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Crying for Argentina: Hedge Funds Initiate Litigation To Collect On Sovereign Debt

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June 12, 2013 - When sovereign states become insolvent or default on their debt, there are no statutory bankruptcy protections in place, such as the automatic stay, to orderly distribute assets and prevent litigation to collect on defaulted debt. The alternative to statutory bankruptcy protection is frequently debt restructuring proposals that force debt holders to accept deeply discounted exchange bonds or risk receiving nothing. As Jonathan I. Blackman and Rahul Mukhi wrote in a 2010 article, The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna, in recent years when sovereigns have faced insolvency or default and present debt restructuring proposals to investors, some hedge fund investors have opted out of the proposals and pursued litigation to collect on the defaulted debt.

Background

In 2008, NML Capital, Ltd., a subsidiary of Elliot Associates, led a suit against the Republic of Argentina to collect on sovereign bonds. Beginning in 2001, Argentina defaulted on nearly $100 billion of its sovereign debt. After four years of failing to pay on the bonds, Argentina gave investors a choice to either trade existing bonds for newly issued bonds at a significant haircut on the original value, or keep the old bonds and get nothing. While most investors accepted the haircut, several hedge funds declined the exchange offer, held the existing bonds, and filed a series of lawsuits in the United States to collect on the debt. The holdout creditors filed lawsuits alleging breach of contract and seeking injunctive relief, and in some cases successfully won judgments against Argentina, as the Second Circuit noted in *NML Capital, Ltd. v. Republic of Arg.*, 699 F.3d 246, 253 n.5 (2d Cir. 2012). Other examples include: *EM Ltd. v. Republic of Arg.*, 473 F.3d 463, 472 (2d Cir. 2007) (affirming vacatur of attachment of central bank reserves); *NML Capital, Ltd. v. Banco Central de la República Arg.*, 652 F.3d 172, 197 (2d Cir. 2011) (vacating attachment of reserves); *Aurelius Capital Partners, LP v. Republic of Arg.*, 584 F.3d 120, 131 (2d Cir. 2009) (rejecting attempt to restrain assets to be acquired by Argentine social security system); *but see NML Capital, Ltd. v. Republic of Arg.*, 680 F.3d 254, 260 (2d Cir. 2012) (affirming attachment and restraining orders); *EM Ltd. v. Republic of Arg.*, 389 F. App'x 38, 43 (2d Cir. 2010) (affirming post-judgment restraint and pre-judgment attachment orders on certain assets of Argentina held in trust in the United States). However, Argentinian courts refused to honor the judgments.

Recent Litigation

The holdout creditors responded by filing suit in the U.S. District Court for the Southern District of New York alleging that, pursuant to the *pari passu* clause in the debt instruments, Argentina could not continue to pay its exchange bondholders without also paying the holdout creditors. The *pari passu* clause in the Argentinian debt instruments promised to maintain the equal ranking of the country's "payment obligations."

After sixteen months of briefing and hearings, Judge Griesa of the U.S. District Court for the Southern District of New York held that Argentina violated the *pari passu* clause and enjoined Argentina and domestic agent-banks from making payments on the exchange bonds unless the other bondholders were also paid. Argentina appealed the district court injunctions, and on October 26, 2012, the Second Circuit affirmed the district court's findings and conclusions, but remanded the matter to Judge Griesa to clarify "how the injunctions' payment formula is intended to function." The district court clarified the payment formula in an opinion dated November 21, 2012. *NML Capital, Ltd. v. Republic of Arg.*, 2012 U.S. Dist. LEXIS 167272 (S.D.N.Y. Nov. 21, 2012). The case returned to the Second Circuit, and on March 1, 2013, the Second Circuit gave Argentina a chance to submit in writing "the precise terms of any alternative payment formula and schedule to which it is prepared to commit." *NML Capital, Ltd. v. Republic of Arg.*, No. 12-105 (2d Cir. Mar. 1, 2013), ECF No. 903. Argentina submitted a written proposal that the holdout creditors characterized as "unacceptable and unresponsive" that offered holdout creditors less than fifteen percent of the amount owed under the terms of the bonds.

On May 22, 2013, Citibank, a non-party, filed a motion in the district court requesting confirmation that Citibank's Argentine branch is not bound by the injunctions, arguing that their Argentine branch is beyond the jurisdictional reach of the district court injunctions. In an order dated May 24, 2013, however, Judge Griesa declined to rule on the request pending the Second Circuit's opinion.

The Second Circuit has not yet issued its decision on this matter, but its ruling will likely have ripple effects across the sovereign debt market and be appealed to the Supreme Court. The United States filed an amicus brief in the Second Circuit on December 28, 2012 arguing that, if affirmed, the injunctive relief "could adversely affect U.S. foreign relations and threaten U.S. government assets." The Second Circuit, however, anticipated that this case will not have widespread effects because nearly all New York-law bonds issued over the last eight years include collective action clauses that eliminate the holdout creditor problem.

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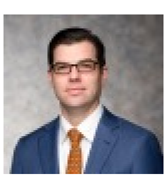

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