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Sovereign Damage Control

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INTRODUCTION

Italy changed its debt contracts, Belize passed a law, and Taiwan sued Grenada this year, all thanks to a string of court rulings in New York that try to make Argentina pay its debts. The case—*NML Capital Ltd. et al. v. Republic of Argentina*—has breathed new life into policy initiatives ranging from sovereign bankruptcy to marketwide contract reform.

While they go to unprecedented lengths to isolate Argentina, the rulings cannot make the country pay. If upheld, they threaten collateral damage to other countries and parts of the financial system. The impact may be felt sooner and farther afield, even compared with Argentina's record-breaking 2001 default, because court action unfolds against the background of public debt distress in Europe, new emerging-market restructurings, and regulatory focus on clearing and payment systems.

Argentina exchanged nearly $100 billion in principal and past-due interest on its defaulted foreign bonds in two waves in 2005 and 2010. Both times some creditors refused to take the deal and insisted on full payment. Among them, NML Capital Ltd., an affiliate of Elliott Associates, has been chasing Argentina in courts around the globe for years, trying to seize government property but mostly failing. The latest lawsuit promises to give creditors like Elliott much more potent tools to use against the debtor. The shift would come courtesy of one obscure debt contract term that has gained destructive power in a case where the government and its creditors are uniquely willing to test the limits of the law.

A federal judge in the Southern District of New York ruled in December 2011 that the *pari passu* [equal step] clause in its old defaulted bonds required Argentina to pay NML and its fellow plaintiffs "ratably" any time it paid its new restructured bonds. Judge Thomas P. Griesa then ordered Argentina not to service the new debt unless NML got paid in full. He barred Argentina from rerouting payments beyond the court's jurisdiction and later threatened to sanction a wide range of third parties if they helped Argentina evade his orders. The Bank of New York Mellon as trustee for the new bonds, as well as clearing and payment system operators such as the Depository Trust & Clearing Corporation (DTCC), Euroclear, and the Clearing House Interbank Payments System (CHIPS) are among those in the crosshairs, because they form parts of the payment chain on the new bonds.

When Argentina appealed Judge Griesa's ruling, US State and Treasury Departments intervened on its side. They argued that sovereign immunity should prevent the court from telling a foreign government how to spend its public funds. They also worried that targeting restructured bonds would hinder future crisis management: What creditor would agree to reduce its claim on a government only to have its new payments caught up in holdout lawsuits?

The US Court of Appeals for the Second Circuit dismissed these concerns in October 2012. The judges agreed with the lower court's core premise, that NML and its co-plaintiffs should be paid alongside the new bondholders. But they questioned Judge Griesa's payment formula and the effect of his order on third parties. His response in November 2012, and another round of appeals, triggered an avalanche of third-party briefs from investors in restructured and defaulted bonds, financial institutions, and academics on all sides. At this writing, the appeal is still pending. When it is decided, one or both sides almost certainly will try to take it to the US Supreme Court.

Until this case, countries could rely on sovereign immunity to gum up debt collection: Creditors might sue them but could not reach their assets. For countries, which cannot file for bankruptcy, immunity offered a shield akin to bankruptcy protection and encouraged most creditors to compromise. Governments typically paid off the few holdouts to avoid the costs of endless litigation. But for Argentina's politicians, freezing out the holdouts became a domestic political strategy. The government has ignored court orders to pay, as officials inveighed against "vulture funds" in the media. In response, US courts have sought to tilt the playing field in favor of the creditors, with implications beyond Argentina.

[*NML v. Argentina*] promises to shift the balance of power from sovereign debtors to their creditors.

As unnerving as it is to watch Argentina walk away from contracts and judgments, court decisions so far do not offer a viable alternative. They threaten sanctions against financial institutions with a presence in New York, in the hope that they might pressure Argentina into paying. This approach fails to solve the old problems of sovereign unwillingness to pay and unequal treatment among creditors, while creating new problems for sovereign restructuring. Courts can commandeer clearinghouses to help the plaintiffs; they cannot make Argentina turn over the money or distribute it among all creditors. They are more likely to dissuade creditors and trustees from participating in future restructurings, if doing so would expose them to lawsuits.

Because this new model of debt collection hinges on a single contract clause, damage control is straightforward. The affected third parties—securities clearinghouses and payment system operators—can require governments to remove or change the *pari passu* clause in their contracts as a condition of access. This will limit collateral damage from *NML v. Argentina* while bypassing the usual challenges of contract reform, such as borrowers' reluctance to innovate and lack of marketwide standardization. Reforming the *pari passu* clause will not eliminate the deeper dysfunctions of sovereign debt: no guarantee of fair treatment for all creditors, no fresh start for the debtor, and no way to enforce government promises to pay, even when they have the money. A more radical solution that addresses these dysfunctions must await a new political consensus.

FALSE APPEARANCES

At first blush, a sovereign debt obligation looks just like any other: a solemn promise to repay, enforceable in court. Governments typically waive sovereign immunity in their debt contracts. Even if they did not, the doctrine of restrictive immunity makes it easy to sue governments in foreign courts in connection with "commercial activities." Since borrowing money in the market is a well-established commercial activity,[1] national courts in New York, London, Brussels, Hong Kong, and Accra can hold defaulting foreign governments accountable.

But governments are not like other debtors. When people and firms do not pay their debts, creditors can seize their houses, bank accounts, and wages. When they ignore court orders, people can be held in contempt, fined, and even sent to jail. Not so with a sovereign government. When creditors win a judgment, they can, in theory, collect it against the government's commercial assets. These are hard to find outside the debtor's borders after decades of privatization. Embassies and central bank accounts abroad enjoy separate, stronger immunities. And government officials who ignore foreign court orders cannot be jailed.

In the world of people and firms, creditors might rush to sue and strip the debtor's assets at the first sign of trouble. Because this rush destroys value for the creditors as a group and for society at large, countries enact bankruptcy laws to shield the debtor and distribute available assets fairly among all creditors.[2] In the world of sovereign governments, immunity does just enough work to dissuade most creditors from rushing to the courthouse and persuade them to reduce their claims. It preempts demand for bankruptcy. But unlike bankruptcy, immunity does not rehabilitate the debtor or guarantee fair treatment for all creditors. Instead, sovereign debtors must settle separately with different groups of creditors. As a general rule, creditors cannot be forced to give up their claims. After most of the debt has been restructured, the debtor faces the prospect of running from the remaining creditors for years, maybe decades. Unlike people and firms, a government gets no fresh start.

The result is a paradox—and a business model for a small minority of sophisticated creditors. Sovereign debt is mostly unenforceable, but it never goes away. Investors buy foreign sovereign debt expecting to be paid and, failing that, to enforce their contracts in court. Foreign government bonds routinely contain clauses where the debtor submits to the jurisdiction of a court in New York, London, or another place the creditors find reassuring. They discover too late that enforcement requires skill, commitment, and resources beyond the reach of all but a few specialists. Facing default, most either agree to exchange their bonds for new ones worth a fraction of the old, or sell their old bonds to the specialists at a deep discount. The specialists

1. See, e.g., *Republic of Argentina v. Weltover*, 504 US 607 (1992).

2. Bankruptcy does much more than stop asset grabs and other coordination failures. On sovereign bankruptcy as a response to a broader range of incentive problems and coordination failures, see Bolton and Skeel (2004). For an expansive account of bankruptcy goals outside the sovereign setting, see, e.g., Warren (1987).

may proceed to test the legal system, and secure full repayment from the funds freed up by the original creditors' concessions.

In the vast majority of cases, it never gets this far. Litigation was a factor in only 29 out of 180 sovereign debt restructuring episodes involving private creditors between 1976 and 2010. (Schumacher, Trebesch, and Enderlein 2012). Governments that successfully restructure most of their debt usually pay off the remaining creditors under the table, to avoid lawsuits. For example, Greece continues to pay the holders of its foreign-law bonds that refused to accept its 2012 restructuring offer (Zettelmeyer, Trebesch, and Gulati 2013). Participating creditors rarely mind, since they themselves have no stomach for a long court battle and might even appreciate what they see as the holdouts' disciplining effect on the sovereign (Fisch and Gentile 2004). This is the delicate compromise that enables restructurings to go on in the shadow of immunity.

The latest case to test the system is different. It features worthy adversaries: Argentina and Elliott Associates have, together and apart, made some of the most important case law in sovereign debt. They are perhaps the most determined debtor-creditor pairing in modern memory, which almost by definition puts their dispute on the cutting edge.

EQUALITY AS A COLLECTION TACTIC

The provision at the heart of the case is part of the *pari passu* clause, which has been in sovereign debt contracts for over a century (Gulati and Scott 2012). There are three core variations of the clause in modern sovereign bond contracts. The most common promises to rank the bonds under the contracts *pari passu* with other senior unsecured external debt of the government. Less common versions, which have become more widespread since the 1990s, mention the ranking of payment obligations (wording often found in syndicated loans) or promise to make ratable payments (Weidemaier, Scott, and Gulati 2013). Table 1 presents some examples.

In general, all versions of the *pari passu* clause promise that the debt contract that contains it will be on equal footing with some subset of others—except that lawyers cannot agree on what equal footing means or what to do when it becomes unequal.

A common interpretation of *pari passu* limited it to the legal ranking of the debt. An "equal ranking" clause makes sense in bankruptcy, where all debts are due at the same time, where the debtor can be liquidated, and where liquidation proceeds can be distributed to the creditors in order of contractual priority, from senior to subordinated, under judicial supervision. *Pari passu* also helps ensure that claims of equal rank are treated equally in corporate reorganization, which happens in the shadow of liquidation.

For countries, similar reasoning might apply to obligations backed by dedicated assets or revenues. Sovereigns issued revenue bonds more often over a century ago, when government debtors could not be sued. When giving multiple creditors contractual claims against a customs fund, the debtor assured them it would not be raided by some at the expense of the others (Cooper et al. 2013, Black Eagle Bond (Mexico) 1843).

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If *pari passu* only promised equal rank, it would be useless to modern-day creditors of sovereign governments. Countries have generally stopped pledging and earmarking revenues to repay their debts. The only way for a debtor to violate the clause would be to pass a domestic law expressly subordinating some debt or adding burdensome legal requirements for its enforcement (Buchheit and Pam 2004). Just about nobody does it. Countries that want to stiff a subset of their creditors can simply stop paying. Passing a law adds nothing from the point of view of most debtors.

In 1997, Elliott Associates gave *pari passu* a more capacious meaning. In lawsuits against Nicaragua and Peru, Elliott claimed that the clause required a debtor unable to pay all its creditors in full to pay each creditor proportionately or "ratably." A debtor defaulting on some but not all the obligations described in its *pari passu* clause (often limited to external debt) violated the ratable payment promise. Payments on its performing debt could be blocked, perhaps seized, until everyone was paid. An eminent academic explained the clause as follows in a case involving Peru:

> 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'll pay Harry." If there is not enough money to go around, the borrower faced with a *pari passu* provision must pay all three of them on the same basis . . . . But if the borrower proposed to pay Tom [everything], Dick [something] and Harry nothing, a court could and should issue an injunction at the behest of Harry. The injunction would run in the first instance against the borrower, but I believe (putting jurisdictional considerations aside) to Tom and Dick as well.[3]

3. *Elliott Associates, L.P. v. Banco de la Nacion*, 2000 US Dist., LEXIS 368 (S.D.N.Y. January 18, 2000) (executed August 31, 2000); Declaration of Professor Andreas F. Lowenfeld, August 31, 2000, at 11-12 (footnote omitted), Elliott Associates, 2000 WL 1449862 (96 Civ. 7916 (RWS), 96 Civ. 7917 (RWS).

Table 1 ***Pari passu* clauses in sovereign bond contracts**

Ranking: Belize 2013	Ranking of Payment Obligations: Argentina 1994	Promise of Ratable Payment: Italy 2003
The Securities are general, direct, unconditional, unsubordinated and unsecured obligations of Belize…and Belize shall ensure that its obligations hereunder shall rank *pari passu* among themselves and with all of its other present and future unsecured and unsubordinated Public Debt….	The Securities will constitute… direct, unconditional, unsecured, and unsubordinated obligations of the Republic and shall at all times rank *pari passu* and without preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness. …	The Securities are the direct, unconditional and general and … unsecured obligations of Italy and will rank equally with all other evidences of indebtedness issued in accordance with the Fiscal Agency Agreement and with all other unsecured and unsubordinated general obligations of Italy for money borrowed. … Amounts payable in respect of principal of (and interest on) the Securities will be charged upon and be payable out of the [Treasury of Italy], equally and ratably with all other amounts so charged and amounts payable in respect of all other general loan obligations of Italy.

Sources: Ministry of Finance, Government of Belize (2013); Republic of Argentina (1994); Republic of Italy (2003).

In 2000, this interpretation was endorsed by a Belgian court, which barred Euroclear from distributing Peru's payments to holders of restructured bonds until Elliott was paid.[4]

The idea that creditors who agreed to restructure would not get their pennies on the dollar until the holdouts got paid in full startled many observers. It was fine for some creditors to do better than others—where bankruptcy law does not require equal treatment, hard work and creativity should pay off—but it seemed perverse to derive the windfall from theories of equality. Holdouts could get much more *only* because everyone else got much less and freed up the resources to pay them. Sovereign debt spreads rose in response to the decision, perhaps reflecting uncertainty about how distress would be handled from then on (Bradley, Cox, and Gulati 2010).

Peru was then in the middle of a domestic political crisis that saw its president escape to Japan; it was anxious not to disrupt its recent bond restructuring and settled on terms very favorable to Elliott. Belgium was also anxious about Euroclear's vulnerability to creditor lawsuits. It responded with a law shielding Euroclear from similar injunctions—even as its higher courts later rejected Elliott's argument.[5]

After Peru, the meaning of *pari passu* went from marginal and forgotten to all-important and hotly contested. Since the clause was ubiquitous, it offered the first replicable path for collecting sovereign debt, one that did not rely on finding one-off commercial assets left outside the debtor's borders. Tom, Dick, and Harry would halt the perpetual cat-and-mouse chase of sovereign debt enforcement.

The "ratable payment" interpretation of *pari passu* made the clause relevant but opened a host of operational questions. What should count as "ratable" was anybody's guess without bankruptcy, a single moment of reckoning, or a fund to divvy up among a fixed group of claimants. A government's general revenue flows might suffice to pay its debts due on Monday, but not on Tuesday—or next week or next month. Would paying everything until the coffers ran dry mean subordination, or just bad luck, for the debts that came due later? Would creditors receiving the early payments have to share with others? Would creditors such as NML, if they recovered on the ratable payment theory, have to share with those who might sue later? Would payments to the World Bank, the International Monetary Fund (IMF), and others excluded from restructuring by custom, count as super-senior for *pari passu* purposes? How might such a payment scheme be administered across different instruments held by dispersed creditors—would it be up to every creditor to trace and block payments to every other? Most such questions had no good answers.

Some saw the holdout victory in Brussels as a source of long-overdue discipline for sovereign borrowing. It also made for a policy dilemma. The incident and its progeny highlighted the vulnerability of a purely contractual debt framework (Bratton 2004), where ambiguous terms could be used "off-label" to overcome immunity. With immunity weakened, creditor coordination problems were bound to explode. Such reasoning led the IMF to feature the Elliott case in its argument for a treaty-based Sovereign Debt Restructuring Mechanism (SDRM).[6]

4. Elliott Associates, L.P., General Docket No. 2000/QR/92 (Ct. App. of Brussels, 8th Chamber, September 26, 2000).

5. *Republic of Nicaragua v. LNC Investments LLC*, General Docket No. 2003/KR/334 (Ct. App. Brussels, 9th Chamber, March 19, 2004).

6. Anne Krueger, IMF's first deputy managing director, International Financial Architecture for 2002: New Approach to Sovereign Debt Restructuring, speech at the National Economists' Club Annual Members' Dinner, November 26, 2001, www.imf.org/external/np/speeches/2001/112601.htm. Between

There was no way of knowing the full impact of *pari passu* on debt enforcement without knowing where New York and London courts would come out, both because most foreign sovereign debt was governed by New York or English law and because these jurisdictions were central for cross-border payment flows at the heart of the remedy. After Peru, courts in the United Kingdom and the United States, as well as Belgium, saw similar claims against other countries in Africa and Latin America.[7] For years, no court had clearly endorsed the ratable payment interpretation and some had disavowed it; however, the sum total of the decisions and settlements was interpretive fog.

When creditors tried to block a debt exchange by one of its provinces using the *pari passu* clause in 2004, Argentina asked Judge Griesa to declare that the clause could not be used to support a ratable payment order under New York law. The Federal Reserve Bank of New York and the US government joined Argentina in opposing the ratable payment interpretation; the New York Fed called the enforcement strategy "terrorism of payments and settlement systems."[8] Creditors argued that the issue did not need to be decided, since they had not brought a *pari passu* claim against Argentina itself.[9] The court agreed. It took six more years for the other shoe to drop.

PARI PASSU RETURNS

NML leads a shifting coalition of distressed debt funds and individual investors that began suing Argentina soon after its 2001 default. They got money judgments and have tried many creative strategies to satisfy them, targeting central bank funds on deposit at the New York Fed, taxes and revenues owed by French companies to Argentina, the presidential airplane, and a military ship docked in Ghana. Although they came close many times, the plaintiffs have collected precious little. Argentina has successfully used immunity to shield its assets from judgement creditors. Meanwhile, fighting "vultures" became an important part of the government's domestic political strategy.

Finding money judgments of little use, NML and allies tried something different. They asked Judge Griesa to enforce a promise that Argentina had made in contracts they had not reduced to a judgment: that its payment obligations would rank "at least equally" with the rest of its foreign debt. They argued that Argentina broke the promise by refusing to pay them while paying its new bonds. The remedy would not be another toothless order to pay, but rather an order directing Argentina *not* to pay restructured debt unless and until it paid the plaintiffs. By February 2012, they got exactly what they had asked for: a ruling that Argentina breached its promise of equality and an order directing Argentina to stop paying its new debt—although the order was stayed while the government appealed.

On earlier occasions, Judge Griesa had expressed skepticism about the *pari passu* remedy. Even as he ruled for NML this time, he seemed doubtful about its soundness, speculating that he might be reversed on appeal. What made him take the leap?

Since he deferred consideration of *pari passu* in 2004, Argentina enacted a Lock Law that made it hard for the government to pay off holdouts on the side. The law, along with contract terms promising "most favored creditor" treatment to the new bondholders, was meant to reassure those participating in the 2005 exchange that they were getting the best possible deal. It was also the rare bit of domestic legislation that could be read as violating even the narrow "ranking" interpretation of *pari passu*. Perhaps more importantly, a decade of judging Argentina left Judge Griesa thoroughly fed up. Something had to be done lest US courts look feckless. It was a bold move on his part: The *pari passu* question had hovered over the sovereign debt markets for over a decade, with no court willing to make the definitive statement. Most market and media observers joined Judge Griesa in expecting reversal on appeal.

As they had done in 2004, the State and Treasury Departments joined Argentina in urging reversal. They argued that the injunction was an end-run around sovereign immunity because it restrained treasury funds in Buenos Aires, and that the precedent would impede future sovereign restructurings.

The US Court of Appeals for the Second Circuit heard the case in July 2012. It ruled in October that (1) Judge Griesa was right to interpret Argentina's contracts to support ratable payment to holdouts, (2) Argentina violated its contracts by some combination of protracted default, public statements that it would never pay holdouts, and the Lock Law, and that (3) NML and its fellow plaintiffs were entitled to an injunction telling Argentina to pay them and the new bondholders in equal step.

2001 and 2003, the IMF developed a proposal for a treaty-based mechanism to facilitate debt restructuring agreed among the debtor and a majority of its creditors under private foreign-law instruments. The mechanism used features of national corporate reorganization laws, such as classified voting, and would ensure that a majority of creditors could bind a dissenting minority. Although the initiative enjoyed support among European countries and in some parts of the US Executive Branch, the United States and large emerging-market issuers opposed it in the IMF. This doomed its prospects (Hagan 2005, Setser 2010).

7. See, e.g., *Red Mountain Finance, Inc. v. Democratic Republic of Congo*, No. CV 00-0164 R (BQRx) (C.D. Cal. May 29, 2001); *Kensington International Ltd. v. Republic of Congo*, [2003] EWHC 2331, www.bailii.org; *Republic of Nicaragua v. LNC Investments LLC*, General Docket No. 2003/KR/334 (Ct. App. Brussels, 9th Chamber, March 19, 2004).

8. Letter from Thomas C. Baxter, Federal Reserve Bank of New York, to the Honorable Thomas P. Griesa, dated January 12, 2004, re: *Macrotecnic Int'l v. Argentina and EM Ltd. v. Argentina.*

9. In making this argument, NML joined EM, Ltd., a fund affiliated with Kenneth Dart, who famously sued Brazil in the 1990s.

Box 1 Judge Griesa's Injunction

November 21, 2012 Opinion

Assuming that Argentina pays 100% of what is then due on the Exchange Bonds…Argentina would be required to pay 100% "multiplied by the total amount currently due" to plaintiffs. There is no question about what is "currently due" to plaintiffs. The amount that is currently due is the amount of the unpaid principal, the due date of which has been accelerated, and accrued interest. The total of these amounts due to plaintiffs is approximately $1.33 billion. Thus, at some time in December 2012, when Argentina makes the interest payments on the Exchange Bonds, amounting to a total of about $3.14 billion, Argentina will be required to pay plaintiffs approximately $1.33 billion. [emphasis in the original; footnote omitted]

November 21, 2012 Order

[P]articipants in the payment process of the Exchange Bonds ("Participants")…shall be bound by the terms of this ORDER…and prohibited from aiding and abetting any violation of this ORDER, including any further violation by the Republic of its obligations under Paragraph 1(c) of the FAA [Fiscal Agency Agreement], such as any effort to make payments under the terms of the Exchange Bonds without also concurrently or in advance making a Ratable Payment to NML.…

"Participants" refer to those persons and entities who act in active concert or participation with the Republic, to assist the Republic in fulfilling its payment obligations under the Exchange Bonds, including: (1) the indenture trustees and/or registrars under the Exchange Bonds (including but not limited to The Bank of New York Mellon…); (2) the registered owners of the Exchange Bonds and nominees of the depositaries for the Exchange Bonds (including but not limited to Cede & Co. and The Bank of New York Depositary (Nominees) Limited) and any institutions which act as nominees; (3) the clearing corporations and systems, depositaries, operators of clearing systems, and settlement agents for the Exchange Bonds (including but not limited to the Depository Trust Company, Clearstream Banking S.A., Euroclear Bank S.A./N.V. and the Euroclear System); (4) trustee paying agents and transfer agents for the Exchange Bonds (including but not limited to The Bank of New York (Luxembourg) S.A. and The Bank of New York Mellon (including but not limited to The Bank of New York Mellon (London)); and (5) attorneys and other agents engaged by any of the foregoing or the Republic in connection with their obligations under the Exchange Bonds.

Sources: NML Capital Ltd. v. Republic of Argentina, Nos. 08 Civ. 6978 (TPG), 09 Civ. 1707 (TPG), 09 Civ. 1708 (TPG) (S.D.N.Y. Nov. 11, 2012) (opinion describing Ratable Payment formula and clarifying application of injunction to third parties); *NML Capital Ltd. v. Republic of Argentina*, Nos. 08 Civ. 6978 (TPG), 09 Civ. 1707 (TPG), 09 Civ. 1708 (TPG) (S.D.N.Y. Nov. 11, 2012) (order amending the February 23, 2012 Order).

Though it ruled for NML, the appeals panel sent the case back to the Judge Griesa to clarify what he meant by ratable payment[10] and how the injunction would affect third parties, such as the banks processing payments from Argentina to its bondholders. On the eve of Thanksgiving in 2012, the lower court again gave NML all it had asked for. Ratable payment meant that NML and those who sued with it should get full principal and past due interest over $1.3 billion. Every part of the payment chain, starting with the Bank of New York Mellon as trustee for the restructured bondholders and including clearing and payment system operators such as DTCC and Euroclear, was exposed to sanctions for sending money to the bondholders while NML remained unpaid (box 1). Ratcheting up the pressure, Judge Griesa lifted the stay on his injunctions in time to block a large December payment on the new bonds and told Argentina to put the money due to NML and others in an escrow account.

An Amicus Avalanche

The Second Circuit panel had committed to review Judge Griesa's answers to its two questions. After his Thanksgiving orders, just about everyone—the trustee, the exchange bondholders, other holdouts, clearing and payment system opera-

10. See *NML Capital Ltd. v. Argentina*, 699 F.3d 246, 244–255 (2d Cir. 2012) ("[The ratable payment formula] could be read to mean that if, for example, Argentina owed the holders of restructured debt $100,000 in interest and paid 100% of that amount then it would be required to pay the plaintiffs 100% of the accelerated principal and all accrued interest. Or it could be read to mean that, if such a $100,000 payment to the exchange bondholders represented 1% of the principal and interest outstanding on the restructured debt, then Argentina must pay plaintiffs 1% of the amount owed to them. We cannot tell precisely what result the district court intended.").

Box 2 How Argentina breached its *pari passu* clause: A view from the Second Circuit

October 26, 2012 Opinion

The record amply supports a finding that Argentina effectively has ranked its payment obligations to the plaintiffs below those of the exchange bondholders. After declaring a moratorium on its outstanding debt in 2001, Argentina made no payments for six years on plaintiffs' bonds while simultaneously timely servicing the Exchange Bonds. Argentina has renewed that moratorium in its budget laws each year since then. It declared in the prospectuses associated with the exchange offers that it has no intention of resuming payments on the [defaulted] FAA Bonds. …It stated in SEC [Securities and Exchange Commission] filings that it had "classified the [FAA Bonds] as a separate category from its regular debt" and is "not in a legal…position to pay" them. …Its legislature enacted the Lock Law, which has been given full effect in its courts, precluding its officials from paying defaulted bondholders and barring its courts from recognizing plaintiffs' judgments. [Citations omitted]

Source: NML Capital Ltd. v. Republic of Argentina, 699 F.3d 246 (2nd Cir. 2012).

tors, bankers' associations, former officials, and academics of all stripes—wanted to file a brief in the case. The judges accepted papers from all who filed, reinstated the stay, rejected the escrow account, and scheduled a follow-up hearing for February 27, 2013. On top of all the market drama, the case now promised a celebrity lawyer rematch: Ted Olson and David Boies, who had argued *Bush v. Gore* in 2000, represented NML and the new bondholders, respectively.

In the next two months the panel got over two dozen briefs, letters, and motions. Together, these submissions told two conflicting stories: "No Big Deal" and "End of the World."

The No Big Deal story has Argentina as a uniquely bad debtor, with uniquely unfavorable contracts, and unique disregard for the US judiciary. No other country could ever stiff its creditors so badly or flout US court judgments for so long—and no other country had *pari passu* clauses as favorable to NML's interpretation. It follows that disciplining Argentina would vindicate creditor rights and the US judiciary but would have no effect on other debtors or debt restructurings.

The End of the World story is, predictably, just the opposite. It highlights the broad language of the District and Circuit Court opinions, which list common misdeeds like selective default among the grounds for sanctioning Argentina (box 2). It points to the many bond contracts with *pari passu* clauses equally or more vulnerable than Argentina's (notably Cyprus and Italy). And it holds that future trustees and creditors would be mad to get involved in distressed sovereign exchange offers, knowing that this would make them easy targets for holdout litigants. Some briefs pointed to English court decisions and UK policy pronouncements as evidence that *pari passu* injunctions would be inconceivable in the United Kingdom (Financial Markets Law Committee 2005). They predicted that sovereign borrowers would leave New York in droves, threatening its role as a global financial center.

The first story was plausible considering the court's infinite frustration with Argentina and the fact that the *pari passu* question had been hovering over the sovereign debt markets since 2000 with no apparent adverse impact. On the other hand, its contention that Argentina's version of *pari passu* was an extreme outlier was inaccurate: The ratable payment language had become both more prevalent and more difficult to change in recent years (Weidemaier 2012).

The second story got a temporary boost in December 2012 from the US government, which joined Argentina to ask the full Second Circuit to reconsider the ruling by its three-judge panel. The US chose not to challenge Judge Griesa's remedy. Instead, it questioned the fundamental basis of the appellate interpretation of the *pari passu* clause and its ability to support a ban on debt payments by Argentina. The US brief reiterated concern with the policy impact of the case, but also gave judges a way out: A footnote said that a ruling based on the Lock Law would not harm the broader restructuring regime, since so few countries freeze out their holdouts by statute. The rehearing petition was summarily denied on March 26, 2013. For the second time, federal appeals judges brushed off US policy arguments in this case.

"Trial of the Century"

On February 27, 2013 more than 250 lawyers, investors, analysts, journalists, and gawkers packed into two overflow rooms at the Federal Courthouse in downtown Manhattan. The main courtroom was too small to fit all who had filed briefs in the case. Some had lined up for hours in the cramped marble elevator bank, with no food, drink, or phone access. Every so often, rumors about hearing logistics, gasps from late arrivals, and scuffles with interlopers would send a shudder down the hushed line. As the protagonists arrived in the afternoon, the scene turned into a tense sort of red-carpet ceremony. Those in the know pointed out Argentina's vice president and economy minister; famous lawyers swept in with their retinue; and journalists began scribbling notes.

Once the hearing started, consensus predictions flew out the window. Going in, most analysts had bet that the court would revisit the injunction's effect on the trustee and payment and clearing systems, which claimed to be systemically important bystanders with no control over Argentina. If Argentina decided to ignore the injunction and the Bank of New York Mellon as trustee could escape it, NML's interpretation victory would be for naught. But these judges had no trouble telling the trustee that their orders should trump the trustee's contract duty to pass money to the new bondholders. While the court agreed that the new bondholders themselves would not break the law simply by getting paid, it was cold comfort to David Boies' clients: They had no way of getting the money without involving the trustee or collaborating with Argentina to circumvent court orders.

In another surprise, the judges seemed open to alternative payment formulas. This was remarkable because Judge Griesa's order was based on a straightforward reading of NML's debt contract. Under his interpretation, ratable payment would give each creditor its full payment due on any given day. This happened to be a coupon payment for the new bondholders and full accelerated principal plus interest for NML and colleagues. If they chose to depart from the contract, the judges would have to make up a fair payment formula using their discretion, with no bankruptcy rules to guide them. It seemed improbable that a court so clearly frustrated with Argentina would venture so far afield to give it a break; yet the judges' questions lingered over the payment formula, to the puzzlement of many.

Argentina's lawyer told the visibly stunned court that his client would rather default on all its foreign bonds than "voluntarily obey" orders to pay the holdouts. Jonathan Blackman may have had to take this position to enable the trustee and the new bondholders to claim harm from the *pari passu* remedy. As Ted Olson argued for NML, Argentina was free to service the new bonds if only it would pay his clients—and no one would be harmed. But as far as Argentina was concerned, paying this group of plaintiffs would expose it to claims from other defaulted bondholders and maybe even claims from the new bondholders demanding "most favored creditor" treatment under their contracts. Paying NML was politically untenable and would open a legal can of worms.

In the end, Blackman zeroed in on the idea that some judgments against sovereign governments were meant to go unenforced under US law. He warned of more litigation to come if Judge Griesa's order were upheld.

The proceedings went on for twice the allotted time. As the dizzy and hungry audience filed out of the courthouse, the consensus was unmistakable: The judges were done with Argentina, and it would lose badly. The price of one-year credit default swaps on Argentina topped 6,000 basis points—or double the price at the start of the year.[11]

And then the case took another crazy turn.

Sovereign Bankruptcy, Day One?

On Friday, March 1, 2013 the Second Circuit panel issued an order directing Argentina—and Argentina alone—to propose a payment formula to the court in four weeks, explaining how it would come "current" on the old defaulted debt and why anyone should believe it. Two days after they collapsed, debt prices began to climb back up (Werning 2013).

The order was important quite apart from how the case might turn out. The idea that a US federal court would propose departing from debt contract terms outside bankruptcy is radical—even if the range of departures acceptable to the court is narrow. A regime where a court modifies contracts over creditors' objections looks suspiciously like sovereign bankruptcy, achieved here using the judges' equitable discretion against the background of the debtor's immunity.

Argentina's response on March 29 showed that it was either unwilling or politically unable to seize the opportunity. It offered a menu of par and discount bonds and new growth-linked securities along the lines of its 2010 exchange, which the plaintiffs had rejected. Analysts and journalists stayed up late on a Friday night only to be disappointed. The new consensus was that the Second Circuit would reject the proposal out of hand. Yet again, the court surprised: Instead of ruling against Argentina, it sought the plaintiffs' views on the formula.

NML and others promptly rejected the offer on April 19, 2013, in a brief full of righteous indignation at Argentina's scofflaw ways. They also pushed back at the Republic's forecast of more lawsuits and its contention that it did not have enough money to go around. If future creditors came calling for equal treatment, Argentina could always defend itself by showing it was out of funds. Not having enough for all creditors was no reason to stiff these plaintiffs. As if on cue, a group of individual investors tried to join the fray two days

11. Sujata Rao and Jorge Otaola, "Argentine Bonds Suffer as US Hearing Fuels Default Fear," Reuters, February 28, 2013.

later, demanding that Argentina pay *all* its holdouts, not just the plaintiffs in NML's lawsuit. This time, both NML and Argentina opposed the newcomers. But Argentina's filing had an air of "we told you so": The arrival of more creditors highlighted the apparent inequity of NML's "first to sue" theory of ratable payment. The court rejected the new *amicus* brief on April 25, 2013.

Two basic theories for how the court might approach this case have crystallized in the commentariat. The first is simple: The Second Circuit judges know that Argentina's politicians have painted themselves into a corner but are careful to give the sovereign all the due process it needs to self-destruct. A decision against it is foreordained. The second is complex: The judges realize belatedly that they made a giant mistake in October 2012 and are now willing to impose a bankruptcy-style distribution to contain the fallout.

The first scenario would have Judge Griesa's 2012 Thanksgiving eve orders upheld in full. It makes sense where Argentina has no political scope for compromise, where the holdouts stand on their rights to refuse old exchange offers, and where the court insists on protecting these rights. Add to it the courts' natural reluctance to rewrite contracts outside formal bankruptcy, the absence of authoritative benchmarks for any such rewriting, and the assumption, based on oral arguments, that the trustee must come within the scope of the injunction. Coming "current" would give the NML plaintiffs much of what they want, since most of the claim in this case is past-due interest. Argentina's proposal suggests that this is politically untenable. The time-honored way to close such gaps is with accounting tricks and financial engineering, but this particular gap seems to be more of a loaves-and-fishes proposition: It would take a miracle to bridge it.

The second scenario starts with the same facts but makes radically different assumptions about the court's disposition. Circuit Court judges are not in the business of issuing orders for laughs—if they had thought there was no formula that Argentina could offer and the plaintiffs could accept, they would not have asked the question. They know everyone is watching, they are eager to be unanimous, they picture floods of *amici curiae* begging for Supreme Court review, and they wish they had taken the easy way out in fall 2012, leaving the *status quo* and blaming it on sovereign immunity (Weidemaier 2013). Assuming again that the judges are inflexible about the trustee, they could be more disposed to play their own accounting games with the formula. But even if they go through the trouble of finding a new formula and imposing it on the parties, any such formula would promptly be challenged by one or both sides.

At this stage, the first scenario seems much more likely, but it is not a foregone conclusion. If Argentina loses again, it may ask again for a full-circuit rehearing, this time on the formula and the effect on third parties. As before, the Second Circuit is highly unlikely to grant a rehearing—it almost never does (Federal Bar Council 2011).

No matter how the Second Circuit rules, it would seem courteous to extend the stay on injunctions until the Supreme Court decides whether to take the case. Then again, if these judges are truly fed up with Argentina and know the full circuit would not pull the rug out from under them, they might lift the stay. A single Supreme Court justice assigned to the Second Circuit (here Justice Ruth Bader Ginsburg) can put the stay back on, but the presumption seems to be that lower courts handle such things.[12]

Adding to pending litigation confusion are all the work-around mysteries—will the Bank of New York Mellon resign? If it does, Argentina would be hard-pressed to replace it. Under its contracts, the new trustee would have to be a big New York bank exposed to the same risks as the old trustee. Will Argentina try to swap its restructured bonds for new ones payable in Buenos Aires? Will it try to prepay? Can it settle with NML without paying more to the exchange bondholders? It seems that no matter what Argentina does, it will end up in court—and it is probably prudent to hold predictions until it is clear who is suing whom for what.

THE FALLOUT

NML v. Argentina may or may not change the world of sovereign debt restructuring as we know it. Whatever happens to the parties in this case, the market will adapt. The more urgent question is whether the *pari passu* remedy as it stands today makes for bad law and creates a policy problem—even assuming the market adapts in the end. I suggest that it does for three reasons.

First, the *pari passu* remedy is premised entirely on maximizing collateral damage, without reaching the debtor.[13] A fundamental problem with ratable payment orders is their

12. Rules of the Supreme Court of the United States, Rule 23, www.supremecourt.gov/ctrules/2010RulesoftheCourt.pdf; see also Allotment Order, Supreme Court of the United States, www.supremecourt.gov/orders/courtorders/allotmentorder9-28-10.pdf.

13. This concern was "determinative" for the English court that denied a ratable payment injunction against Congo in 2003, rejecting a remedy "directed towards the coercion of third parties rather than securing immediate compliance by the defendant" (*Kensington International Ltd. v. Republic of Congo*, [2003] EWHC 2331).

inability to compel Argentina to do as it promised. If Argentina is determined not to pay NML, it can continue stonewalling it. Ignoring the court will not land officials in jail or damage Argentina's reputation any more than it is already damaged. In contrast, the various market actors heretofore on the sidelines in the fight between Argentina and NML have suddenly become the holdouts' principal levers and opponents. The court orders operate like a secondary boycott: If Argentina defies court orders, parties who are within the court's reach risk punishment for dealing with it.[14] The country remains sovereign and immune, if increasingly isolated.

...the *pari passu* remedy is premised entirely on maximizing collateral damage, without reaching the debtor; ... is partial, arbitrary, and inequitable...; and bad for debt management and debt restructuring incentives.

The new enforcement path complicates life for debtors and creditors in future restructurings. More vulnerable or less-determined countries, which cannot survive a prolonged period of market exclusion, will be tempted to settle as Peru and Congo had done before the definitive US ruling on *pari passu*—even if their case is stronger than Argentina's. Creditors weighing whether to participate in a distressed bond exchange after *NML v. Argentina* must consider the terms of the new bonds along with the likelihood that any new payments would be blocked by another creditor wielding a *pari passu* clause. For the majority that might prefer a quick and certain exit, this does not make holding out more attractive—chasing sovereigns for years around the globe is still a specialty sport—but it does make participation less attractive.

Those who argue that the outcome in Argentina will have no impact on future debtors and creditors point to the successful debt exchange in Belize, completed in March 2013 against the background of Second Circuit proceedings.[15] It is too early to tell whether Belize is a sign of things to come: It might have succeeded thanks to factors unique to Belize, continued uncertainty about Argentina, or Argentina's ultimate irrelevance. Reflecting uncertainty, countries' reactions to the New York proceedings have ranged from expressions of concern in Securities and Exchange Commission (SEC) filings to radical contract surgery and lawsuits (box 3).

Apart from debtors and creditors, financial-market utilities and service providers may face new risks as a result of this case. Trustees and fiscal agents in sovereign debt restructurings are on notice that they could be implicated in a later injunction under other people's contracts containing the *pari passu* clause—contracts potentially unknown to them at the time they sign up to serve.

Payment and clearing systems are similarly vulnerable to being drafted in the enforcement task. US law and the court orders purport to shield "intermediary banks," entities that serve as pure payment conduits with no contractual ties either to the debtor or the new bondholders. However, this concept is not particularly useful when the real economic owner of a debt security is many custodial links removed from the first legal owner in the chain (most likely a large depositary). Formally, it is plausible to describe the Bank of New York Mellon as "beneficiary's bank"—the final destination of Argentina's bond payment—which would make it a fair target for the courts. But in every practical sense it is a stop on a long journey that winds through DTCC or Euroclear, which hold ownership stakes for their member institutions, which hold smaller stakes for their customers, and so on.

Current financial reforms highlight the fact that trustees, securities depositaries, and clearinghouses are public utilities with a public mission; they should not be hijacked for private enforcement. This argument has two caveats that flow from different value judgments. First, if Argentina's defiance puts it on par with money launderers and terrorist financiers, then market utilities should steer clear of Argentina for their own sake and that of the system. Second, New York could make the policy choice to have its market utilities serve as enforcement tools against sovereigns that are now immune, with the attendant administrative and due diligence costs. Belgium's different choice with respect to Euroclear should not dictate policy in New York.

What about the implications for the international financial institutions, such as the World Bank, the IMF, and other government creditors? The general terms of the court rulings would seem to include payments to these creditors among those that could be blocked under the ratable payment theory. However, the plaintiffs have wisely stressed that they were not challenging the established multilaterals' preferred creditor status in this case. The courts agreed for now. Payments to the IMF enjoy additional protection because they technically relate to an exchange of assets, not external indebtedness within the meaning of the conventional *pari passu* clause. However, governments and multilateral development banks do make

14. See Fed. R. Civ. P. 65(d)(2)(C) (describing the concept of "active concert or participation" to extend an injunction to a nonparty).

15. "Belize Debt Offer Exchange Successful," Reuters, March 8, 2013.

Box 3 Countries react

Mexico, Colombia, and Paraguay chose to highlight the Second Circuit proceedings in their own securities offering disclosure this year, noting that some outcomes might make sovereign debt restructuring more difficult in the future. However, they stopped short of changing their contracts to remove or refine *pari passu* in their documentation.

> *Supplemental Risk Factor Disclosure*
>
> …
>
> *Recent federal court decisions in New York create uncertainty regarding the meaning of ranking provisions and could potentially reduce or hinder the ability of sovereign issuers to restructure their debt.*
>
> *In ongoing litigation in federal courts in New York captioned NML Capital, Ltd. v. Republic of Argentina, the U.S. Court of Appeals for the Second Circuit has ruled that the ranking clause in bonds issued by Argentina prevents Argentina from making payments in respect of the bonds unless it makes pro rata payments on defaulted debt that ranks pari passu with the performing bonds. The judgment has been appealed.*
>
> *We cannot predict when or in what form a final appellate decision will be granted. Depending on the scope of the final decision, a final decision that requires ratable payments could potentially hinder or impede future sovereign debt restructurings and distressed debt management unless sovereign issuers obtain the requisite bondholder consents pursuant to a collective action clause, if applicable, in their debt, such as the collective action clause contained in the Notes.*[1]

Belize went a step further in its distressed debt exchange, adding express disclosure in its Offering Memorandum to "clarify" that its *pari passu* clause meant ranking, not ratable payment. The language came from a new National Assembly Resolution authorizing the debt exchange:

> *The New Bonds will be general, direct, unconditional, unsubordinated and unsecured obligations of Belize and will rank at least equally among themselves and with all of Belize's existing and future unsecured and unsubordinated bond indebtedness (it being understood that this equal ranking status shall not require Belize to pay all items of its bond indebtedness on a ratable basis).*[2]

Italy has one of the most vulnerable *pari passu* clauses in the market, expressly promising to pay amounts due on the debt securities "equally and ratably with…all other general loan obligations of Italy." The government quietly stripped this language from its latest Fiscal Agency Agreement:

> *The Securities are the direct, unconditional and general and …unsecured obligations of Italy and will rank equally with all other evidences of indebtedness issued in accordance with the Fiscal Agency Agreement and with all other unsecured and unsubordinated general obligations of Italy for money borrowed, <u>except for such obligations as may be preferred by mandatory provisions of international treaties and similar obligations to which Italy is a party</u>.… ~~Amounts payable in respect of principal of (and interest on) the Securities will be charged upon and be payable out of the [Treasury of Italy], equally and ratably with all other amounts so charged and amounts payable in respect of all other general loan obligations of Italy~~.*[3] [marked to reflect changes from 2003]

On March 4, 2013 **Taiwan's** Export-Import Bank tried to stop **Grenada** from servicing the debt it restructured six years ago unless it also paid Taiwan on the ratable payment theory. While Ex-Im Bank's complaint closely tracks NML's, Grenada's debt contracts are less vulnerable than Argentina's, and Taiwan's procedural posture is less favorable than NML's, since it holds a judgment. However, Grenada has announced another debt restructuring, and the lawsuit could complicate it.[4]

1. United Mexican States (2013).
2. National Assembly of Belize (2013).
3. Republic of Italy (2013).
4. *Export-Import Bank of the Republic of China v. Grenada*, No. 13 Civ. 1450 (S.D.N.Y. March 13, 2013) (Order on Consent).

loans, and payments to them could be caught unless specifically exempted. The banks' preferred status is a matter of practice, not law. Whether the courts' recognition of this status in this case would prove durable and generalizable is an open question.

Second, as proposed by NML, the *pari passu* remedy is partial, arbitrary, and inequitable, replicating the original "Tom, Dick and Harry" problem, this time with the help of US courts. It gives a single enterprising creditor a large windfall payment, not shared with the other defaulted bondholders—as the late-coming holdouts discovered in their failed attempt to get a ratable share of this case. Even those who welcome the recent court orders as a long-overdue check on sovereign impunity might be troubled by the arbitrary incidence of the check: Some of the debtor's assets are blocked for the benefit of a small group of creditors, while everyone else suffers deep losses. It stands in contrast to the bankruptcy ideal, where the debtor's estate is distributed among all its creditors.

A statutory sovereign bankruptcy regime is the most obvious response, and the least likely to happen.

Third, the *pari passu* remedy is bad for debt management and debt restructuring incentives. The Second Circuit opinion does not differentiate between an ordinary debtor that runs out of cash and what some have termed a "rogue debtor" (Porzecanski 2005). Future courts will need to flesh out when a good apple turns bad or when default becomes subordination. Until the standards are clear, creditors may attach the same litigation risk premium to both, lending the good apple too little and the bad apple too much. In distress, fear of lawsuits may delay the debtor's decision to restructure and reduce the creditors' willingness to participate, though the magnitude of this effect is unclear.

WAYS OUT

Three solutions would solve all three problems.

A statutory sovereign bankruptcy regime is the most obvious response, and the least likely to happen. Treaty-based bankruptcy could offer countries the prospect of a fresh start, or debt discharge, in exchange for paying all their creditors on an equitable basis. Debtor discipline would come courtesy of treaty form and conditional debt forgiveness. The fairness of distribution would depend on the treaty's scope, covering all or nearly all of the country's creditors—domestic, foreign, public, and private. Statutory bankruptcy would also have the advantage of greater political legitimacy and public accountability for its distribution choices.

The failure of SDRM in 2003 for lack of support from key stakeholders (Setser 2010) suggests that even a modest creditor coordination scheme may be doomed: There is no evidence of wholesale conversion among those that blocked it a decade ago. But if debtors become a little more hesitant to launch a restructuring, and if creditors become a little more reluctant to participate, it would bolster the case for sovereign bankruptcy. The tipping point is hard to tell.

Contract reform to overcome creditor coordination problems is the presumptive alternative to statutory bankruptcy. Collective action clauses (CACs), which have proliferated in sovereign bonds since 2003, allow a supermajority of creditors to bind would-be holdouts in a restructuring. If CACs could eliminate all holdouts, there would be no *pari passu* lawsuits—the meaning of the clause would be irrelevant. But CACs cannot and should not guarantee the success of every restructuring operation. They cannot because for the most part, CACs operate on an issue-by-issue basis. This allows creditors to buy blocking stakes in small issues trading at a deep discount and keep them out of the restructuring. For example, more than half of Greece's foreign-law issues with CACs failed to get enough votes, held out, and continue to be serviced on time. This made little difference for the overall outcome of the debt exchange because over 90 percent of the Greek debt stock had been governed by Greek law and was amended across multiple issues, leaving no holdouts[16] (Zettelmeyer, Trebesch, and Gulati 2013).

Contract reform to overcome creditor coordination problems is the presumptive alternative to statutory bankruptcy.

A small but growing number of contracts allow votes across multiple bond issues, a device known as aggregation or cross-series modification. In most cases, aggregation procedures require a double-majority vote (conducted across the debt stock and for each issue) and let single bond issues drop out of the restructuring. As a result, it is still possible—though harder—to hold out and sue under aggregation. Aggregated

16. In the past, a combination of immunities, restructuring, and CACs made it extremely unattractive to hold out and kept the holdout population to a minimum in the vast majority of sovereign restructurings, even those involving foreign-law bonds. The combination owed its success in part to the credibility of the debtor's threat not to pay the holdouts. Ironically, this made subsequent side payments more affordable and acceptable, since they were tiny. *NML v. Argentina* will raise the risk from nonpayment for most debtors and the risk of lawsuits for participating creditors. This would make it harder to achieve the necessary creditor majorities to amend bonds under CACs. The debtor could face the choice between making larger side payments and defending *pari passu* lawsuits.

CACs that provide for a single vote and do not allow any issues to drop out would blur the line between contract and bankruptcy; these could be a harder sell. Under the best circumstances, promoting CACs with aggregation would take sustained official outreach and achieve incomplete reform, as happened a decade ago.

Some outstanding bonds (no one quite knows how many) still do not have CACs because they were issued under New York law before 2003, where the custom was to require unanimous bondholder consent to modify the financial terms. A few post-2003 issues have resisted CACs. Moreover, not all sovereign debt instruments with *pari passu* clauses are in the form of bonds susceptible to the inclusion of CACs. For example, syndicated and bilateral loan contracts with *pari passu* clauses may present a distinct source of vulnerability.

The third solution is limited and direct: change or eliminate *pari passu* clauses that give rise to ratable payment injunctions.

Most importantly, CACs are not and should not be designed to eliminate all holdouts at all costs. They are supposed to give creditors a meaningful voice, which should include some capacity to block or stay out. Voting thresholds should be set with a view to identifying terms that put the debtor on a sustainable footing, are acceptable to most creditors, and fair to all. Put differently, preventing *pari passu* lawsuits at all cost is not and should not be the dominant objective of CACs.

The third solution is limited and direct: change or eliminate *pari passu* clauses that give rise to ratable payment injunctions. Unlike the first two solutions, which try to reform the overall regime for debt restructuring, the third focuses on collateral damage control.

Because the *pari passu* remedy targets trustees, clearinghouses, and operators of payment systems, it is in their interest to shield themselves. Private-sector initiative would be particularly appropriate in this area, dominated by a small cohort of large regulated institutions that serve as gatekeepers for the securities market. Stock exchanges and clearinghouses have a history of driving contract change through listing and membership requirements (Flandreau 2013, Buchheit and Gulati 2003). Clearing and payment systems and trustees already seek commitments from participants to protect themselves from risks associated with particular counterparties and contracts.

After *NML v. Argentina*, market utilities could require sovereign debtors to represent that none of their outstanding debt contracts contain ratable payment terms that would expose the utility to injunctions. A debtor that refuses either would not get the service or would have to pay more for it. Additional sanctions could apply if the representation is discovered to be false after the fact. The requirement could also take the form of clearing eligibility criteria, covenants, indemnity provisions, or some combination of all these.

Although the precise formulation should be up to the market utility, any such requirement would have three benefits. First, it would force governments to discover and disclose information about their debt contracts (not just bonds with CACs) that could impose costs on third parties. Second, it would prompt governments to eliminate particularly risky formulations of *pari passu* for fear of paying more or losing market liquidity. Third, it would preserve any given government's ability to promise ratable payment to its creditors up front in clear and unambiguous terms. Even if the value of this promise as a collection device would be dubious, some creditors might want it as extra protection against "rogue debtors." They would pay more or lose liquidity—and so they should. The requirement would force debtors and creditors that present the highest risk to the system to internalize their costs.

Like any contract reform, this one would entail transition challenges. It would be burdensome and expensive for countries to change all their debt contracts overnight.[17] However, having market utilities drive *pari passu* reform should be quicker, easier, and more likely to produce a standardized outcome than the CAC campaigns of the 1990s and 2000s.[18] The utilities are motivated to protect themselves and provide essential services across the sovereign debt market. This should help overcome the network and agency problems that seem to keep governments and their lawyers from changing suboptimal contracts (Gulati and Scott 2012).

Even if it is wildly and instantly successful, the third solution would not do much to advance a comprehensive sovereign debt restructuring regime. It is all about damage control. A new regime would require a new political bargain, in which countries agree to cede some sovereignty and immunity protections, while creditors agree to join in a comprehensive collective proceeding. For as long as such a bargain remains out of reach, sovereign debt will remain unenforceable, inescapable, and deeply dysfunctional.

17. Amending *pari passu* in bond contracts now generally requires the highest supermajority vote. The advantage of a successful vote is that it binds dissenters. Governments can also change their debt contracts as part of liability management operations, issuing new debt and retiring the old.

18. Back then, each borrower had to struggle with the question whether adopting CACs would raise its borrowing costs (Gelpern and Gulati 2006). Securities regulators could not decide whether CACs were good or bad for investors and ultimately forced them to be disclosed as "Risk Factors" in offering documents.

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