a debt restructuring context, a collective action problem arises due to the unusual nature of multicreditor debt instruments, such as bonds and syndicated bank loans.[19] Indeed, while in most contracts the parties know each other's identity beforehand, in a multicreditor debt instrument investors usually do not know who the other creditors are. This difference has led some commentators to argue that bond investors are like the patrons in a theatre audience: each one has decided to see a particular play on a particular night, but none has any idea who the other audience members will be.[20] In a universe without restrictions imposed by contract or bankruptcy law,[21] following an event of default each investor generally has the right to accelerate its loan or bond and to commence proceedings against the borrower, even if such actions can dramatically affect the interests of the debtor's other creditors. This invites one or more investors to strategically delay the closing of a debtor's reorganisation plan (holdout) by refusing to participate in the

[19] Lee C. Buchheit and Mitu Gulati, *Sovereign Bonds and the Collective Will,* Emory Law Journal (2002) at p. 1320.

[20] Id.

[21] Important contractual exceptions are no-action clauses and acceleration thresholds. No-action clauses prohibit a bondholder from commencing proceedings to enforce payment of the principal and interest owing under the bonds, and from instituting any other legal proceedings to enforce their rights, unless certain preconditions are met. Acceleration thresholds also limit the ability of individual creditors to initiate litigation against the debtor by requiring a minimum percentage of bondholders to agree to accelerate the bond. In the bankruptcy context, the automatic stay is a rule that prevents a creditor from exercising its right to seize property of the debtor during the pendency of the bankruptcy without court permission.

restructuring and threatening to take the debtor to court.[22] Through the use of this strategy, such creditors hope that the overall desire to reach an agreement will induce the other parties to buy out their claims or pay them a premium, even though the creditors as a group would be better off by agreeing to a restructuring in a unanimous fashion.[23] For this reason the holdout problem has been considered a form of market failure that justifies legal intervention on the grounds that such regulation prevents individual creditors from acting in a way that is contrary to the interests of creditors as a group.[24]

Despite the lack of a regulatory framework in the sovereign context, dealing with the holdout problem was relatively easy during the age of the syndicated loan.[25] This was in part due to the fact that sovereign debtors knew who their lenders were, many of whom had existing commercial relationships with these countries.[26] Therefore, in the event it became necessary to restructure existing debt, sovereigns and their private lenders could quickly communicate among each other,

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[22]Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships,* U. Ill. L. Rev.(1988) at p. 504-508. See also Jill Fisch & Caroline Gentile, *Vultures or Vanguards?: The Role of Litigation in Sovereign Debts Restructuring,* (2004) at p. 5.

[23] Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, Georgetown Journal of International Law (2005) at p. 308.

[24] Id. For a good account of the holdout problem in the corporate restructuring context see D. Baird, R. Gertner & R. Picker, *Game Theory and the Law* (1994) at p. 196.

[25] S. Goldman, *Mavericks in the Market: The Emerging Problem of Hold-Outs In Sovereign Debt Restructuring,* UCLA J. Int'l L & Foreign Aff., 2000-2001 at p. 167. For a good account on the ways sovereign debt restructurings were handled during the 1980s, see Buchheit & Ralph Reisner, *supra* note 22.

[26] R.M. Aureback, *Sovereign Debt – Default and Restructuring of Debts Owed to Private Creditors*, J.I.B.L.R. (2003) at p. 446.

chiefly through the London Club forum.[27] The few reluctant banks intending to exercise their rights individually were forced to participate in these restructurings through peer pressure and encouragement from bank regulators.[28] As countries turned to the bond market as the primary source of financing, however, sovereign restructurings have become considerably more difficult to coordinate thereby potentially exacerbating the holdout problem. To a significant extent, this lack of coordination is due to the change in the profile of creditors. New investors are less regulated,[29] more heterogeneous,[30] harder to identify[31] and represent a wider variety of interests than their older counterparts.[32]

Nevertheless, the holdout threat can only become real if the creditors who refuse to participate in a sovereign restructuring have the ability to extract preferential treatment through the legal enforcement of their claims. In order to

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[27] Id. For an account on the London Club, see A. Rieffel, *Restructuring Sovereign Debt*: *The Case for Ad Hoc Machinery* at p. 95-131. In the case of restructurings of debt owed to governments, the negotiations are held under the auspices of the Paris Club. For an account on the Paris Club, see A. Rieffel, *The Paris Club, 1978-1983*, Columbia Journal of Transnational Law, Vol. 23 (1984) at p. 83.

[28] Lee C. Buchheit, *Sovereign Debtors and Their Bondholders,* Unitar Training Programmes on Foreign Economic Relations, at p. 9. Available at http://www.unitar.org/fer/sovereign.pdf. For an excellent account on how peer pressure used to work during those negotiations, see Jill Fisch & Caroline Gentile, *supra* note 22.

[29] Institutions that purchase emerging markets sovereign bonds on the secondary market are often unregulated and accordingly not subject to the influence of the official sector. See Hagan, *supra* note 23 at p. 310.

[30] Sovereign bonds are held by large commercial banks, smaller commercial banks, local banks, investment banks, insurance companies pension funds, mutual funds, retail funds, hedge funds, non financial companies and retail investors. See Jill Fisch & Caroline Gentile, *supra* note 22 at p. 24.

[31] As bonds are typically issued in bearer form it is often very difficult to identify bondholders prior to making the offer to restructure. See R.M. Aureback, *supra* note 26, at p. 446.

[32] As opposed to lenders in syndicated loans, bondholders may have no previous relationship with the debtor and may be only interested in obtaining a short term profit.

demonstrate that the collective action problem is not only a theoretical one, commentators cite successful cases involving holdout litigation against sovereigns, particularly in the context of Brady bonds negotiations.[33] Perhaps the most emblematic case in this regard is *Elliott Associates LP v. Banco de la Nación and the Republic of Peru*,[34] where Elliott, the plaintiff, decided not to participate in the restructuring of Peru's debt, and instead sought a judgement against the country. Using a very creative enforcement strategy, Elliott was successful in attaching interest payments that were about to be made to the creditors who a few years before had accepted the Brady Plan, thereby forcing Peru to settle with Elliott in order to avoid a default on its Brady bonds.

Creditors specializing in the purchase of distressed debt at a discount, such as Elliott, have been perjoratively labeled predators,[35] vultures[36] and pirates[37] capable of disrupting other creditors' attempts to reach an orderly debt workout with sovereigns in financial distress. With these types of creditors in mind, leading commentators have asked themselves the following questions: how could the "grab and run" instinct of each creditor be kept in check long enough to permit a

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[33] Brady bond is the name which has come to be given to collaterised bonds issued by the sovereign debtors in exchange for existing unsecured debt (mainly loans) proposed by US Treasury Secretary Nicholas Brady, known as the "Brady Plan". See Aureback, *supra* note 26, at p. 443.

[34] Discussed in greater detail below in Section III.B. See also Hagan, *supra* note 23, at 313.

[35] See for example Glover Urges Protection for Poor Nations, (22.05.07). Available at http://www.topix.net/forum/source/newsday/TN9L59J9BU6KB80BM.

[36] See for example *Vulture funds' circle but debtors stay a moving target,* Financial Times (18.02.07) Available at http://www.ft.com/cms/s/f9684f5c-bf78-11db-9ac2-000b5df10621.html.

[37] Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, The Business Lawyer. Vol. 56 (2001).

coordinated workout to the ratable benefit of all creditors? How could the majority of the creditors ensure that their collective judgement about the terms of such a workout would be binding on all creditors? How could the majority neutralize the ability of holdout creditors to force a preferential buyout of their claims as the price to closing a restructuring with the other creditors?[38]

In response to these questions a number of proposals have been suggested. Some experts have advanced a form of statutory-based framework that would operate as a bankruptcy regime for sovereigns[39] - the Sovereign Debt Restructuring Mechanism (SDRM) being the most prominent example[40] - as the best formula to address complex sovereign debt workouts. Others have spent a significant amount of ink promoting the use of collective action clauses[41] and aggregation

[38] These questions, phrased in a slightly differed manner, are discussed in Lee C. Buchheit and Mitu Gulati, *supra* note 19 at p. 1321.

[39] This approach has been advocated by Steven Schwarcz, *supra* note 18.

[40] The SDRM was endorsed by Anne Krueger, in *A New Approach to Sovereign Debt Restructuring*, International Monetary Fund (2002), but it failed to obtain sufficient support from the United States. To be sure, the SDRM was a comprehensive proposal that intended to address issues such as IMF Financing, the moral hazard problem, coordination between the private sector and the official sector, intercreditor and debtor-creditor dialogue in debt restructurings, etc. For an excellent account on the SDRM see Hagan, *supra* note 23.

[41] Although the terms of collective action clauses vary, the types found in a number of international sovereign bonds can be classified into two general categories. The first consists of "majority restructuring" provisions, which enable a qualified majority of bondholders of an issuance to bind all holders of that issuance to the financial terms of a restructuring, either before or after a default. The second type can be described as "majority enforcement" provisions, which enable a qualified majority to limit the ability of a minority of creditors to enforce their rights following a default, thereby giving the debtor and the qualified majority of creditors the opportunity to agree upon a restructuring. Since Mexico's ground-breaking issue, a significant number of emerging market countries have included CACs in new bonds issued in New York. These include Belize, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Guatemala, Indonesia, Korea, Mexico, Panama, Peru, the Philippines, Poland, South Africa, Turkey, Uruguay and Venezuela. For a good account on collective action clauses, see IMF, *Collective Action Clauses in Sovereign Bond Contracts–Encouraging Greater Use* (2002), available at https://www.imf.org/external/np/psi/2002/eng/060602a.pdf; IMF, *The Design*

mechanisms,[42] thus advocating that the most appropriate answer to collective decision-making issues lies in a contractual-based approach.[43] Further market oriented recommendations to protect sovereign debtors from aggressive litigation include the appointment of a bondholder trustee, as is typical in bonds issued under English law[44] and coercive strategic voting via bond exit consents as part of restructurings conducted through exchange offers.[45]

As all of these proposals reveal, a tremendous effort has been undertaken by a wide range of actors in order to improve collective decision-making among creditors and avoid the possibility of holdouts. What some of those proposals have failed to take into account is that in some circumstances it is the debtors, rather than the holdout creditors who pose the greatest barrier to sovereign debt restructurings, and Argentina is the best example of such a debtor.

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and Effectiveness of Collective Action Clauses, available at http://www.imf.org/external/np/psi/2002/eng/060602.htm; See also Buchheit and Gulati, *supra* note 19.

[42] A legal technique that permits modification to the terms of two or more series of securities.

[43] See for example, S. Galvis, *Sovereign Debt Restructurings - The Market Knows Best*, International Finance 6 (1), at p. 145–155 (2003).

[44] See Paul Bedford, *Sovereign bond contracts: a workshop at the Bank of England* (2005) at p. 102.

[45] Because the sovereign issuer solicits the consent of its creditors to amend the old bonds at the same time those lenders exchange their bonds for the sovereign's new instruments, this technique is referred to as an "exit" consent. The amendments to the old bonds are intended to encourage the prospective holdout creditor to accept an offer that the holdout may not, except for the prospects of being left with a bond stripped of important protective covenants, have otherwise found attractive. See Lee C. Buchheit & Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges,* 487 UCLA L. Rev. (2000-2001) at 59.

II

ARGENTINA AND THE DEBT RESTRUCTURING EXERCISE

A. Overview

Argentina went through the mother of all sovereign restructurings,[46] as the country defaulted on more bonds,[47] in more jurisdictions,[48] and in more currencies[49] than any other emerging economy. Moreover, as the percentage of retail investors holding Argentinean bonds was higher than in other cases, coordination efforts became a more difficult task for creditors.[50] All of these complexities ensured that Argentina's restructuring would give rise to almost every problem that could arise in a sovereign debt workout.[51] Surprisingly, the core lessons from the Argentinean case have not been about the costs created by holdout litigation. Instead, what is striking about the Argentinean experience is that notwithstanding the problematic circumstances, the country behaved opportunistically by abusing its sovereign

[46] N. Roubini & B. Setser, *Bailouts or Bail-Ins, Responding to Financial Crises in Emerging Economies* (2004) at p. 298.

[47] At the time of the restructuring, a total of 152 bonds were in default (98 international bonds and 54 bonds governed by Argentine law). Id.

[48] New York (51%), England (18%), Germany (17%), Argentina (11%), Japan (25%) and others (1%). Argentina's Restructuring Guidelines, September 22, 2003, Porzecanski, *supra* note 5 at p. 326.

[49] Id.

[50] A substantial portion of the Argentine debt was retail, by one estimate 44 per cent., held principally by individuals in Italy and Germany. See Hal Scott, *Sovereign Debt Default: Cry for the United States, Not Argentina* at p. 2.

[51] N. Roubini & B. Setser, *The Reform of Sovereign Debt Restructuring Process: Problems, Proposed Solutions and the Argentine Episode* (2004) at p. 7.

status, ignoring the majority of its foreign creditors and making the poorest offer ever made in a sovereign debt workout.

B. Traditional Approaches to Debt Restructuring

In theory at least, countries in default either reach an agreement with creditors or risk costly and prolonged litigation and ostracization from financial markets should they decide to repudiate their debt.[52] Although there are no bright-line rules dictating the manner in which a sovereign debtor and its creditors must approach a post-default restructuring, over time precedents have accumulated and become market conventions.[53] Historically, countries needing debt relief have followed one of two procedures. The first one has been the route whereby governments sit down to negotiate face-to-face an amendment of existing instruments with an advisory or steering committee of representative creditors.[54] This approach was followed by dozens of governments in the rescheduling of their bank loans, from Argentina in the early 1980s to Vietnam in the late 1990s.[55] They all negotiated with a bank advisory committee.[56] The relevant bank advisory committee would then recommend to other private creditors that they accept the terms agreed

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[52] J.F. Hornbeck, *Argentina's Sovereign Debt Restructuring* (2004) at p. 5. Available at http://www.cnie.org/NLE/CRSreports/04Oct/RL32637.pdf.

[53] See Paul Bedford, Adrian Penalver and Chris Salmon, *Resolving Sovereign Debt Crises: The Market-Based Approach and the Role of the IMF* Financial Stability Review (2005) at p. 96.

[54]Porzecanski, *supra* note 5, at p. 323.

[55] Id.

[56] Also known as the London Club. See *supra* note 27.

upon with the government in question, and most would usually do so.[57] As explained earlier, this was possible because, although ostensibly voluntary, the restructurings were in a practical sense mandatory for creditors holding sovereign debt, as peer and regulatory pressures were brought to bear on the recalcitrant banks that preferred to holdout from the negotiations.[58]

The second procedure, which has been the preferred method in the case of bond restructurings, is the unilateral exchange offer of outstanding debt instruments for new ones. Although at first glance its name implies a "take-it-or-leave-it" offer, these exchanges have usually taken place after the sovereigns' financial advisors have sounded the market through informal consultations with a critical mass of investors about the possible shape of an acceptable settlement, which is then crafted and presented to all creditors. Additionally, a minimum threshold of 80 per cent. to 85 per cent. of participating creditors is usually required as a condition to close the exchange.[59] A combination of carrots (such as good deal terms or cash in advance) and sticks (exit consents to amend the bonds' non-financial terms) have resulted in deals that almost all creditors decided to accept.[60] Among the reasons for following this less orthodox form of negotiation, commentators cite tactical considerations,

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[57] Porzecanski, *supra* note 5 at p. 323.

[58] See S. Goldman, *supra* note 25 at p. 167. See also Jill Fisch and Caroline Gentile, *supra* note 22 at p. 11.

[59] This was the approach followed by Uruguay and the Dominican Republic, among others.

[60] This process worked in Pakistan, Ukraine, Ecuador, Russia and Uruguay, where over 90 per cent. of the creditors accepted the debtor's initial offer. See N. Roubini & B. Setser, *supra* note 51 at p. 8; See also Porzecanski, *supra* note 5 at p. 323.

difficulties associated with the number of bondholders, and problems of identification resulting from the issue of bonds in bearer form.[61]

Although exchange offers can be as effective as the traditional negotiated route, the absence of a formal channel for debtor-creditor communication increases the likelihood that debtors will behave opportunistically by disclosing insufficient information about their financial situation or by circumventing their creditors with respect to the design of the restructuring strategy.[62] Acknowledging the essential need of strengthening dialogue and information exchange between debtors and creditors, market-based reforms have proposed the inclusion of engagement provisions in sovereign bond contracts.[63] Engagement clauses formalise the process of setting up creditor committees thereby ensuring that a single point of contact is established among the parties.[64] These clauses typically provide that, post-default and subject to positive bondholder vote, a representative bondholder committee would be formed with which the debtor would engage in good faith negotiations

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[61] R.M. Aureback, *supra* note 26 at p. 446. Where bondholders need to be lobbied to achieve an amendment, it has to be done through international clearing systems, Euroclear and Clearstream, and through advertisement in the financial press. The international clearing systems will not disclose to an issuer or its advisers the identity of those who have positions in the bonds. Notices or request for proxies are given to the clearing system which pass them on to their participants. These participant are typically custodians, who in turn are expected to pass all communications on to the beneficial owners. See Robert Gray, *Collective Action Clauses*, at p. 10.

[62] International Monetary Fund, *Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework* (2003) at p. 5.

[63] See Paul Bedford, *supra* note 44 at p. 102.

[64] Paul Bedford, Adrian Penaviel and Chris Salomon, *supra* note 53 at p. 94.

and whose reasonable expenses would be borne by the debtor.[65] Engagement clauses, however, have not proved very popular with issuers. One reason has been the concern that a separate creditor committee would be established for each bond, thus driving the issuers into a plethora of bilateral negotiations and very significant expenses.[66] Bondholders may also believe that these clauses are insufficient. Investors that do not feel well informed and satisfied that a deal is fair between different classes of instruments will be tempted to shun or vote against an exchange.[67]

An important additional development in fostering the formation of creditor committees have been the Principles for Stable Capital Flows and Fair Debt Restructuring (the "Principles") agreed between some key trade associations and a group of sovereign borrowers.[68] The Principles constitute a set of voluntary guidelines designed to add further structure and predictability to the relationship between sovereign debtors and their creditors beyond that contained in contracts.[69] The Principles provide that structured, early negotiations with a creditor committee should take place when a default has occurred in order to ensure that the terms for amending existing debt contracts or an exchange are consistent with market realities

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[65] Robert Gray, *Collective Action Clauses*, at p. 15 (2003).

[66] Id.

[67] Id.

[68] The principles were published jointly by a number of emerging market issuers of sovereign bonds, the Institute for International Finance (IIF), and the International Primary Markets Association (IPMA) in November 2004. See http://www.iif.com/data/public/principles-fina-0305.pdf.

[69] Paul Bedford, Adrian Penalver and Chris Salmon, *supra* note 53 at p. 96.

and the restoration of growth and market access.[70] Ideally, the committee should: coordinate across affected instruments and with other affected creditor classes with a view to forming a single committee; be a forum for the debtor to present its economic program and financing proposals; collect and analyse economic data; gather, evaluate, and disseminate creditor input on financing proposals; and generally act as a communication link between the debtor and the creditors.[71] As compared with its contractual counterpart, the fact that the committee envisaged by the Principles would operate across-the-board could prove extremely helpful as it would minimize both the risk of a proliferation of creditor committees as well as the expenses that are to be paid by the borrower. The lack of a formal compromise, however, raises questions about the effectiveness of the Principles insofar as there is typically relatively little cost for debtors in reneging on voluntary commitments.[72]

The International Monetary Fund ("IMF") has also acknowledged the need to improve dialogue between sovereign borrowers and their creditors. The IMF has issued a paper that states the importance that debtors consult with creditors on the design and process of the restructuring strategy and individual instruments to improve the prospects for a successful conclusion.[73] The paper further recognises that, in circumstances in which creditors have organized a representative committee

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[70] Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets.

[71] Id.

[72] Paul Bedford, Adrian Penaviel and Chris Salomon, *supra* note 53 at p. 94.

[73] International Monetary Fund, *Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework,* (2003) *supra* note 62.

on a timely basis, the debtor's interest would normally be well served by elaborating a restructuring proposal in close cooperation with such committee.[74] Moreover, the good faith criterion set out by the IMF's Lending into Arrears policy explicitly includes disclosure and transparency requirements for information needed to enable creditors to make informed decisions on the terms of a restructuring.[75] According to the IMF, it would seem reasonable that, at a minimum, when a member has reached a judgement that a rescheduling of its debt is necessary, it should: (i) engage in an early dialogue with its creditors, which should continue until the restructuring is complete; (ii) share relevant, non-confidential information with all creditors on a timely basis; and (iii) provide creditors with an early opportunity to give input on the design of early restructuring strategies and the design of individual instruments, thereby increasing the likelihood of high participation in the restructuring.[76] While this framework acknowledges that the members are the ones who need to judge the most appropriate modality for conducting a dialogue with their creditors, the IMF has made clear that, as the number and heterogeneity of creditors increases and the range of instruments to be covered by a restructuring becomes more diverse, there will be greater need for a more formal negotiation between a debtor and its creditors.[77]

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[74] Id. at p. 15.

[75] International Monetary Fund, *Fund Policy on Lending Into Arrears to Private Creditors - Further Consideration of the Good Faith Criterion* (2002).

[76] Id. at p. 10.

[77] Id at p. 11 and 17.

C. Argentina: An Unprecedented Approach to Debt Restructuring

Argentina was clearly the exception to the mechanisms described above, not only because the country ignored what are considered the best procedural practices of sovereign debt restructuring, but also because it surprised its creditors with the world's largest debt write-off in the history of international finance.

In a press release dated March 22, 2004, IMF's Acting Managing Director and Chair, Anne Krueger, stated that the "[Argentinean] authorities' intention to discuss with creditors all aspects of the debt exchange offer, including how best to take into account proposals received from creditors, is crucial. The authorities are encouraged to work diligently to design a debt exchange offer that attains the highest possible creditor participation, reduces the risk of protracted litigation, and restores debt sustainability."[78] However, although the Argentinean government provided assurances to the IMF that it was going to negotiate in good faith with all representative creditor groups, and made similar public statements in the same direction,[79] it actually declined to do so. Its actions proved inconsistent with its

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[78] IMF Executive Board Completes Second Review of Argentina's Stand-By Arrangement, Press Release No. 04/57 March 22, 2004. Available at http://www.imf.org/external/np/sec/pr/2004/pr0457.htm.

[79] In September 10, 2003 *Letter of Intent, Memorandum of* Economic *and Financial Policies of the Government of Argentina for 2003-2006:* Technical Memorandum of Understanding, the Government assured the IMF that its commitment to "…a collaborative dialogue with creditors and our commitment to treat all creditor groups in a fair and equitable manner will help secure a high participation rate in the eventual restructuring." Global Committee of Argentina Bondholders, *The Importance of and the Potential for the Expeditious Negotiation of a Consensual and Equitable Restructuring of Argentina's Defaulted Debt* (Aug 3, 2004), at p. 2. Available at http://www.gcab.org/images/GCAB_White_Paper_Final.pdf. See also J.F. Hornbeck, *supra* note 52 at p. 7.

commitment to negotiate with all representative creditors and with the impression it had provided to the IMF that it was arranging for such negotiations.[80]

The terms of the exchange were basically dictated unilaterally by Argentina.[81] Evidence of this approach is the fact that Argentina's exchange offer did not include minimum participation conditions to make closing binding upon it.[82] Instead, the government declared to be satisfied if it achieved an extremely low minimum acceptance rate of 50 per cent. to 70 per cent.[83] The seriousness of its predicament became evident at the time Argentina filed its final terms with the US Securities and Exchange Commission ("SEC"), stating that the financial terms of the exchange offer would depend on whether bondholder participation "(i) exceeded 70 per cent; or (ii) was equal to or less than 70 per cent of, the total amount of defaulted indebtedness."[84] Although the government hired financial advisors in early 2003 and early 2004, it quickly became apparent that these firms were not going to engage

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[80] In its *Second Review* dated March 12, 2004 (the "March 12 Review") the IMF cites the unequivocal commitment of the Government to negotiate: "*In their March 10, 2004 Letter of Intent, the authorities indicate that the main element[s] of their approach are [is] to …engage in meaningful and constructive negotiations with all representative creditors groups."* Global Committee of Argentina Bondholders (GCAB), *supra* note 79 at p. 3.

[81] Hal Scott, *supra* note 50 at p. 4.

[82] As was the case in other restructurings, such as the one of Uruguay. See Andrés de la Cruz, *supra* note 14 at p. 326-327.

[83] When launching the debt restructuring proposal, Finance Minister Roberto Lavagna went so far as to say that the government would regard any rate above 50 percent as having effectively cured the country's default. Porzecanski, supra note 5 at p. 325. See also Global Committee of Argentina Bondholders, *July Presentation* (2004) at p. 10. Available at http://www.gcab.org/images/GCAB_Presentation_7.30.04.pdf.

[84]Form 18-K/A, June 10, 2004 at p. 2. Available at http://www.sec.gov/Archives/edgar/data/914021/000090342304000633/repargentina-18ka1_0610.txt

in a dialogue with the investor base.[85] Moreover, bondholders did not have their first significant meeting with Argentine authorities until March 2003, fifteen months after the default.[86] This was a significant postponement, considering that every month Argentina delayed its restructuring it saved approximately US $700 million in past-due interest.[87]

Notwithstanding the difficulties associated with coordinating a wide range of creditors, in January 2004, key bondholder groups and committees from around the world organised themselves and formed the Global Committee of Argentine Bondholders ("GCAB") a body representing about 75 per cent. of foreign bondholders and over 37 billion dollars in debt.[88] Immediately upon being formally organized, GCAB invited the government to meet for good faith negotiations.[89] However, even though Argentina had promised GCAB to hold a technical meeting in Buenos Aires where the country was going to justify its economic assumptions and establish an economic basis for negotiations, unexpectedly, before the scheduled

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[85] Porzecanski, *supra* note 5 at p. 324.

[86] See J.F. Hornbeck, *supra* note 52 at p. 7.

[87] This was in part due to the fact that Argentina did not recognise a large fraction of its past-due interest in its exchange offer. See Dania Thomas & Javier García-Fronti, *Good Faith in Sovereign debt Restructuring: the Evolution of an Open Norm in 'Localised' Contexts?*, at p. 10.

[88] Global Committee of Argentina Bondholders, *July Presentation, supra* note 83 at p. 5.

[89] Global Committee of Argentina Bondholders, *The Importance of and the Potential for the Expeditious Negotiation of a Consensual and Equitable Restructuring of Argentina's Defaulted Debt*, *supra* note 79 at p. 3.

dates for the meeting, Argentina's minister of finance publicly announced a "final proposal" for the restructuring of the country's public external indebtedness.[90]

Argentina's unilateral approach continued throughout the second half of 2004, when the government registered the final terms of the proposed debt restructuring[91] and subsequently filed its registration statement with the SEC.[92] Hiding behind US securities regulation, Argentina argued that due to restrictions imposed by the Securities Act of 1933, the GCAB "will have to wait until the SEC approves our filing and we are in a position to meet with our creditors."[93] Although US securities laws prohibit conditioning the market through selling or offering to sell securities during the so-called pre-filing period,[94] once a statement has been filed with the SEC such laws do permit oral offers, communications, discussions and negotiations related to those securities.[95] Argentina's excuse was clearly inconsistent with its own behaviour, as the country had already disclosed information concerning the proposed restructuring through public announcements and in

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90 The announcement was given in Argentina by Minister Roberto Lavagna on June 1, 2004.

91 The final terms were announced on June 10, 2004 in Amendment No. 1 to the government's Form 18-K/A. See *supra* note 84.

92 The filing of the registration statement took place on July 2, 2004. Available at http://www.sec.gov/Archives/edgar/data/914021/000095012304008163/y98698svb.htm.

93 GCAB Letter to Minister Roberto Lavagna. Available at http://www.gcab.org/images/GCAB_Response-151014-180804.pdf.

94 The period of time prior to the filing of a registration statement. US Securities Act of 1933, Section 5.

95 Id.

private consultations with securities analysts.[96] The assertions of the Argentinean government were sharply disputed by GCAB, who urged the country to engage in meaningful negotiations as quickly as possible.[97]

But Argentina did not stop playing hard ball. At the time it finally launched the exchange offer in 2005, it reinforced that the deal would go through even if bondholder participation was below the 70 per cent. threshold.[98] Moreover, as evidence that it was willing to repudiate a substantial portion of its debt, its offer included the following statement: "Argentina has announced that it has no intention of resuming payments on any Eligible Securities that remain outstanding following the expiration of the Offer. Consequently, if you elect not to tender your Eligible Securities pursuant to the Offer there can be no assurance that you will receive any future payments."[99] President Kirchner also made it clear that he would repudiate the bonds of investors who did not accept the offer, and the Argentine Congress backed him up. In less than ten days it passed a law prohibiting the government from reopening the exchange offer and from negotiating other terms in any legal cases connected with the debt in question.[100]

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[96] GCAB Letter to Minister Roberto Lavagna, *supra* note 93.

[97] Id.

[98] F. Hornbeck, *supra* note 52 at p. 11-12.

[99]See Prospectus Supplement, filed on 10 January 2005. Available at http://www.sec.gov/Archives/edgar/data/914021/000095012305000302/y04567e424b5.htm

[100] N. Maurer & A. Musacchio, *The Barber of Buenos Aires: Argentina's Debt Renegotiation*, Harvard Business School (2006) at p. 7.

D. Specific Terms of Argentina's Offer

Widely accepted guidelines suggest that a government in default should make every reasonable effort to pay as much as it can.[101] Argentina was also inconsistent with this principle creating another low water mark in the history of sovereign restructurings.

A summary of its proposal was presented in Dubai in September 2003 (the "Dubai proposal").[102] The Dubai proposal called for a 75 per cent. reduction in the nominal value of their defaulted bonds (the "haircut")[103] with no recognition of past-due interest and an extension of some of the bonds' maturity dates by over 40 years.[104] "The haircut should have been 100 per cent." said Argentina's finance minister, "but facing a complex situation, we decided to be completely transparent and hide nothing. An econometric model showed that 25 per cent. was the maximum limit that we could afford."[105] On a net present value ("NPV") basis, financial institutions estimated this to be a 90 per cent. rather than a 75 per cent. reduction on the value of the bonds.[106]

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[101] J.F. Hornbek, *supra* note 52 at p. 6.

[102] N. Maurer & A. Musacchio, *supra* note 100 at p. 6.

[103] When new bonds are worth less than old bonds, the market describes this as giving a "haircut" to the old bonds.

[104] N. Maurer & A. Musacchio, *supra* note 100 at p. 6. See also Andrew Cooper & Bessma Momani, *Negotiating Out of Argentina's Financial Crisis: Segmenting the International Creditors,* New Political Economy Vol. 10, No. 3 (2005) at p. 311.

[105] Id.

[106] J.F. Hornbeck, supra note 52 at p. 7.

Argentina justified its offer in terms of its determination to achieve a "sustainable settlement", so as to avoid future defaults.[107] Sustainable settlement implies that the debt payment schedule must be reduced, smoothed out and extended so that the country can afford payments under reasonable economic assumptions.[108] But Argentina's sustainability model was never updated to reflect the significant increase in its fiscal revenues and other crucial economic parameters in 2004, or to incorporate the government's bulging financial assets at the National Treasury.[109] Instead, Argentina stuck to its offer and made clear that it was not going to commit more than 3 per cent. of its GDP to finance the restructuring.[110]

The IMF published reports indicating that Argentina could allocate at least 4 per cent. of its GDP to serve its debt.[111] GCAB also claimed that the exchange offer provided bondholders with substantially less than Argentina's payment capacity could afford.[112] Specifically, GCAB claimed that by forecasting a more realistic average GDP growth rate of 3.6 per cent., using a reasonable portion of the US $8

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[107] A. Dhillon, J. García-Fronti, S. Ghosal & M. Miller, *Bargaining and Sustainability: The Argentine Debt Swap of 2005*, Centre for Economic Policy Research (2005) at p. 6.

[108] F. Hornbeck, *supra* note 52 at p. 6.

[109] Porzecanski, *supra* note 5 at p. 324.

[110] J.F. Hornbeck *supra* note 52 at p. 13.

[111] IMF Staff, *Comments of the GOA to Argentina's Debt sustainability Analysis* (July 12, 2004) at p. 1. See also Appendix to Class Notice to holders of Republic of Argentina Bonds in the case of *H.W. Urban GmbH v. Republic of Argentina*, available at http://www.argentinaclassaction.com/appendix.pdf at 4.

[112] Global Committee of Argentina Bondholders, *supra* note 79 at p. 12.

billion increase in its cash and reserves[113] and prudently accessing the capital markets, Argentina's ability to pay could potentially increase by approximately US $45 billion.[114] All of these assumptions had some basis, because at the time Argentina filed its registration statement, data indicated that the economy was rebounding strongly from the depths of its economic crisis, reporting a real GDP growth of 8.7 per cent. in 2003, and expected to grow over 8 per cent. by the end of 2004.[115]

Argentina's final offer was made to private international creditors in January 2005. Argentina offered to exchange its bonds in default for Par Bonds due December 2038, Discount Bonds due December 2033 and Quasi-Par Bonds due December 2045.[116] The new bonds were issued under the laws of New York, England and Argentina,[117] and contemplated a haircut of around 73 per cent.[118] Although the final offer backdated the new bonds to December 31, 2003, implicitly recognizing past-due interest starting from that date, it did so at very low rates.[119] Interest arrears were not recognized at all for the preceding twenty-four months

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[113] From US $10 billion at the end of 2002 to US $18 billion in 2004 due in part to the government having not paid interest on its own defaulted debt.

[114] Global Committee of Argentina Bondholders, *supra* note 79 at p. 8-10.

[115] Registration statement filed on July 2, 2004, *supra* note 92.

[116] For a full description of Argentina's offer see Gabriel Gomez-Giglio, *A New Chapter in the Argentine Saga: The Restructuring of the Argentine Sovereign Debt*, J.I.B.L.R., (2005) at p. 345.

[117] Id.

[118] Laura Alfaro, *Creditor Activism in Sovereign Debt: "Vulture" Tactics or Market Backbone,* Harvard Business School (2007) at p. 1.

[119] Porzecanski, *supra* note 5 at p. 324.

(2002-2003).[120] Perhaps, the major improvement made on Argentina's part was the attachment of GDP-linked securities to every new offered bond. These instruments provided that 5 per cent. of all real GDP growth above a certain threshold (the "baseline GDP") would go to make additional payments to bondholders, something which on the margin, may have helped the "successful" outcome of the Argentine offer.[121]

E. The Outcome: "An Offer You Can't Refuse"

As has occurred at other times in its history, Argentina was miraculously helped by the hand of God.[122] Indeed, international capital markets evolved in favour of the Argentinean offer, as interest rates in the US, Europe and Japan reached historic lows. What might have looked like an outrageous offer in 2003 looked more attractive using 2005 discount rates.[123] In the end, and quite likely due to the unique economic conditions surrounding the exchange, approximately 76 per

[120] Id.

[121] Also referred to as warrants. The threshold started at 4.2 per cent. growth in 2005 and slowly decreased to 3 per cent. by 2015. The Financial Times called the GDP-linked securities a revolutionary instrument, closer to equity than debt. N. Maurer & A. Musacchio, *supra* note 100 at p. 7. For an account on Argentina's GDP-indexed bonds, see S. Griffith-Jones and K. Sharma, *GDP-Indexed Bonds: Making It Happen,* Department of Economic and Social Affairs (2006) at p. 4-6.

[122] I borrow the terminology form Diego Maradona who claimed it wasn't his hand, but "the Hand of God" which had guided the ball to the goal during a semi-final match between Argentina and England in the 1986 world cup. See http://www.travelblog.org/South-America/Argentina/Buenos-Aires/BA/blog-62247.html.

[123] Anna Gelpern, *After Argentina*, Policy Briefs in International Economics, (2005) at p. 3.

cent. of bondholders accepted the offer.[124] Holdouts were left with debt possessing a face value of almost US $20 billion, but with an uncertain real value.[125] The government of Argentina expressed its satisfaction at the swap outcome. President Kirchner said that Argentina had achieved "the best renegotiation in history",[126] while Latin Finance, a magazine specializing in Latin American markets, gave the Argentine government the prize for "Deal of the Year" in sovereign liability management and called the restructuring "the Mother of all Deals."[127]

At this point it is clear that in achieving the exchange Argentina owed little to recent ideas for revising the international financial architecture for sovereign debt restructurings. Instead, it seems that after maintaining a tough stance for more than three years, Argentina managed to wear down a large fraction of creditors and benefited from a sharp decline in emerging markets debt yields, an unexpected exogenous development that produced a substantial improvement in the real value of the debt exchange.[128] Further, the effective rate of acceptance by international creditors was in reality much lower than 76 per cent. Indeed, domestic Argentine bondholders (many of which were state-controlled entities like banks and pension

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[124] Andrew Cooper & Bessma Momani *supra* note 104 at p. 313.

[125] N. Maurer & A. Musacchio *supra* note 100 at p. 7.

[126] BBC News, *Argentina closes $102.6bn debt swap* (26.02.05). Available at http://news.bbc.co.uk/1/hi/business/4299005.stm.

[127] N. Maurer & A. Musacchio *supra* note 100 at p. 7.

[128] P. Bolton & D. Skeel, Jr., *Redesigning the International Lender of Last Resort,* at p. 29 (2005). Available at http://www0.gsb.columbia.edu/faculty/pbolton/PDFS/Redesigning_Lender.pdf

funds) owned 46.9 per cent. of the debt, and were subject to strong government pressure to enter the exchange.[129] If one assumes that all domestic creditors accepted the exchange, the acceptance rate for international creditors would only have been 53.4 per cent.[130] This rate was substantially below the effective rate of 75 per cent required to even trigger eventual collective action clauses contained in contracts, as that calculation typically excludes bonds held by state-controlled entities.[131]

The first reaction to the government's decision to unilaterally impose a haircut on bondholders was that the international debt markets closed to Argentina and Argentine companies at a time of low interest rates.[132] However, Argentina suffered far less than any rational analysis of events had predicted. Immediately after the exchange, Standard & Poor's said that it would give Argentina a credit rating of B-minus, a rank that Ecuador did not attain for five years after its default in 1999.[133] Further, in March 2006, the Argentine government returned to the dollar-denominated debt market with a US $500 million offering which, although issued in Buenos Aires, was oversubscribed by more than 300 per cent.[134] Argentina's debt restructuring process, however, was far from over. It remained to be seen what

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[129] Hal Scott, *supra* note 50 at p. 4.

[130] Id.

[131] Id.

[132] N. Maurer & A. Musacchio, *supra* note 100 at p. 7.

[133] Helen Thompson & David Runciman, *Sovereign Debt and Private Creditors: New Legal Sanction or the Enduring Power of States?* New Political Economy Vol. 11, No.4 (2006) at p. 551.

[134] See Antonio Guerrero "*$500 MILLION BOND ISSUE LURES INVESTORS*", Global Finance. May 2006. Available at http://findarticles.com/p/articles/mi_qa3715/is_200605/ai_n17174320.

would happen with the remaining bondholders representing approximately US $20 billion in claims who chose not to participate in the exchange, seeking instead to be paid with Argentinean assets in US, Italian and German courts.[135]

III

WORLDWIDE LITIGATION AND PROBLEMS OF ENFORCEMENT

A. Background

For a creditor wishing to enforce its claims against a sovereign, obtaining a judgement is no longer as an onerous task as it was in the past. The traditional concept of absolute sovereign immunity has been significantly eroded under the laws of those jurisdictions that typically govern international debt instruments.[136] Private creditors began to have judicial recourse against sovereigns when, in the 1970s, England and the US amended their legislation governing sovereign immunity depriving sovereigns of their immunity from jurisdiction in certain cases.[137] Moreover, the number of defences available for sovereigns under both systems of law have been narrowed down considerably during past years. For example, the champerty defence - which has the effect of prohibiting litigation in circumstances where the creditor has acquired a claim with the express intention of pursuing legal

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[135] Laura Alfaro, *supra* note 118 at p. 1.

[136] Sean Hagan, *supra* note 23 at 311. See also Charles Proctor, *Sovereign Debt Restructuring and the Courts –Some Recent Developments, Part 1*, Butterworths Journal of International Banking & Financial Law (2003) at p. 303.

[137] Helen Thompson & David Runciman, *supra* note 134 at p. 545. See also Sean Hagan, *supra* note 22 at p. 311.

action - has proven unsuccessful in litigation taking place in England,[138] while in the US several states have abolished it through legislative reform.[139]

Insofar as the adjudicative jurisdiction of the English courts is concerned, the State Immunity Act of 1978 (SIA) provides that a state is not immune if the dispute involves "any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation."[140] In the US, the Foreign Sovereign Immunities Act of 1976 (FSIA) also enables a court to exercise adjudicative jurisdiction over a sovereign where it has waived, explicitly or implicitly, its immunity from suit,[141] or where the action by the foreign state qualifies as a commercial activity.[142] US courts have ruled that the financial transactions of foreign states qualify as commercial activities.[143]

There is, however, a crucial distinction between obtaining a court judgement against a foreign state and enforcing that judgement. Even if debt agreements provide for a broad waiver of immunity with respect to the attachment of assets, property belonging to sovereign states has traditionally been very difficult to attach.

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[138] See e.g. *Camdex International Ltd. v. Bank of Zambia* [1996] 3 LL ER 431 CA.

[139] In New York, for example, the champerty defence was effectively abolished in 2004. See N.Y. Jud. Law §489(2).

[140] State Immunity Act of 1978 §3(1). See also Issam Hallak, *Courts and Sovereign Eurobonds: Credibility of the Judicial Enforcement of Repayment* (2003) at p. 8. (CFS Working Paper No. 2003/34). Available at: http://www.ssrn.com/abstract=473187.

[141] Section 1605(a)(1).

[142] Section 1605(a)(2).

[143] See *Republic of Argentina v. Weltover, Inc.* 504 U.S. 607 (1992).

First of all, the laws of the foreign state will generally prevent a judgement creditor from seizing assets of the sovereign located within the sovereign's territory.[144] Additionally, not all assets located outside the sovereign's territory are available for attachment. In the United Kingdom, §13(4) of the SIA provides that the property of a foreign state shall not be subject to enforcement, unless that property is presently in use or intended for use for commercial purposes.[145] Similarly, under US law, provided certain conditions set forth in the FSIA are met, only property of a foreign state "used for a commercial activity in the United States" is available for attachment.[146]

Equally important, the reserves of the central bank will not normally be available in enforcement proceedings brought against a foreign state. English courts have treated central banks as separate entities.[147] Therefore, except where central banks assume liability under the terms of a debt instrument, their property will not be available to satisfy such debt,[148] provided however that if foreign states hide their commercial assets in accounts with their central banks to avoid judgement creditors, a court may conclude that such assets are actually not the property of the central

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[144] Sean Hagan, *supra* note 23 at p. 312.

[145] SIA §13(2)(b) and (4).

[146] FSIA Section 1610.

[147] See *Trendtex Trading Corp. v. Central Bank* [1977] Q.B. 529.

[148] Even if central banks incur liability for state obligations, under English law their property is immune from *enforcement* unless they "specifically" consent to waive such immunity. See William Blair, *The Legal Status of Central Bank Investments under English Law* (1998) at p. 377 and 380.

bank.[149] Likewise, in the US, the property of a central bank held for its own account is not available for judgements against the sovereign. This is so, unless the central bank contractually supports the obligation of its government through a guarantee or other security arrangement and explicitly waives its immunity,[150] or where a court decides to disregard the central bank's separate legal status under the so-called *Bancec* principles.[151]

B. The "Pari Passu" Strategy

Faced with the difficulty of locating assets of a sovereign debtor that are subject to attachment, judgement creditors developed a creative strategy that involves seeking injunctive relief to "interrupt" the servicing of debt held by other creditors. That was the strategy followed by Elliott against the Republic of Peru.[152] In 1996, Elliott Associates, a New York hedge fund, bought Peruvian debt at a discount when the Peruvian government was concluding an agreement with its creditors to restructure its debts into Brady bonds. Elliott withdrew from the negotiations and

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[149] Id. at p. 381, suggesting that there are legal remedies against an accessory to fraud citing *Royal Brunei Airlines v. Tan* [1995] 2.A.C. 378.

[150] Under US law, Central Banks' sovereign immunity can be waived, but only with respect to attachments in aid of execution (i.e. post judgement attachments). See FSIA Section 1611(b)(1). See also Paul Lee, *Central Banks and Sovereign Immunity*, Colum. J. Transnat' L. (2003) at p. 366.

[151] The Bancec principles were established in *First National City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. The Bancec principles allow to disregard an entity's separate legal status (1) where the agency or instrumentality is so extensively controlled by its owner that a relationship of principal and agent is established; and/or (2) where equitable principles dictate that the separate legal status should be disregarded to avoid working fraud or injustice.

[152] See Elliott Assoc. No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26). See also Helen Thompson & Davis Runciman, *supra* 133 at p. 547.

sued Peru in the US for full repayment, which with interest came to US $20.7 million. In 2000, a federal New York court ordered Peru to pay Elliott the full face value of the debt, plus interest, which added up to US $57.2 million. After several unsuccessful attempts to collect its judgement in New York, Elliott filed an *ex parte* motion with the Commercial Court of Brussels seeking to restrain Euroclear from processing any funds wired by Peru in an attempt to pay interest on its Brady bonds. When, on appeal, the Belgian Court of Appeals ordered the attachment, Peru, which was close to defaulting on its Brady payments, chose to settle with Elliott.[153]

Relying on a broad interpretation of the *pari passu* clause,[154] Elliott was successful in convincing the Belgian Court of Appeals that Peru was contractually barred from paying one group of creditors unless a ratable and simultaneous payment was also made to Elliott.[155] In 2003, the Brussels Commercial Court followed in the footsteps of the Elliott panel in *LNC v. Nicaragua*,[156] interpreting the

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[153] See Buchheit and Pam, *The Hunt of Pari Passu* IFLR (2004), at p. 20; See also Gulati & Klee, *supra* note 37 at p. 636.

[154] A sample clause of a *pari passu* provision in a loan agreement reads as follows "Its payment obligations under the Finance Documents rank at least *pari passu* with the claims of all its other unsecured and unsubordinated creditors." For samples of *pari passu* clauses see Lee Buchheit, *How to Negotiate Eurocurrency Loan Agreements* (2004) at p. 82.

[155] Andreas Lowenfeld, writing for Elliott, argued that "A borrower from Tom, Dick and Harry can't say 'I will pay Tom and Dick in full, and if there is anything left over I will pay Harry.' If there is not enough money to go around, the borrower faced with a pari passu provision must 'pay' all [its creditors] on the same basis." See Gulati & Klee *supra* note 37 at p. 637.

[156] The injunction was issued against the paying agent by Belgian Commercial Court on Sept. 8, 2003.

pari passu clause in Nicaragua's loan agreements to require proportional payment to creditors of equal ranking.[157]

The Elliott decision was the subject of much criticism because it disregarded the "ranking" interpretation given to the clause by some commentators.[158] According to the ranking interpretation, the purpose of the *pari passu* provision in the sovereign context is not to require proportional payments, but instead to prevent borrowers from adopting legislative measures aimed at changing the legal status of the debt or "ear-marking" assets or revenue streams to benefit specific creditors.[159] The criticisms to the payment interpretation were quickly welcomed by other players in the market. In the context of the litigation in the US arising from Argentina's default, for example, the US government, the New York Federal Reserve and the New York Clearing House Association all filed briefs supporting Argentina in its attempts to obtain a declaratory judgement to foreclose the use of the *pari passu* provision for purposes of enforcing judgements against the country. Although at that time the court ruled that the matter was non-justiciable because the plaintiffs had yet to use the *pari passu* argument in their proceedings, it directed creditors to

[157] Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, Emory Law Journal (2004) at p. 1137.

[158] See for example Buchheit and Pam, *supra* note 153.

[159] Id. at p. 20.

provide 30 days' notice to Argentina before seeking to interfere with any payments through efforts to enforce the *pari passu* clause.[160]

The decision in Elliott was reversed in 2004 in *LNC v. Nicaragua,* when the Brussels Court of Appeals held that because Euroclear was not a party to the *pari passu* agreement between Nicaragua and LNC, it could not be compelled to enforce the contract term in question.[161] Later, in 2005, Belgium enacted a statute protecting all settlement systems against the Elliotts of this world.[162] In England, the Financial Markets Law Committee (the "FMLC") has stated that, insofar as English law is concerned, the ranking interpretation is the proper interpretation of the *pari passu* clause in sovereign debt obligations.[163] The report prepared by the FMLC concluded that the consequences of following the payment interpretation were such that both

[160] See Anna Gelpern, *supra* note 157 at p. 1137-1138. See Also Kathryn Brown, *Market Discipline in Sovereign Debt: Reinforcing the Rights of Bondholders and Private Creditors* at p. 37.

[161] République du Nicaragua contre LNC Invs. LLC, Euroclear Bank S.A., General Docket No. 2003/KR/334 (C. App. of Brussels, 9th Chamber, Mar. 19, 2004). As some have suggested, a strong policy interest seems to lie behind the ruling: if Euroclear were to become a collection agency, its capacity to fulfil its basic mandate to settle financial transactions promptly and efficiently would be fundamentally impaired, and the business would move from Belgium to different jurisdictions. See Anna Gelpern, *supra* note 157 at p. 1138. See also Anna Gelpern, *supra* note 123 at p. 7.

[162] Under Article 9 of the Belgian Act of April 28, 1999, as modified by Article 15 of the Belgian Act of November 19, 2004, no cash settlement account with a settlement system operator or agent *nor any transfer of money to be credited to such cash settlement account, via a Belgian or foreign credit institution*, may in any manner whatsoever be attached, put under trusteeship or blocked by a participant (other than the settlement system operator or agent), a counterparty or a third party. The amendment, which is reflected in italics, was published in the Belgian State gazette of December 28, 2004 and entered into force in January 2005.

[163] See generally, Financial Markets Law Committee, Issue 79 – *Pari Passu* Clauses (2005) *Analysis of the role, use and meaning of pari passu clauses in sovereign debt obligations as a matter of English Law.* Available at http://www.fmlc.org/papers/fmlc79mar_2005.pdf.

debtors and creditors would be prejudiced by such construction.[164] It must be noted that this statement was released in the absence of direct English case law addressing the proper interpretation of the *pari passu* provision.[165]

As can be observed, attempts around the world have been made to bury the payment interpretation of the *pari passu* provision in the sovereign context, a move that would have the effect of leaving creditors with practically no legal tools to enforce their contracts against their debtors. This is good news for rogue debtors such as Argentina, who can now repudiate their debt and keep their assets insulated against adverse judicial decisions. The bad news for the Argentinas of this world, however, is contained in *Nacional Financiera S.N.C. v. Chase Manhattan Bank, N.A.*, a case decided by the Southern District Court of New York (the "District Court") in 2003. In that decision, the District Court observed that a fiscal agency agreement, which contained a standard *pari passu* provision,[166] would have effectively enabled the plaintiff to obtain an injunction to bar the borrower from making preferential payments to some of its noteholders.[167] Although decided in the corporate context, *Nacional Financiera* is a useful reminder that the *pari passu* clause could still bite hard

[164] Id. at p. 22.

[165] In *Kensington Int'l Ltd. v. Republic of Congo*, the *obiter dicta* in Tomlinson J's opinion expressed reservations about the payment interpretation of the *pari passu* clause on the basis of the discussion on *pari passu* clauses found in the Encyclopaedia of Banking Law. 16th April, 2003, unreported. Approved by the Court of Appeal [2003] EWCA Civ. 709.

[166] The provision read as follows "*Ranking of the Notes and Guarantees.* The notes will be general unsecured and unsubordinated obligations of the Company and will rank *pari passu* with each other and with all other present and future unsecured and unsubordinated indebtedness of the Company."

[167] Not reported in F. Supp. 2d.

those debtors who decide to discriminate amongst their creditors when servicing their debts.

C. Litigation Against Argentina in the United States

1. *Individual Litigation and Class Actions.* In the US, almost all litigation commenced against Argentina after the default has been brought in the District Court, where individual creditors have been able to obtain judgements in their favour. In *Lightwater Corp. Ltd. v. Republic of Argentina*,[168] the court summarily rejected Argentina's request for a stay pending negotiations with its creditors and granted summary judgement for plaintiffs, observing that "the obligation of the Republic on the bonds involved in these lawsuits is unconditional. Sovereign immunity has been waived. The Republic defaulted on the bonds when it ceased to pay the interest."[169] The District Court subsequently granted summary judgements in favour of hundreds of individual holders of Argentine bonds based on the same criteria. Although Argentina has appealed only a handful of the rulings entered by the District Court, those rulings have been generally affirmed by the Court of Appeals for the Second Circuit.[170]

[168] 2003 WL 1878420 (S.N.Y.D May 14, 2003). The action was later consolidated with *Old Castle Holdings v. Republic of Argentina* and *Macrotecnic v. Republic of Argentina*.

[169] See Charles D. Schmerler, *Restructuring Sovereign Debt,* in *The Law of International Insolvencies and Debt Restructurings*, J. Silkenat and Ch. Schmerler, eds. (2006) at p. 450.

[170] See Prospectus Supplement, filed on 10 January 2005, *supra* note 99.

Things have not been as easy for creditors intending to obtain judgements through class actions, a vehicle almost never used in previous sovereign debt litigation.[171] The two largest class actions filed in the District Court, *HW Urban v. Republic of Argentina*[172] and *Applestein v. Republic of Argentina,*[173] were dismissed on the grounds that the proposed class actions were "too large, too diverse, and too vaguely defined" in the first case[174] and "amorphous and ill-defined" in the second.[175] Subsequently, in *HW Urban*, the plaintiff amended its complaint to seek to represent holders of a narrower series of bonds. By the end of 2003, the District Court granted the motion to certify this narrower, redefined class.[176]

Some have pointed out that class actions are an unsuitable means to resolve sovereign debt disputes.[177] This lack of suitability has been justified on the grounds that, given the restrictions that class actions impose on creditor-debtor

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[171] Lee Buchheit and Mitu Gulati mention one case, against Bolivia, in which two holders of bonds issued by that country brought a class action in the US District Court for the District of Columbia. See *supra* 19 at p. 1355.

[172] 2004 WL 307293 (S.N.Y.D. Feb. 17, 2004).

[173] 2003 WL 21058248 (S.N.Y.D. May 12, 2003).

[174] In *Urban*, the plaintiff sought to certify a class of all holders (except Argentine citizens) of an unspecified number (anywhere from 30 to 68) of different series of bonds denominated in six different currencies amounting to an amount that Argentina estimated to exceed US $12 billion. *See* W. Debevoise and D. Orta, *The class action threat to sovereign workouts,* (2003), Intl. Financial L. Rev. at p. 41 and 42.

[175] In *Applestein,* the class plaintiff proposed to certify a class of all persons (except Argentine citizens) who, as of December 23 2001, held bonds issued by Argentina pursuant to the October 19, 1994 Fiscal Agency Agreement. Argentina estimated that the proposed class included approximately US $23 billion in outstanding debt. Id.

[176] See Prospectus Supplement, filed on 10 January 2005, *supra* note 99. See also generally F. Sturzenegger & J. Zettelmeyer, *supra* 8 at p. 41.

[177] See W. Debevoise and D. Orta, *supra* note 174 at p. 42.

communication, a sovereign debtor that is a defendant in such proceedings may be prevented from engaging in dialogue with its creditors after a class has been certified and before the class members file opt-out forms, thereby hindering the efforts to organise and negotiate a restructuring plan.[178] The District Court seemed to have been aware of this problem when it denied plaintiffs' application to enjoin Argentina from presenting its exchange offer to class members, by observing that "[Y]ou cannot expect this Court to prevent the Republic from, in some fair form, giving the exchange offer to the members of this class. And you can't expect this Court to have the members of the class somehow blocked from receiving the exchange offer."[179]

On efficiency grounds, this appears to have been the right approach because, by way of insulating the exchange offer from plaintiffs' attacks, the court advanced a solution for a large number of creditors who opted to accept, rather than to litigate, Argentina's proposal, and who would have otherwise ended up worse off if prevented from tendering their bonds. Once a sovereign exchange offer closes, however, class action vehicles should be widely welcomed by the courts as they

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[178] Id.

[179] On October 28, 2004 the representative of the class action in *Urban* had moved to enjoin the Argentinean government from engaging in or otherwise consummating the exchange offer relating to the two series of bonds held by potential class members on the grounds that any such exchange offer must be made only through class counsel rather than directly to potential class members. On November 16, 2004, the District Court granted in part and denied in part that motion, stating that the Republic is entitled to launch such an exchange offer, but recognizing that potential members of the class should be notified concerning the class action, including the existence of the class action, the definition of the class, and that by accepting the exchange offer a potential class member would forego any right to join the class action. See Prospectus Supplement, filed on 10 January 2005, *supra* note 99. See also Charles D. Schmerler, *supra* note 169 at p. 451.

allow debtors to deal with holdouts in a uniform and efficient fashion and address creditor collective action problems typically associated to sovereign debt workouts.[180] Awareness of these sort of benefits could explain the big shift in the District Court's latest set of decisions, given that since after the expiration of the exchange offer in early 2005, that court has certified 10 additional class actions in favour of holders of one or two series of bonds.[181]

2. *Playing a Shell Game: The Difficult Task of Attaching Argentinean Assets.* Aware that its decision not to pay its creditors was going to prompt investors to seek to enforce their rights in court, the Argentine government transferred approximately US $2 billion in assets out of the US to the Bank of International Settlements in Switzerland, a judicial safe heaven where Argentina not only receives the London Interbank Bid Rate minus 1/8th of a per cent., but also complete immunity from attachment.[182] This was just one of the various measures taken by Argentina to avoid paying its creditors. As an Argentine government official publicly admitted it in explaining the country's strategy: "Reserves of the Central Bank of the Argentine

[180] This is particularly true in the case of mandatory class actions, where individual class members cannot "opt out" of the class and pursue their individual remedies, and where any debt rearrangement that is eventually worked out between the sovereign and the bondholders can potentially bind all members of the class. This is said to overcome the collective action problem because unless treated as a class, the more diligent litigants may deplete the limited funds of assets and substantially impair the interests of the less agile litigants. Lee Buchheit and Mitu Gulati, *supra* 19 at p. 1353.

[181] *Azza v. Republic of Argentina*, 04 Civ. 937 (TPG); *Azza v. Republic of Argentina*, 04 Civ. 1085 (TPG); *Hickory Secs. Ltd. v. Republic of Argentina*, 04 Civ. 936 (TPG); *Castro v. Republic of Argentina*, 04 Civ. 506 (TPG); *Chorny v. Republic of Argentina*, 04 Civ. 2118 (TPG); *Puricelli v. Republic of Argentina*, 04 Civ. 2117 (TPG); *Seijas v. Republic of Argentina*, 04 Civ. 400 (TPG); *Seijas v. Republic of Argentina*, 04 Civ. 401 (TPG); *Valls v. Republic of Argentina*, 04 Civ. 937 (TPG).

[182] Hal Scott, *supra* note 50 at p. 12.

Republic on deposit in New York banks have been withdrawn, funds on deposits in the New York branch of Banco Nación have been repatriated and salaries of Argentine officials posted to other countries are being deposited in Argentina or paid in the form of cash sent via diplomatic pouch, which has immunity."[183] Unsurprisingly, after these manoeuvres Argentina saw no problem in representing to the District Court that it had no assets in the US used for a commercial activity in the US that would provide a legal basis for an attachment or execution sought by its creditors.[184]

The first attempts to attach Argentinean assets were more an expression of creditors' anger and despair rather than a serious attempt to recoup their losses.[185] This explains why, soon after Argentina defaulted in late 2001, some creditors attempted to seize assets clearly protected under the FSIA, such as diplomatic residences and the mission to the Organization of American States.[186] Some more serious, but equally unsuccessful attempts to seize Argentinean assets included the freezing of approximately US $14 million belonging to Correo Argentino, a former state-owned company indebted to Argentina which maintained those funds in New York branches of Lehman Brothers and BNP Paribas, and which was subject to

[183] *The Government Is Protecting Itself From Attachment*, La Nación, (February 5, 2004).

[184] See Prospectus Supplement, filed on 10 January 2005, *supra* note 99.

[185] *The End of the Affair*, The Economist, Feb 20, 2004.

[186] *Argentina at Crossroads: A Conflict of Interests*, (April 13, 2004). Available at http://www.networkideas.org/news/apr2004/news13_Argentina_final.htm

insolvency proceedings in Argentina.[187] In *Macrotecnic v. Republic of Argentina*,[188] the plaintiff argued that the accounts of Correo Argentino were an attachable asset of Argentina by virtue of the company's debt to the government.[189] The plaintiff also contended that Argentina had renationalized Correo Argentino as in 2003 the government had issued a decree terminating a 20-year concession contract with the entity responsible for its operation. In the plaintiff's opinion this was an administrative decision that had the effect of transferring the accounts to Argentina. Argentina defended itself by claiming that those assets belonged to Correo Argentino - not to Argentina - and accordingly that they should be available to pay Correo Argentino's creditors generally in bankruptcy proceedings brought in Argentinean courts. The District Court ruled in favour of Argentina as it found that the plaintiff had not met the burden of establishing that Argentina had an attachable interest in the accounts.

The judicial battles in US courts were far from over, however, as some creditors decided to commence proceedings seeking to attach the bonds tendered pursuant to the exchange offer, the collateral held for the Brady bonds and the reserves of Argentina's Central Bank held in the New York Federal Reserve Bank.

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[187] *Correo Argentino: Government Demands ARS50M In Guarantees*, (April 2nd, 2004) Available at http://bankrupt.com/TCRLA_Public/040402.mbx

[188] S.N.Y.D. February 13, 2004; 02 Civ. 5932 (TPG).

[189] The plaintiff supported this claim under the argument "the debtor of my debtor is my debtor." *Sigue el Bloqueo a fondos de Marci, pero faltan razones para ejecutarlos,* (February 18, 2004). Available at http://www.pagina12.com.ar/imprimir/diario/economia/2-31652-2004-02-18.html

3. *Attempts to Attach the Bonds tendered in the Exchange Offer.* In *NML Capital Ltd. et al. v. the Republic of Argentina*, plaintiffs obtained an *ex parte* attachment of US $7 billion in bonds that had been tendered to Argentina by creditors participating in the bond exchange and that were held in what amounted to an escrow account of the Bank of New York at the Depository Trust Company.[190] The plaintiffs asserted that the property restrained was Argentina's right to receive the tendered old bonds and also the tendered bonds themselves at the precise instant when they were surrendered to Argentina for cancellation.[191] Argentina challenged the validity of the orders of attachment, arguing that the bonds were not yet property of Argentina because they had not been turned over pursuant to the exchange.[192] Argentina also argued that the attachment would frustrate the bond exchange, as Argentina would not go through with the swap if the tendered old bonds were attached.[193] In vacating the orders of attachment, the District Court found - over the plaintiffs' objection - that, since an essential part of the exchange offer was the contractual right of Argentina to cancel those bonds, the Republic's contractual rights under the exchange offer were not merely to receive the bonds, but to receive the bonds and to

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[190] (S.N.Y.D. March 31, 2005). In *EM Ltd. v. The Republic of Argentina, 382 F.2d 291 (2004)* the Second Circuit Court of Appeals decided that Argentina was required to pay the plaintiff bondholders US $728 million on defaulted debt. Likewise, in *NML Capital Ltd. v. Republic of Argentina,* the plaintiff obtained a judgement in the amount of US $284 million. See Laura Alfaro *supra* note 118 at p. 13.

[191] See Charles D. Schmerler, *supra* note 169 at p. 454.

[192] Id.

[193] Hal Scott, *supra* note 50 at p. 15.

cancel them.[194] Of course, even if the plaintiffs got these old bonds, they could not compel Argentina to honor them. However, the plaintiffs' announced intention was to sell these US $7 billion worth of bonds at a discount over time in the aftermarket and use the proceeds to satisfy their claims and judgements against Argentina.[195]

On appeal, the Second Circuit affirmed the lower court's decision, holding that it was within the reasonable discretion of the District Court to deny the attachment, and further stated, quoting the lower court: "If these attachments [and restraints] are still in effect, we throw into doubt, to say the least, the conclusion of the exchange offer."[196] The Second Circuit went on to say that the District Court had acted well within its authority to vacate the remedies in order to avoid a substantial risk to the successful conclusion of the debt restructuring, something that was "obviously of critical importance to the economic health of a nation."[197] Although at first sight it may appear that US courts protected the exchange in the name of Argentina, it has already been noted that their decision may have also been driven by the desire of providing a solution to the many bondholders who were willing to abstain from litigating against a difficult and elusive debtor.

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[194] Id. See also Charles Schmerler, *supra* note 169 at p. 454. (S.N.Y.D. March 31, 2005).

[195] Hal Scott has stated that an increase by US $7 billion of unsatisfied debt may have put additional pressure on Argentina to negotiate with the holdouts. *Supra* note 50 at p. 15.

[196] See *EM Ltd. et al. v The Republic of Argentina*, Summary Order, US Court of Appeals, 2nd Cir, May 23, 2005.

[197] Id.

4. *Attempts to Attach the Collateral Held for Brady Bonds.* Creditors have also sought to attach the collateral held for Brady bonds issued by Argentina in 1992, i.e. US Treasury zero-coupon bonds and German government bonds (the "Brady Collateral") and kept in a collateral account at the New York Federal Reserve Bank.[198] The agreements governing such instruments provided that, if the Brady bonds were redeemed prior to maturity, Argentina would be entitled to the return of the Brady Collateral. As part of the exchange offer, Brady bondholders were offered newly issued bonds plus some cash proceeds, and Argentina expected to obtain at least part of the cash by liquidating the Brady Collateral that would revert to it pursuant to the exchange. Because in the brief interval between the release of the Brady Collateral and the payment of the proceeds of its liquidation to tendering bondholders creditors may have attached either the Brady Collateral or its proceeds, prior to the exchange offer Argentina entered into a continuation collateral agreement, pursuant to which the tendering bondholders were granted a security interest in the Brady Collateral and also in its proceeds.[199]

In *Capital Ventures International v. Republic of Argentina*[200] the plaintiffs claimed to be entitled to attach the Brady Collateral that was going to be liquidated to pay the tendering bondholders on the grounds that such collateral would revert to Argentina free and clear of the tendering bondholders' security interest. They also

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[198] Hal Scott, *supra* note 50 at p. 16.

[199] US Court of Appeals, 2nd Cir, March 2006, No. 05-2591-cv.

[200] Id.

asserted the right to attach the Brady Collateral still held by the New York Federal Reserve Bank to secure the claims of the non-tendering bondholders.[201] The District Court denied the order of attachment because it concluded that the continuation collateral agreement effectively served its purpose of extending the lien over the Brady Collateral and its proceeds. The District Court also seemed to be concerned that the issuance of an order of attachment "could create a lot of confusion" and would "disrupt the marketplace" during the pendency of the exchange offer.[202]

The plaintiffs appealed to the Second Circuit. While their claims were moot with respect to the Brady Collateral used to pay the tendering bondholders, they nevertheless asserted a right to attach the Brady Collateral still held by the New York Federal Reserve to secure the claims of the non-tendering bondholders.[203] The Second Circuit reversed the District Court holding that the plaintiffs were entitled to attach Argentina's interest in the reversion of the Brady Collateral securing the non-tendered bonds on the basis that the plaintiffs had met all the requirements to obtain the attachment.[204] At first sight, the outcome of this case may sound promising for the plaintiffs. However, because the plaintiff's lien on the Brady Collateral is junior

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[201] Hal Scott, *supra* note 50 at p. 16.

[202] Id.

[203] Id.

[204] Id.

to that of the remaining Brady bondholders, their ability to realise anything by the levy may be exceedingly remote.[205]

5. *Attempts to Attach the Reserves of Argentina's Central Bank Based on the Appropriation Theory.* In early 2006, EM Ltd. and NML Capital Ltd. collectively brought a claim seeking to attach US $105 million in reserves held by the Argentine Central Bank in the Federal Reserve Bank of New York, after the President of Argentina issued decrees giving Argentina the power to use Argentine Central Bank's unrestricted reserves to repay more than US $9 billion in IMF loans.[206] The plaintiffs argued that these decrees demonstrated the Republic's power to assign or transfer, with the stroke of a pen, the Argentinean Central Bank assets to itself, thereby changing the legal status of those reserves.[207] As usual, Argentina challenged these arguments supported by briefs from the Federal Reserve and the US government. While the Federal Reserve focused on operational concerns (such as that attachment orders of this type would interfere in the timely completion of payments) the US government stressed the importance of protecting the catalytic role of the IMF in the world financial system and its unofficial status as a preferred creditor.[208] The US government also stressed the importance of preventing central

[205] Id. at p. 17.

[206] One of the decrees created a new category of reserves known as "unrestricted reserves," comprised of the reserves in excess of the amount necessary to support the Argentine monetary base, and ordered that as long as the monetary effect is neutral, the unrestricted reserves may be used for payment of obligations undertaken with monetary authorities. *EM Ltd. et. at. v. Republic of Argentina* (US Court of Appeals, 2nd Cir, January 5, 2007).

[207] Id.

[208] Hal Scott, *supra* note 50 at p. 29.

banks from withdrawing their funds from the US and thereby damaging the US balance of payments.[209]

The District Court ruled in favour of Argentina holding that, while the decrees may have manifested the Republic's ability and willingness to control the Central Bank, they did not cause the assets to be transferred from the Central Bank to Argentina. The District Court also concluded that even if the funds were owned by Argentina, it was not clear that they were to be "used for a commercial activity in the United States", as the repayment of an IMF loan was instead a "governmental financial activity."[210] In 2007, the Second Circuit Court of Appeals affirmed the District Court's opinion on similar grounds[211] and in October of that year the US Supreme Court denied a petition for *certiorari* filed by the plaintiffs. [212]

6. *Attempts to Attach the Reserves of Argentina's Central Bank Based on the Alter Ego Theory*. In 2006 EM Ltd. and NML Capital Ltd. commenced a second proceeding against Argentina and Argentinean Central Bank. This time the plaintiffs have argued that the Argentinean Central Bank is so extensively controlled by Argentina that its separate juridical status should be disregarded under the *Bancec* principles for the purposes of attaching Argentina's assets in the US in the form of Argentinean

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[209]Id.

[210] Paul Hughes, *Argentinean Funds in Fed Reserve May Not Be Attached to Fulfil Judgement* (January 2006).

[211] EM Ltd. v. Argentina, NML Capital Ltd. v. Argentina; NML Capital Ltd. v. Argentina; NML Capital Ltd. v. Argentina, Banco Central de la Republica Argentina, 06-0403, 06-0405, 06-0406, 2nd Cir.

[212] EM Ltd. and NML Capital v. Argentina Supreme Court Writ of Certiorari Denied. Available at http://www.emta.org

Central Bank's accounts. The plaintiffs have contended that Argentina has made the Central Bank its "*alter ego*" by, among other things, commandeering the Central Bank's monetary policymaking function, ordering the Central Bank to make daily purchases of US dollars to serve the government's political ends, and using the Central Bank's funds to pay Argentina's debts, all in contravention of the Central Bank charter. As additional evidence of Argentina's control over the Central Bank, plaintiffs have also pointed out the high turnover and forced resignations of Central Bank officials in the preceding six years. The plaintiffs have further stated that it would be fundamentally unfair to allow Argentina to hide behind the Central Bank's corporate form to avoid paying its creditors, while at the same time the country ignores the Central Bank's separate legal status for all other purposes. The defendants have challenged this action on procedural grounds arguing that the plaintiffs' renewed attempt to attach the Central Bank's reserves is *res judicata* and should be barred on the basis that it could have been raised in earlier litigation. The defendants have further contended that the assets subject to attachment are covered by Section 1611 of the FSIA, implicitly asserting the argument that the reserves at issue are owned by the Central Bank, not by Argentina. The proceedings in this litigation are still pending.

Under the *Bancec* principles, plaintiffs will have the burden to demonstrate either that the Central Bank is an entity so extensively controlled by the Argentine government that a relationship of principal and agent is created, or that recognizing the distinction between the Central Bank and Argentina would allow Argentina to perpetrate fraud or injustice against the plaintiffs. Although prior decisions have shown a strong aversion to overriding the presumption of independent status for separate corporate agencies or instrumentalities,[213] in light of the arguments and evidence presented by the plaintiffs, this time US courts may find that the Argentine government has such an excessive control over the day-to-day operations of the Central Bank that it amounts to the *alter ego* of the government. In this sense, the *dicta* of the Court of Appeals for the Second Circuit in *EM Ltd. et. at. v. Republic of Argentina* may provide the plaintiffs with some hope. In that decision, the court explicitly addressed the appropriateness of the alter ego doctrine stating that: "The Republic's alleged interference with the Central Banks' affairs and efforts to remove attachable assets from the United States arguably could have supported arguments for disregarding [the] Central Bank's separate legal status in order to avoid fraud or injustice. This approach, rather than the legally unsupported one advanced by plaintiffs, might provide a means by which creditors could avoid allowing Argentina to play a shell game to deprive creditors of their legitimate remedies."[214]

D. Litigation against Argentina in Italy and Germany

1. *Italy.* Proceedings were commenced in Italy by numerous bondholders, most of them involving small amounts, but their luck has been no better than in the

[213] See Paul Lee, *supra* 150 at p. 364, citing *LNC Investments, Inc. v. Republic of Nicaragua.*

[214] *EM Ltd. et. at. v. Republic of Argentina* (CA2 Jan 5, 2007) at p. 28.

US. Although in 2002, in *Rep. Argentina c. Sandri e altro*,[215] a group of Italian bondholders obtained a freeze order from the Tribunal of Rome through interim proceedings for approximately US $2.3 million,[216] the same tribunal subsequently vacated the order on jurisdictional grounds. Thereafter, Italian courts have consistently ruled that they lack jurisdiction on the basis that the suspension of payments was ordered through Argentina's domestic laws aiming to deal with a serious economic and financial crisis.[217] In 2005, the Italian Supreme Court of Cassazione held that Argentina enjoyed sovereign immunity with respect to its default under the concept of *acta jure imperii*.[218]

Nevertheless, a new route is being attempted by Task Force Argentina (TFA), an organization that represents more than 195,000 Italian retail investors holding US $4.4 billion of debt who decided not to participate in the exchange.[219] In 2007, the TFA successfully registered its request for arbitration with the International Centre for Settlement of Investment Disputes (ICSID) to secure full reimbursement of

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[215] *Rep. Argentina c. Sandri e altro* (Tribunale de Roma 30.09.2002).

[216] The freeze covered real-estate assets and even Italy's pending payments to organizations like the IMF which could eventually be destined for Argentina. See Pamela Druckerman *Fed Up Argentine Bondholders Turn to Suing the Government* The Wall Street Aug 23, 2002; *Italia embarga bienes argentinos para compensar a sus inversores en el país austral* (Agosto 2002). Available at http://www.americaeconomica.com/numeros3/171/noticias/mrargeitaliaspecu.htm.

[217] *Gallo c. Rep. Argentina* (Tribunale di Roma 31.03.2003); *Goldoni e atro c. Rep. Argentina* (Tribunale di Milano, 11.03.2003).

[218] See Corte Suprema di Cassazione, Ordinanza No. 6532/2005 of May 27, 2005. Available at http://.altalex.com?index.php?idstr=31&idnot=9653. The concept *Jure Imperii* embraces public acts that a nation undertakes as a sovereign state, for which the sovereign is generally immune from suit or liability. See Black's Law Dictionary (7th Edition).

[219] For more information about the FTA see http://www.tfargentina.it/english.php.

capital plus accrued and unpaid interest.[220] The request alleges that Argentina has breached several obligations under the Italy-Argentina Investment Treaty. The parties have already agreed on the composition of the ICSID arbitral panel and as soon as a procedural schedule is established, the arbitration will move forward to address issues of jurisdiction and the substance of the dispute.[221] However, despite the green light given to the plaintiff in accepting its request for arbitration, some have suggested that recovering money through ICSID will be difficult because there are no assurances that buying a bond qualifies as an investment protected by the bilateral treaty signed between the two countries.[222]

2. *Germany.* More than 100 legal proceedings for approximately €60 million were commenced against Argentina in Germany.[223] A significant number of claims included payment orders,[224] but Argentina disputed every single payment order it was served, claiming a "state of necessity."[225] In 2006 the Frankfurt Court of Appeal

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220 *Giovanna a Beccara and others v. Argentina Republic,* ARB/07/5.

221 *Italian Bondholders' Arbitration Against Argentina Advances*, TFA. Available at http://www.tfargentina.it/download/TFA%20Press%20Release%209%20May%202007.pdf.

222 *New tack on Argentina debt,* Benedict Mander (28/9/2006) http://www.euro2day.gr/articlesfna/21526346/.

223 See Prospectus Supplement, filed on 10 January 2005, *supra* note 99.

224 Under German law, payment order procedure provides a cheap, rapid and efficient way for a creditor to enforce a pecuniary claim by an *ex parte* court order for payment. The underlying idea is to avoid costly and time-consuming lawsuits, and especially to avoid court hearings in cases where debtors are aware of their obligation but are either unwilling or unable to pay. See http://www.iuscomp.org/gla/literature/sijanski.htm.

225 Porzecanski, *supra* note 5 at 327.

dismissed an appeal lodged by Argentina based on the necessity defence.[226] The appeal proceeding was initially stayed to await a decision by the German Constitutional Court on whether public international law allows a country in financial straits to plead necessity as the basis for suspending payments due to private creditors. However, the Frankfurt Court of Appeal later revoked the stay and dismissed Argentina's appeal of its own motion on the basis that Argentina was not able to establish conclusively that a state of necessity in fact existed.[227] The fact that Argentina had recently repaid US $9.9 billion on a loan from the IMF, before it was due, led the court to conclude that Argentina could no longer plead necessity.[228] Since then, German courts have ruled against Argentina in several cases.[229]

In 2007 the German Constitutional Court handed down a decision on the more substantive question of whether Argentina could invoke necessity under general international law as an affirmative defence against claims brought in German courts by private individuals. The court held that "currently no rule of general international law can be ascertained entitling a State, vis-à-vis private individuals, to suspend the performance of due obligations for payment arising

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[226] *Recent Decisions Indicate that Argentina Can No Longer Plead "Necessity" in Domestic and International Proceedings*, by Latham & Watkins (Dec. 2006) at 1.

[227] Id.

[228] Id.

[229] See for example, La Nacion, *New Judicial Setback of the Swap of Defaulted Debt* (13.08.2007). Available http://www.atfa.org/cgi-data/news/files/147.shtml.

under private law by invoking necessity based on an inability to pay."[230] After this set of decisions, Argentina has no more excuses not to pay its German creditors, but it remains to be seen whether these creditors will be able to find, and then attach, Argentine assets in Germany.

IV

CONCLUSION

Argentina's restructuring indicates that holdout litigation is not the most important problem that can arise in a major sovereign debt restructuring. Although bondholder representation is harder to coordinate today than in the past, collective action problems are perhaps among the easiest of the issues that arise in a sovereign debt workout.[231] The Argentinean experience has confirmed that enforcing judgements against sovereign debtors is extremely difficult not just because of the strong protections sovereign assets enjoy in key jurisdictions, but also because the property against which execution can be sought is limited. In an unregulated setting where sovereigns enjoy such important protections against enforcement, "rogue" sovereign debtors have the ability to act opportunistically and to take advantage of

[230] Bundesverfassungsgericht [BVerfG], Decision of May 8, 2007, available at http://www.bverfg.de/entscheidungen/ms20070508_2bvm000103.html. For a commentary in English see Stephan W. Schill *German Constitutional Court Rules on Necessity in Argentine Bondholder.* Available at http://www.asil.org/insights/2007/07/insights070731.html.

[231] Roubini & Sester, *supra* note 46 at p. 301.

their strategic position during the bargaining process with creditors. Argentina has been there and done that.

Even if an argument can be made that sovereigns already pay a premium because investors factor in the decreased likelihood of collection, Argentina's extreme behaviour would not have been expected by bondholders as Argentina was much less generous, paid much less to holders by means of the exchange offer than is typical, and was much more non-cooperative than most sovereign debtors are once they default, which left many holders with no recourse other than courts, a place where they seldom have success recovering against defaulting sovereigns. An important question then is: how could we keep in check the Argentinean instinct of a sovereign debtor, add predictability to the bargaining process and level the playing field in future sovereign debt restructurings?

To start with, the international financial system needs to agree on minimum thresholds necessary to restructure sovereign debt as a way to address the holdout problem. The use of existing market-based tools - such as collective action clauses - or the implementation of a statutory-based framework - such as the SDRM - can effectively take care of the holdout threat and foster more efficient debt restructurings. Any country that seriously intends to restructure its debt will find these mechanisms useful as they invite borrowers to offer proposals that are good enough to attract a critical mass of creditors. This is so because in a universe with collective decision making provisions, a decision to accept a restructuring proposal by a majority of creditors makes such deal legally binding on all creditors involved in the restructuring and forecloses the option of litigation. But this is just the start.

It is equally important to have the appropriate vehicles to reach the required thresholds and thus improve the prospects for a successful restructuring. Regardless of what the "magic number" is, if the parties lack an appropriate forum where they can express their views and discuss and assess proposals, the risk of not obtaining the required levels of creditor participation increases. It's not just the destination, it's also the journey. Although engagement provisions are perhaps an attractive tool, the fact that they imply high transaction costs and pose inter-creditor transparency issues invites us to look for other alternatives. The Principles for Stable Capital Flows and Fair Debt Restructuring are a good start. However, we will have to wait and see if these non-binding principles are followed in times of crises. The proposed features of the SDRM also fostered the creation of a representative creditors' committee, a proposal that is worth revisiting in greater detail.[232]

Further, relevant information about the financial position of a sovereign should be provided as part of a due diligence ideally conducted by the financial adviser to the creditors and which could resemble due diligences carried out by multilateral organisations. Currently, the absence of a regulatory framework guiding the transferring of information makes it more difficult for creditors to have a clear picture of the sovereign's financial condition, something that invites sovereigns to act opportunistically by cherry-picking or otherwise limiting the data

[232] *Proposed Features*, February 13, 2003, Paragraph 8. Available at http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf.

provided during a debt workout. If creditors were allowed to obtain certain categories of information from a country's Ministry of Finance or Central Bank during the restructuring process, creditors' confidence would increase thereby making it easier to reach an agreement. In this sense, a statutory framework could set out clear guidelines regarding the type of information to be provided by sovereigns as well as the terms and frequency under which such information should be given.

While minimum thresholds of acceptance to make a restructuring binding on all creditors are a big carrot for countries restructuring their debts, national regulators should also think about the sticks that could kick in should a sovereign borrower decide not to engage in meaningful negotiations. Given that mere reputational sanctions on countries unwilling to repay their debts do not seem to cause too much pain in practice, and that enforcing bondholder rights through courts has shown somehow discouraging, regulation by means of negative economic incentives could prove a more powerful tool to punish rogue debtors. For example, countries that are home to the most important financial centres in the world could step in and legally shut pirate debtors out of their capital markets by not allowing them to offer securities using their legal platforms for an appointed amount of time. Another attractive weapon would be the imposition of heavy taxes on the proceeds of foreign investment made in countries that do not meet the good faith standard when rescheduling their debts. All of these sanctions could be imposed after an independent decision-maker has arrived to the conclusion that the borrower has not acted in good faith during the restructuring stage.

On the judicial front, it would seem appropriate to strengthen bondholders' rights. Thus, after a country closes its restructuring without reaching the minimum threshold required to block litigation, some legal weapons should become available to creditors. For example, at the adjudicative level, class actions should be a permissible tool to deal with the claims of non-tendering bondholders in a swiftly and homogeneous fashion. Additionally, at the enforcement level, the *pari passu* provision could operate as a useful instrument to allow judgements creditors to get paid on an equal basis with the rest of a sovereign's creditors.

In the end, a comprehensive sovereign debt restructuring mechanism, with both carrots and sticks, will add predictability to sovereign debt workouts because creditors will be able to anticipate the bargaining environment in which they will find themselves should a rescheduling become necessary. This new environment should be a win-win situation because if sovereigns borrow money in a universe where they have all the incentives to offer the best possible restructuring deal they can sustain should they need to reschedule their debt, then they will raise money from the international capital markets at much better rates of interest than they do in the absence of such an environment.