LatinSOURCE ARGENTINA MARKET BRIEF

Has Argentina found a true Amicus?

January 15, 2003
Guillermo Mondino, Esteban Fernández Medrano & Luciano Laspina

The US Government and the New York FED just entered a "Statement of Interest" to the Southern District of New York Court in support of Argentina's request to interpret the scope of pari-passu clauses in sovereign debt contracts. In short, the US gave judge Griesa the political and technical arguments to rule in favor of Argentina and to reject the broad interpretation of pari-passu, which gives all creditors the same proportional right on Argentina's sovereign payments (as previously ruled by Belgian Courts).

Were the judge to accept Argentina's motion (which we regard as the most likely outcome now), it would represent a strong blow to the legal strength of claims against the sovereign, undermining the strategy of potential "hold outs". A significant component of both presentations is to argue that hold-outs typically represent a minority in an orderly, good-faith, debt restructuring process and that there is no reason to grant them the ability to intercept debt payments to third parties hiding behind a novel interpretation of the pari-passu clause (be it to IFI's or bond holders at large that accepted a restructuring).

The US motivates such a strong statement on the importance of the protection of the international financial architecture. Yet, there is no question that it will be read, in Argentina and elsewhere, as a sign of support to the argentine position. It might not be the (illusory?) Marshal Plan requested by Kirchner in Monterrey, but this is probably as close as it gets to it. With the difference that the economic costs of it will be carried by bond holders, rather than US carpenters and plumbers (unless of course they bought bonds…).

The Background

On December 12, following the advice of its Counselors[1] Argentina filed a motion, seeking to avoid EM Limited and Macrotecnic (the legal plaintiffs) from relying upon the pari-passu clause to obtain an injunction interfering with Argentina's payments to other creditors. Specifically, Argentina argued that

the Court should reject a novel reading of pari-passu adopted by a Belgian Court of Appeals in 2000, which would require that, before a sovereign debtor could make a payment to any one of its unsecured creditors, it must simultaneously make prorated payments to all other creditors whose debt instruments contain a pari-passu provision. In other words, the Belgian Courts in practice forced Argentina to reach an agreement with all its creditors (through debt restructuring or court rulings) before it could effectively start honoring new debt obligations that emerged from a potential debt restructuring. Furthermore, skillfully, Argentina argued that this immediately jeopardized payments to IFI's such as the IMF, a traditional pillar of debt restructuring episodes. After all the IFI's senior status is founded on common practice, rather than explicit legal rights.

Argentina's legal counsel is top notch, no question about it. They argued that, the natural uncertainty arising from the interpretation of the Belgian court rulings had to be clarified before advancing with Argentina's debt restructuring proposal. Otherwise, holdouts would have very strong incentives to disrupt any effort.

The Statements of Interest

The US response was crystal clear. In two separate statements covering more than 30 pages, the US government and the Federal Reserve Bank sided on this matter with the Republic. The government argument was that "it is in the interest of the United States that this Court Reject a novel reading of the Pari-Passu clause in sovereign debt instruments that would prohibit debtors from making payments to all creditors", while the Fed stated that "the Pari-Passu clause should not be read to permit Plaintiffs to enjoin the operation of payment and settlement systems".

Although none of the headline arguments, directly pledge in favor of allowing Argentina to discriminate between debtors that accept a restructuring and those that do not, the spirit of the presentation makes it clear that the US government wants to see a quick, good-faith, agreement developing. They also make it evident that the administration believes that were the Judge to rule otherwise, several decades of US foreign policy would go down the drain.

While the arguments of the US government were mostly based on political and economic reasons, the Fed appears more specifically concerned with the practical implications of potential injunctions on the payments system. The Fed uses strong language, calling for the need to "discourage the terrorism of payments and settlement systems" by holdouts.

Main points from the US government statement

- "A novel reading of the pari passu clause, that would prohibit sovereign debtors from making payments to third-party creditors or require sovereign debtors to make simultaneous, ratable payments to all creditors would

[1] In line with the working paper by Lee C. Buchheit & Jeremiah S. Pam "THE *PARI PASSU* CLAUSE IN SOVEREIGN DEBT INSTRUMENTS WORKING PAPER", Harvard Law School, Program on International Financial Systems, http://www.law.harvard.edu/programs/pifs/workingpapers.html

undermine [the] well-understood established [financial] framework as well as do damage to settled market expectations."

- "The adoption of the Belgian Courts' interpretation of the Pari Passu clause would adversely affect U.S. policy interests"
- "Holdouts [would] gain an additional contractual right – a right that they did not bargain for – which allows them to threaten the disruption of sovereign restructuring efforts or payment streams"
- "Permitting judgment creditors to interfere with payments by sovereign debtors to third-party creditors — including third-party creditors who have in good faith endured the sometimes laborious process of negotiating a complex restructuring plan — reduces the incentives of creditors to agree to a restructuring while increasing the incentives for a creditor to become a holdout and pursue litigation strategies".
- "The Elliott Court's interpretation ... would interfere with sovereign debtors' ability to service its debts to international financial institutions. ... The United States opposes any attempt by the judgment creditors to force Argentina to depart from well-established, internationally-accepted payment practices."
- "Argentina is at the beginning of a complex and difficult process to restructure its debt. If, however, holdout creditors are permitted to use novel collection strategies to seize payments Argentina seeks to make to other creditors, voluntary debt restructuring will become infinitely more difficult, if not impossible."

Main points from the Fed statement

- "The New York Fed ... is concerned about the operational and public policy ramifications for payment and settlement systems that could result from an incorrect interpretation of the Pari-Passu Clause. The prospect of injunctions blocking thousands of payments to creditors of the Republic could prove disruptive to Fedwire and other payment and settlement systems throughout the world."
- "A prime objective of sophisticated central banks in industrialized countries is to ensure the smooth functioning of their payment systems ... Adopting the Belgian courts' interpretation of pari passu and granting injunctive relief of the type entered by those courts ... threatens the efficiency of payment and settlement systems, including Fedwire and Fedwire Securities Service."

Implications

Bondholders are stripped of a fundamental legal defense mechanism that could have operated to discipline debtors (Argentina and others) in the restructuring process. It is true that the Belgian court interpretation of the pari-passu clause is a dangerous weapon in the hands of a rogue creditor. It could easily be used to block a restructuring effort that most other creditors were willing to accept. Yet, it is also true that were the debtor to fail structure a reasonable proposal, most creditors would be left legally toothless (until a new legal innovation is introduced).

It is also interesting to note that much of the focus of the presentations by US authorities side with the idea that there may be some disgruntled creditors creating very negative externalities in the negotiation process. Not much is said about the possibility that debtors present unacceptable restructuring proposals. Furthermore, what if the sovereign policy makers were to pick-and-choose whom they pay to? The lack of bankruptcy law to protect equal treatment and the now US sponsored view of pari-passu, both give legal room for the country to decide who is to get paid (almost permanently?). That is, under this scenario, Minister Lavagna's vociferous threats that he will not pay a dime to those that sue, gain new credibility.

Given these facts, surely not overlooked by US authorities, they were placed by Argentina's legal counsel and the authorities' strategy, between a rock and a hard place. If the prorate payments interpretation of pari-passu survived, the entire debt restructuring architecture built over the last few

decades would collapse. On the other hand, if it didn't, somebody could potentially abuse the system. Thus, it appears that U.S. authorities decided to move in the direction of preserving the system and deal with behavioral deviations through other mechanisms. After all, many participants in international financial markets seem to believe (obviously rightly so, after this last US move) that the only disciplining device arises from the economic hardships that follow a default and the potential sanctions arising from the international community, not courts or the legal system.

This latter argument brings us back to the issue of the disciplining devices available to ensure a quick resolution to Argentina's debt problem. Two thoughts here:

- Minister Lavagna has announced publicly that he thinks that a meaningful formal debt offer will only be brought to markets around June (from the January/mid-February date announced in New York only a few weeks ago). This seems to be a smart tactical move on his part. The authorities know that March is a highly complicated peak month in terms of payments to IFIs (over US$ 3 billion to the Fund alone) and that the IMF program may fall apart if a debt deal fails before that date. Hence, given the current market response to Argentina's restructuring guidelines, it seems that appearing as making progress and moving the offer towards mid-year is a desirable thing to do. After all, around that date the Republic and the Fund would have to negotiate the fiscal targets for '05 in what is expected to be another confrontational round. Thus, encouraged by the latest signs of explicit or implicit support and tolerance, the Minister seems to be pushing forward the potential future economic sanctions on the Republic.
- In the Monterrey presidential summit, President Kirchner has just made debt and its restructuring Argentina's key foreign policy issue. Much of his speech and, apparently, meetings turned around the issue. Furthermore, he has made a very hard stance, a key linchpin of his domestic and international agenda, arguing that not an inch can and will be changed of the Dubai terms. This may be a bit of an exaggeration, but it is clear that not much flexibility should be expected in the next few months. The Argentine authorities feel that they won another round of their hard-fought, long-lasting struggle with the IMF (that was publicly made joint responsible for Argentina's difficulties). Thus, they still do not perceive a need to change much the original offer.

Bottom Line

Even though the Statements of Interest from the US government and Fed are non binding for the courts, chances are that judge Griesa will interpret the Pari-Passu clause in favor of Argentina. And even though this does not imply that holdouts lost all their legal weapons to pressure Argentina, nor that the IMF and the US will accept the current debt restructuring proposal as a good faith effort

(especially if creditor participation is low), the truth is that these statements cleared Argentina's way to advance with its current proposal.

In any case, these statements took out much of the legal teeth of potential lawsuits against Argentina, or any future defaulter for that matter. This implies that now, more than ever, everything depends on the strength of economic sanctions and hardships from lack of market access. In any event, the US move, while not necessarily motivated by the will to support Argentina's hard-line approach, is directed towards sustaining the international financial architecture as we know it. Will they succeed in doing so, or is the US creating the wrong incentives? From Argentina's point of view, this is all rhetorical. For the authorities there, it is pretty clear that they have found (perhaps transitorily) an *amigo*.

LatinSource

135 E. 57th Street
15th Floor
New York, NY 10022

info@latinsource.com
www.latinsource.com

646-521-8590 – phone
646-521-0717 – fax

MacroVision Consulting

Alicia Moreau de Justo 740
3º floor, Office 21
Dock 5, Puerto Madero
C1107AAP Buenos Aires, Argentina

Guillermo Mondino
guillermo.mondino@mv.com.ar

Esteban Fernández Medrano
esteban.medrano@mv.com.ar

Luciano Laspina
luciano.laspina@mv.com.ar

54 11 4342-5484 – phone
54 11 4342-5484 – fax