# The class action threat to sovereign workouts

**Whitney Debevoise and David Orta of Arnold & Porter look at recent rulings on class action suits that followed Argentina's bond default, and argue that negotiated restructurings are the best way to resolve sovereign debt disputes**

Two attempted class action cases filed recently by bondholders in New York thrust the US federal courts into uncharted territory for both sovereign debt litigation and class action law. Both related to the December 2001 default by the Republic of Argentina on its foreign debt. Both class actions failed, and rightly so. Nevertheless, they raise questions about the suitability of class actions as a means for resolving sovereign debt disputes.

The US courts denied class certification in the Argentine cases because they would have proven unmanageable. But there are other reasons, too, why class actions are an unwelcome addition to the difficult task of restructuring sovereign bonds. For a start, they may have a chilling effect on discussions between a sovereign debtor and its creditors. Certifications of a class action also may have serious implications in the secondary market where a country's bonds continue to be traded after the sovereign defaults. Class actions can result in injunctions that are difficult to police and consume funds that should go to out-of-pocket investors. Lastly, in situations like that of Argentina where class members reside all over the world, a class action may fail to provide the defendant with the security that it can avoid further lawsuits, one of the few perks of being the target of a class action. All told, the failure of bondholders in the Argentine cases should come as a relief to sovereign issuers worldwide.

## The Argentine cases

Two class action cases were filed against the Republic of Argentina in the US District Court for the Southern District of New York. Both sought class certification under Rule 23(b)(3). To qualify, the plaintiffs had to show that the class was so numerous that joinder of all members was impractical, that questions of law or fact were common to its members, that the claims or defences of the representative parties were typical of the claims or defences of the class, and that the representative parties would fairly protect the interests of the whole. They had also to prove that questions of law or fact common to the members of the class predominated over any questions affecting the individual class members, and that bringing the case as a class action was the superior manner in which to resolve the claim of the members (see box).

In the first case, *HW Urban v Argentina*, Case No 02-Civ 5699, a retired individual from Hanover, Germany, his wife and their foundation sought to certify a class of all holders (except Argentine citizens) of an unspecified number (anywhere from 30 to 68) different series of Argentine bonds denominated in six different currencies, including those covered by the October 1994 Fiscal Agency Agreement, as well as bonds issued under various German, English and Spanish law documents. Argentina estimated that the total outstanding amount of the series in the proposed *Urban* class exceeded $12 billion. The putative members resided worldwide.

In the second class action, *Applestein v Argentina*, Case No 02-Civ 4124, the class plaintiff proposed to certify a class of all persons (other than Argentine citizens) who, as of December 23 2001, held bonds issued by Argentina pursuant to the October 19 1994 Fiscal Agency Agreement. The proposed class would also include persons who acquired such bonds since December 23 2001. The class was divided into two subclasses: those who had and those who had not accelerated their debt. Argentina estimated that the proposed class included approximately $23 billion in outstanding debt, consisting of thousands of bondholders residing worldwide.

In opposing class certification in both cases, Argentina advanced two main arguments. First, Argentina argued that a class action is not the superior method for resolving the claims of Argentine bondholders. In support of this argument, Argentina pointed to the resolution of prior sovereign defaults through a consensual, restructuring process. Argentina argued that it was not disputing liability and acknowledged that it owed the outstanding debt to its bond creditors. It further argued that there were few creditors who would choose to litigate their claim as opposed to participating in the voluntary restructuring process. Argentina claimed that the proposed classes would be unmanageable, and the court would be unable to oversee the resolution of multiple billions of dollars of claims by bondholders residing around the world. Argentina claimed that certification of a class action would disrupt the orderly restructuring of its debt by, among other things, impeding communications between bondholders that are putative members of the proposed classes and Argentina. Lastly, Argentina argued that the bond contracts themselves called for individual choice by each bondholder as to whether or not to accelerate bonds

and whether or not to litigate claims upon default. The country argued that the class action mechanism supplanted that individual choice, erroneously aggregating control in the hands of a few bondholders and their counsel.

Second, Argentina argued that the class representatives and their counsel were not adequate representatives for the proposed classes and would not adequately represent the interests of the absent members of the proposed classes. They claimed that the class plaintiffs and their counsel had no experience with sovereign debt restructuring and sought to thwart rather than support the restructuring process.

**When settling the claims of sovereign creditors, such as the creditors of Argentina, the factors that play into a settlement are inherently political, economic and financial. One must ask whether a single judge is the appropriate decision-maker for the resolution of inherently troubled questions of political economy**

Plaintiffs in the class action cases countered that they met each of the requirements of Rule 23(a) and Rule 23(b)(3). They also claimed that it would be impractical to require each bondholder who wants to litigate a claim to file a separate lawsuit and that the class action mechanism is a superior means of resolving the claims of Argentine creditors. Lastly, they claimed that the class representatives' claims were typical of the claims of the absent class members and that they, and class counsel, would adequately protect the interests of absent class members.

On May 12 2003, Judge Thomas Griesa issued opinions in both class action cases, denying the class certification motions. In the *Applestein* class, the court, relying on Rule 23(b)(3)(D), held that the proposed class action "is not a reasonably manageable class action". The court reasoned that the proposed class was "an amorphous, ill-defined class". The court was also mindful of the fact that it would be difficult, if not impossible, for Argentina to know which of its bondholders would be possible members of the proposed class and therefore that Argentina would have a difficult time ascertaining which of its bondholders chose to be involved in the debt restructuring process as opposed to pursuing litigation.

For the *Urban* class, the court similarly relied on Federal Rule 23(b)(3)(D), saying the class was also "not a reasonably manageable class action". The court reasoned that the bonds that were the subject of the *Urban* class were issued under an undefined number of contractual documents, many of which were governed by the laws of different countries. The court noted that there had been "no showing as to why, in terms of an identify or concurrence of interest, that class should consist of the holders of 30 series of bonds or the holders of 68 series of bonds or the holders of some still larger aggregation of bonds". The court concluded that "the proposed class is too large, too diverse, and too vaguely defined to be the basis for a manageable class action". In each case, the court provided the class representatives an opportunity to amend their complaints to pursue individual lawsuits.

The proposed classes in each of these cases were ill-defined and would have been unmanageable. For these reasons alone, a denial of class certification was appropriate. However, Judge Griesa's decision could have been premised on several other grounds. If one were considering the utility of class action device against the larger background of sovereign debt defaults and restructuring negotiations, there are a series of other considerations on which one might focus.

## Communication breakdown

As expressed by Argentina in its opposition brief, certification of a class consisting of thousands of bondholders worldwide could have undesirable consequences on communications between sovereign debtors and their creditors. In the non-class action setting, the general rule is that counsel are prohibited from communicating with represented parties in the absence of consent from counsel representing the party, but that parties are allowed to communicate freely with each other about matters at issue in the lawsuit. By contrast, courts in the class action context do not favour "[u]nsupervised, unilateral communications with the plaintiff class" because such communications have the potential of sabotaging "the goal of informed consent by urging exclusion on the basis of a one-sided presentation of the facts, without opportunity for rebuttal".

Moreover, once a class has been certified, counsel for a defendant in a class action cannot directly, or indirectly through its client, communicate with absent class members for the purposes of encouraging them to opt out of the proposed class (see for example *Gulf Oil v Bernard* and *Kleiner v First National Bank of Atlanta*.) Lastly, defendants in a class action proceeding cannot communicate with potential class members if those communications are misleading, coercive, or a deliberate attempt to solicit potential class members to opt out of a proposed class (see *Gulf Oil v Bernard*).

Given these restrictions on communications with class members and the uncertainty as to whether one would violate these restrictions when communicating with class members about a voluntary restructuring process, sovereign debtors may take the position that they are not free to communicate with class members after a class has been certified and before those class members file opt-out forms. In fact, that is the precise position that Argentina took in the class action cases pending in New York. It takes little imagination to envision the ways in which such an impediment to communications between a sovereign debtor and its creditors would hinder efforts to organize and negotiate a restructuring plan. Transparent and continuous dialogue between a sovereign debtor and its creditors is a desirable element of reaching a fair and equitable voluntary restructuring. Thus, a prohibition on communications between a sovereign debtor that is a defendant in a class action proceeding and its creditors which are putative class members suggests class actions are not a superior means to resolve the claims of creditors in the sovereign debt context.

## Judgments not binding

One of the premises behind class actions is that the claims of all class members will be fully and finally resolved by the class action such

## The class action mechanism

A class action is a representative suit brought by a small subset of the members of the proposed class on behalf of a large number of claimants affected by some conduct that the plaintiffs claim is attributable to the defendant. The theory behind the class action mechanism is that it is not practical or realistic to join all of the members of the proposed class in the class action lawsuit. In fact, most members of the class do not participate in the class action proceeding. Instead, the named plaintiffs and their counsel adjudicate the claims set out in the class complaint on behalf of the absent members of the class. Assuming that the requirements of Federal Rule of Civil Procedure 23 are met, the absent class members are bound by the adjudication of common issues of law and fact in the class action case and are, generally speaking, barred from re-litigating those issues in a subsequent suit.

To qualify for class action treatment, all of the requirements of Federal Rule of Civil Procedure 23(a) must be met. Specifically, class representatives must prove that: 1) The class is so numerous that joinder of all members is impractical; 2) there are questions of law or fact common to the class; 3) the claims or defences of the representative parties are typical of the claims or defences of the class; and 4) the representative parties will fairly and adequately protect the interests of the class. In addition to meeting the requirements of Rule 23(a), a case seeking to be certified as a class action must also meet the requirements of Federal Rule of Civil Procedure 23(b).

The first and second provisions of Rule 23(b) deal with mandatory class actions. These are class actions in which all members of the class must participate in the class action. Rule 23(b)(1)(B), for example, is designed in part to address situations where members of a putative class are suing a defendant who lacks the funds to satisfy the claims of all potential class members. The theory behind advancing class action treatment in these circumstances, referred to as a limited fund class, is that an adjudication of the claims of one or more class members will necessarily have an adverse effect on the interests of members of the class who do not participate in the lawsuit given the lack of funds available to satisfy the claims of all potential class members. Thus, Rule 23(b)(1)(B) provides a mechanism creating a mandatory class in which all members of the class are required to participate in the case, and the class representatives seek to settle the claims of the class as a whole (see, for example, *Dickinson v Burnham*, 197 F2d 973 (2d Cir 1952), cert denied, 344 US 875 (1952).

Rule 23(b)(3), on the other hand, does not require all members of a class to participate in the class action, but rather requires that notice be given to all potential class members to provide them with an opportunity to opt out of the proposed class action. The member who elects to opt out of the class action is not bound by any settlement or class action judgment, nor can they participate in receiving any benefits obtained by the class representatives. As well as proving the Rule 23(a) requirements, a class representative seeking class treatment under Rule 23(b)(3) must prove that questions of law or fact common to the members of the class predominate over any questions affecting the individual class members, and that bringing the case as a class action is the superior manner in which to resolve the claim of the class members. In assessing this, Rule 23(b)(3) says that the following points may be pertinent: a) The interest of members of the class in individually controlling the prosecution or defence of separate actions; b) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; c) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; d) the difficulties likely to be encountered in the management of a class action.

**The typical course of a Rule 23(b)(3) class action case**

In a typical Rule 23(b)(3) class action, after the complaint is filed, the parties engage in discovery and briefing on the question of whether a class should be certified, including whether the requirements of Rule 23(a) and 23(b)(3) are met. This process usually involves months of written discovery and depositions followed by a briefing period and then argument before the court on whether a class action is the appropriate mechanism for resolving the claims of putative class members. The court has broad discretion in deciding whether to certify the class and has the power to reshape the class by, for example, limiting the size and scope of the potential class.

Once a Rule 23(b)(3) class has been certified, the parties proceed with merits discovery and then to settlement or to trial. In a Rule 23(b)(3) case, the court "shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members that can be identified through reasonable effort" (see also *Eisen v Carlisle & Jacquelin*, 417 US 156, 173 (1974)). Class members whose identity or location cannot be ascertained through reasonable efforts may be given notice by publication. Exactly when and how often notice is given is determined by the court. The notice procedure is very important because proving that adequate notice was given to the potential class will be paramount in protecting against collateral attacks on any class action settlement or judgment. The notice generally must apprise class members that they have the right to opt out of the class action by a certain date, that the class action judgment will bind all members of the class that do not request to be excluded from the class and that members who wish to participate in the class may appear through their own counsel. Depending on when the notice goes out, it may also advise absent class members about the details of any settlement reached or judgment obtained against the defendant.

The court must approve all class action settlements, usually after extensive hearings on the fairness of the proposed settlement. Absent class members are given notice so that they may have an opportunity to appear at the fairness hearings and lodge objections to the fairness of the proposed settlement. Following final judicial approval of the settlement, including all appeals, class members who have not opted out receive the benefits obtained through the class action case.

that a defendant in a class action may have some measure of certainty that it will not be subject to multiple, and possibly inconsistent, lawsuits by members of the class (see, for example, *Phillips Petroleum v Shutts*). While application of the full faith and credit clause of the US Constitution ensures that a class action judgment by a US court will have *res judicata* effect within the US, there is no similar guarantee that a foreign court will recognize such a judgment as binding upon it or the citizens of its country. Without some degree of certainty that foreign courts will honour a US court judgment, a class potentially consisting of foreign members should not be certified because this violates a defendant's reasonable expectation that it will not be hailed into foreign courts to relitigate issues already decided by a US court.

At least one court has denied class action treatment where proof was presented that the foreign courts in which the putative class members reside would likely not recognize as binding a class action judgment by a US court (in *Bersch v Drexel Firestone*). In a class action case where proof is presented that foreign courts will not honour the judgments of a US court, the court may well deny certification of a worldwide class. In such cases, one remedy that the court may use is to limit the scope of the class to persons who reside within the US. But such a limitation would also not be conducive to achieving equality of treatment among creditors and exposes the weakness of the class action device for sovereign debt cases.

## Secondary trading

Sovereign bonds trade on the secondary market. Maintaining the liquidity of sovereign debt and trading within the secondary market is crucial to fostering a voluntary restructuring. However, it is unclear how debt held by putative class members can be traded successfully in the secondary market once a class action has been certified. The same judge who declined to certify the Argentine class actions has ordered several individual claimants not to trade their bonds without permission from the court. Would such a limitation be placed on all class members? If so, what would be the impact on liquidity, prices and the debt restructuring process? Even if an injunction were imposed, sovereign bonds typically trade under a securities codes identified with a particular issue. How would the purchaser know whether he was getting good title?

## Settlement issues

Class action cases are, generally speaking, resolved through settlement. This is especially the case where there are insufficient assets available to satisfy a class judgment, as is normally the case when a sovereign defaults on its international debt obligations.

When settling the claims of sovereign creditors, such as the creditors of Argentina, the influences on a settlement are inherently political, economic and financial. For example, in determining the consideration that foreign creditors would receive in a voluntary restructuring, complicated questions such as the amount of outstanding public sector debt, the sustainability of debt, the comparability of treatment of several classes of debt and internal economic and fiscal concerns of the sovereign debtor, all play into the calculus. One must ask whether a single judge – who under US law is required to approve the fairness of class action settlements – is the appropriate decision-maker for the resolution of these inherently troubled questions of political economy.

As mentioned, the class action settlement must then be approved by the trial court, which enforces any violations of the settlement agreement through a judgment and a permanent injunction. Therefore, when members of a class or a defendant take some action that violates the class action judgment, parties normally seek enforcement of the court's judgment and injunction to obtain compliance with the terms of the settlement. The problem in the sovereign debt context is that it will be difficult, if not impossible, for a US court to enforce and police an injunction where most of the class members reside in other countries.

## Depleting limited resources

Class certification will only serve to substitute existing bond debt for a judgment that cannot be collected. Sovereigns, like Argentina, that declare moratoriums on their international debt obligations simply do not have available assets to satisfy a judgment worth tens of billions of dollars. In class actions, certain expenses and fees of counsel have priority. Accordingly, using the class action mechanism to resolve the claims of creditors only serves to divert some of the finite resources available to satisfy these claims to pay attorneys' fees for class counsel and the other expensive administrative costs associated with class certification such as class notice.

## Is there ever a role for class action?

Generally speaking, voluntary debt restructuring coupled with transparent and continuing dialogue between a sovereign debtor and its creditors is the best method by which to resolve the claims of the creditors of a defaulting sovereign. When that process works as it should, there is no need for a class action. However, notwithstanding some of the difficulties posed by class actions, if a negotiation ever failed to get started in the sovereign debt context because, for example, the creditors could not organize themselves or the sovereign absolutely refused to engage in a meaningful dialogue with its creditors, there might be a role for class actions as a means of catalyzing a negotiation between a sovereign and its creditors.

In such a context one might want to consider the benefits of using a Rule 23(b)(1)(B) limited fund class as opposed to a Rule 23(b)(3) class. The primary advantage of pursuing a Rule 23(b)(1)(B) limited fund class would be the ability to bind all class members to the negotiated settlement. Whether such a process could work given the complexities involved in the sovereign debt negotiating process is beyond the scope of this article. Moreover, such an approach would not resolve all the issues present in a sovereign debt restructuring. Questions of what debt should be included or excluded would still lurk, since not all claims on sovereigns are in the form of bonds. There would similarly still be a difficult political and economic calculus concerning how to generate the necessary primary surplus to pay bondholders. Accordingly, the mandatory class approach should only be seen as a catalyst, because it would not resolve the problem of insufficient assets to satisfy a class judgment.

Class actions are ultimately probably not a superior device for resolving sovereign debt crises, although they may be a technique that could help organize bondholders and bring sovereigns to the negotiating table. Overall, though, voluntary negotiations remain, as they have in years past, the core structure for resolving sovereign debt crises. ▮