

April 2015

FINANCIAL MARKETS LAW COMMITTEE

PARI PASSU CLAUSES

Analysis of the Role, Use and Meaning of Pari Passu Clauses in Sovereign Debt Obligations as a matter of English Law



www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

WORKING GROUP¹

Sir Robin Knowles CBE (Co-Chair)	Royal Courts of Justice
Professor Rodrigo Olivares-Caminal (Co-Chair)	Queen Mary University of London
Professor Emiliós Avgouleas	University of Edinburgh
Antony Beaves	Bank of England
Francis Fitzherbert-Brockholes	White & Case LLP
Andrew Gamble	Hogan Lovells LLP
Robert Gray	HSBC
Professor Rosa Lastra	Queen Mary University of London
Tom Pauk	Citigroup
Tolek Petch	Slaughter and May
Andrew Shutter	Cleary Gottlieb Steen & Hamilton LLP
Harriett Territt	Jones Day
Mark Trapnell	Freshfields Bruckhaus Deringer LLP
Deborah Zandstra	Clifford Chance LLP
Joanna Perkins	FMLC Chief Executive
Sherine El-Sayed	FMLC Project Secretary

¹ Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

TABLE OF CONTENTS

1.	INTRODUCTION AND EXECUTIVE SUMMARY	4
2.	THE CASE BEFORE THE US COURT OF APPEALS	5
3.	CONCLUSION	10

1. INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

- 1.1 The role of the Financial Markets Law Committee (“FMLC”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the financial markets which might give rise to material risks and to consider how such issues should be addressed. It is within this context that the FMLC has prepared this paper.
- 1.2 In March 2005, the FMLC published an analysis of the role, use and meaning of *pari passu* clauses in sovereign debt obligations as a matter of English law (“the FMLC 2005 Paper”).²
- 1.3 On 16 June 2014 the United States Supreme Court denied petitions for *writs of certiorari* in the case of *Argentina v NML Capital, Ltd. et al* (“the Argentina case”).³ In the court below, the United States Court of Appeals, Second Circuit (“the US Court of Appeals”), had offered an interpretation of a *pari passu* clause in the sovereign debt context.⁴ The following excerpt provides a brief summary of the circumstances giving rise to the litigation

Following its 2001 default on external debt payments, Argentina undertook two debt exchanges (in 2005 and 2010) that restructured approximately 93 percent of its external debt. Creditors holding the remainder of the defaulted bonds (the “holdout creditors”) did not participate in the exchanges. In 2011, a subset of the holdout creditors, led by NML Capital Ltd., with principal and past-due interest claims (now aggregating approximately US\$1.6 billion) filed an amended complaint against Argentina in the United States District Court for the Southern District of New York. They alleged that Argentina had violated the *pari passu* clause in the defaulted bonds

² “Role, Use and Meaning of *Pari Passu* Clauses in Sovereign Debt Obligations as a matter of English Law”, Financial Markets Law Committee (“FMLC”), 14 August 2014 <http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_memo_randum_on_pari_passu_clauses.pdf>.

³ See Supreme Court decision in *Republic of Argentina v NML Capital, Ltd.*, No.13-900.

⁴ See *NML Capital, Ltd., v Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012) (referred to thereafter as “the US Court of Appeals Decision”) and *NML Capital, Ltd., v Republic of Argentina*, 727 F.3d 230 (2 Cir. 2013).

and sought specific performance of the clause, which they characterized as an equal treatment clause.⁵

- 1.4 Following a request from representatives of the International Monetary Fund (“IMF”), the FMLC published a short memorandum (“the 2014 FMLC Memorandum”) on the interpretation of *pari passu* clauses in July 2014.⁶

Executive Summary

- 1.5 This paper expands on the interim findings set out in the 2014 FMLC Memorandum. The FMLC confirms the conclusion that the views expressed in the FMLC 2005 Paper hold good today in English law. The views are not changed by the decision of the US Court of Appeals or by the argument or analysis recorded in that decision.
- 1.6 The FMLC also reaffirms the view that the English Courts would likely take an approach to the grant of remedies different from the approach taken by the US Courts in the Argentina case, and in particular would likely regard the remedy of specific performance as unsuitable.

2. THE CASE BEFORE THE US COURT OF APPEALS

- 2.1 The *pari passu* clause considered by the US Court of Appeals was in these terms:

[t]he Securities will constitute ... direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank *pari passu* without any 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 ...⁷

⁵ See International Monetary Fund (“IMF”) staff paper entitled “Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring”, published in October 2014, p.8, Box 1. The paper can be accessed here <<http://www.imf.org/external/np/pp/eng/2014/090214.pdf>>.

⁶ The 2014 FMLC Memorandum is available at <http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_memorandum_on_pari_passu_clauses.pdf>. The FMLC also prepared a memorandum on the enforceability under English law of an aggregated single-limb “collective action clause” (“CAC”), with regards to the issuance of sovereign debt. It later published a paper providing further analysis on this issue, which can be accessed here <http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_memorandum_on_pari_passu_clauses.pdf>. The IMF staff paper (*ibid.*) refers to the FMLC’s work on collective action clauses and on the interpretation of *pari passu* clauses.

⁷ Defined as obligations payable in non-Argentine currency. The Republic of Argentina issued bonds through a 1994 Fiscal Agreement. See p.5 of the US Court of Appeals Decision.

- 2.2 The clause appeared in a contract governed by New York law and providing for jurisdiction in any state or federal court in the City of New York.
- 2.3 Addressing the first sentence of the clause, the US Court of Appeals considered that:

[a] combination of Argentina’s executive declarations and legislative enactments have ensured that the plaintiff’s beneficial interests do not remain direct, unconditional, unsecured and unsubordinated obligations of the Republic.⁸

Addressing the second sentence of the clause, the US Court of Appeals considered that it prohibited Argentina “as bond *payor*, from paying”⁹ on one class of bonds without paying on another class.¹⁰

“Payment” or “Ranking” Interpretation

- 2.4 As the FMLC 2005 Paper summarises, the argument centres on whether a *pari passu* clause bears a “ranking” interpretation or a “payment” interpretation. A “ranking” interpretation would hold that the purpose of the clause as a

statement, sanctioned by an event of default, as to equal ranking as a matter of law so that the creditors were assured that on competition between creditors there was no mandatory provision for unequal payment.

The “payment” interpretation would hold

that the clause in effect requires that, once the debtor is actually insolvent, the debtor will in fact pay all its claims *pro rata* and could thus be prevented from paying one creditor in full if the obligations concerned went unpaid.¹¹

- 2.5 The US Court of Appeals interpreted the *pari passu* clause in such a way that would prevent Argentina paying its claims other than *pro rata*, as between its creditors. The decision of the US Court of Appeals is not the first time that a “payment” interpretation

⁸ See p.11 [5] of the US Court of Appeals Decision.

⁹ Original emphasis.

¹⁰ See p.10 [5] of the US Court of Appeals Decision.

¹¹ See para 1.2 of the FMLC 2005 Paper.

of a *pari passu* clause has been accepted by a court. It was partly in light of the acceptance of such an interpretation by the Cour d'Appel de Bruxelles¹² in relation to Peruvian indebtedness that the FMLC considered that an analysis should be undertaken of the position under English law, leading to the FMLC 2005 Paper.¹³ In the litigation in Belgium over Peruvian indebtedness, as in the Argentina Case before the US Court of Appeals, the argument by some creditors was that

the *pari passu* clause contained in that debt should prevent the sovereign debtor from making payments to other creditors without at the same time paying the litigating creditors on a pro rata basis.¹⁴

- 2.6 The first and second sentences of the clause before the US Court of Appeals expressly address “ranking”. The argument of the plaintiffs was that there was “de facto subordination” by contrast with “legal subordination” or “formal subordination”.¹⁵ The argument treats not being paid as being reduced in rank; it treats “ranking” and “payment” as the same. Addressing the position, however, of a contract governed by English Law, the FMLC 2005 Paper explained clearly that “ranking” and “paying” are not the same.
- 2.7 It may be material that when later dealing with remedies the US Court of Appeals found itself referring to the contractual obligations of Argentina being “not to *alter the rank* of its payment obligations”.¹⁶

No Sovereign Bankruptcy Proceedings

- 2.8 In support of its conclusion, the US Court of Appeals drew attention to a point raised by some commentators:

[w]hen sovereigns default they do not enter bankruptcy proceedings where the legal rank of debt determines the order in which creditors

¹² See *Elliott Assocs. LP* Unreported September 26, 2000, General Docket No.2000/QR/92., Court of Appeal of Brussels, 8th Chamber.

¹³ It should be noted that the case before the Belgian court does not seem to have been fully argued; it was an *ex parte* motion on a preliminary injunction.

¹⁴ See paragraph 1.1 of the FMLC 2005 Paper.

¹⁵ See p.10 [5] of the US Court of Appeals Decision.

¹⁶ See p.12 [16] of US Court of Appeals Decision (emphasis is added).

will be paid. Instead, sovereigns can choose for themselves the order in which creditors will be paid.¹⁷

2.9 This point was identified and considered in the FMLC 2005 Paper.¹⁸ The FMLC 2005 Paper concluded that it was answered under English law for two reasons in particular.¹⁹

2.10 First, the language used in *pari passu* clauses (including principal variations) favoured the “ranking” interpretation.²⁰ Second, the consequences of the “payment” interpretation would be unworkable and offend the “business common sense” principle used by English courts when construing a contract.²¹

2.11 Amplifying the second reason, the FMLC 2005 Paper said:²²

In particular, it would lead to the result that once the debtor actually became insolvent the debtor would not be able to make any ordinary course of business payments necessary to enable the debtor to maintain its business. Hold-out creditors in pursuit of a bargaining position against other creditors could prevent payments and bring the business to a premature halt. An action of this type could be used to seriously disrupt payment systems through which the debtor made its payments and securities settlement systems through which the debtor paid for investments. Hence if the payment interpretation were correct, the *pari passu* clause would be prejudicial not only to debtors but also to creditors by making it impracticable for all creditors to sustain the debtor’s business if only one of them objected.

2.12 The US Court of Appeals—admittedly not looking at the matter under English law—did not examine this reasoning. In particular it did not show how the consequences of the “payment” interpretation would be workable.

¹⁷ See p.10 [5] of the US Court of Appeals Decision.

¹⁸ See para 2.3(ii) of the FMLC 2005 Paper.

¹⁹ A third point was the persuasive authority against the payment interpretation provided by an analysis of English case law: see para 1.2 of the FMLC 2005 Paper.

²⁰ See para 2.4 of the FMLC 2005 Paper.

²¹ See para 1.2 and section 3 of the FMLC 2005 Paper.

²² See para 1.2 of the FMLC 2005 Paper.

The Lock Law Enacted by the Republic of Argentina

- 2.13 In the case before the US Court of Appeals, within the “combination of Argentina’s executive declarations and legislative enactments” that—the US Court of Appeals concluded—had ensured that “the plaintiffs’ beneficial interests *do not* remain direct, unconditional, unsecured and unsubordinated obligations of the Republic”, was the passing of legislation known as the “Lock Law”.²³
- 2.14 The purpose of the Lock Law was described by the US Court of Appeals as being “to exert additional pressure on bondholders to accept [an] exchange offer”. The Lock Law declared that Argentina’s executive was not to reopen the exchange process offered for original bonds, that Argentina was prohibited from conducting any type of settlement with respect to the original bonds where exchange bonds had not been accepted, and required Argentina’s executive to remove the bonds from listing on all domestic and foreign securities markets and exchanges.
- 2.15 As the FMLC 2005 Paper acknowledged, the “ranking” interpretation has been understood as having the purpose of preventing sovereigns

from “earmarking” revenues of the government or allocating foreign currency reserves to a single creditor or, more generally, to prevent the sovereign from adopting legal measures which have the effect of preferring one set of creditors against the others.²⁴

The point was resummarised as follows:

In other words, although a sovereign cannot be subjected to a formal bankruptcy regime, it can promise not to pass a law that would legitimise a preference given to one unsecured creditor over another.

- 2.16 In contrast, to the extent that the essence of the plaintiff’s case is that paying others ahead (rather than the passing of the Lock Law) was in breach of the clause, the Lock Law itself brings the plaintiff no closer to success and the plaintiff’s claim must establish a payment interpretation to succeed.

²³ See p.11 [6] of US Court of Appeals Decision. Argentina’s Law No. 26.017, 10 February 2005 (promulgated on 10 February 2005).

²⁴ The ranking interpretation is also aimed at preventing a unilateral subordination of other creditors by means of obtaining a better right as was available in Spain and still is in the Philippines (Article 2244(14) of the Civil Code).

Relief or Remedy

- 2.17 The US court at first instance in the Argentina case granted injunctions requiring specific performance by Argentina of the *pari passu* clause (with a “payment” interpretation). The US Court of Appeals declined to interfere, save to require further consideration by the court at first instance of the application of the injunctions to third parties including intermediary banks.
- 2.18 The intended effect of the injunctions was to prevent Argentina paying others unless it also made a rateable payment to the plaintiffs.²⁵ The United States itself submitted an amicus brief to contend that this would have the practical effect of enabling “hold-out” litigation. The US Court of Appeals was not persuaded but found itself identifying collective action clauses as the means by which “hold-out” litigation would be “effectively eliminate[d]”, and indicating that it could make a difference whether bonds were or were not governed by New York law (identifying Greece as an issuer whose bonds were not so governed).
- 2.19 Acceptance of a “payment” interpretation involves acceptance that the focus of the clause is the payment of money. Given that footing, it is hard to accept that any form of remedy could be more adequate or just, as a form of remedy, than a money judgment. In this connection the contract also allowed for acceleration.
- 2.20 The problem for the plaintiff lies instead with the execution of a money judgment, in the context of the sovereign personality of the debtor and the availability of sovereign property. No English law precedent has been identified that shows the use of specific performance to help a plaintiff overcome this problem. The unworkable and uncommercial consequences which tell so powerfully against the “payment” interpretation of the clause in the first place (summarised at paragraph 2.10 above) tell powerfully against the English Courts being prepared, in their discretion, to grant injunctions requiring those consequences.

3. CONCLUSION

- 3.1 The FMLC affirms its conclusion in the FMLC 2014 Memorandum that the views expressed in the FMLC 2005 Paper hold good today in English law. The views are not

²⁵ Rateable payment in view of the US Courts means that each time that Argentina pays an outstanding interest on the Exchange Bonds in full it also has to pay all the principal of and interest on the 1994 Fiscal Agency Agreement owing to bondholders who hold out.

changed by the decision of the US Court of Appeals or by the argument or analysis recorded in that decision.

- 3.2 The FMLC also affirms the view expressed in the FMLC 2014 Memorandum that the English Courts would likely take a different approach in relation to remedies from the approach taken by the US Court of Appeals in the Argentina case and, in particular, would likely not order the remedy of specific performance.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS²⁶

Lord Walker (Chairman)

David Greenwald (Deputy-Chairman)

Andrew Bagley, Goldman Sachs International

Charles Barter, Bridgepoint

Sir William Blair

Hubert de Vauplane, Kramer Levin Naftalis & Frankel LLP

Simon Dodds, Deutsche Bank AG

Michael Duncan, Allen & Overy LLP

Simon Firth, Linklaters LLP

Bradley J Gans, Citigroup

Kate Gibbons, Clifford Chance LLP

Richard Gray, HSBC Bank plc

Wim Hautekiet, Bank of New York Mellon SA/NV

Mark Kalderon, Freshfields Bruckhaus Deringer LLP

Sir Robin Knowles CBE

Piers Le Marchant, JPMorgan Chase Bank, N.A.

Sean Martin, Financial Conduct Authority

Jon May, Marshall Wace LLP

Sean McGovern, Lloyd's of London

Chris Newby, AIG

Graham Nicholson, Bank of England

Stephen Parker, HM Treasury

Sanjev Warna-kula-suriya, Slaughter and May

Geoffrey Yeowart, Hogan Lovells International LLP

Antony Zacaroli QC

²⁶

Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.