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NML v. Argentina – Final Proof of a Glaring Imperfection of International Capital Markets

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Recently, injunctions by a Federal Judge in New York have rocked international capital markets for sovereign debts. Whatever the outcome, Griesa's decisions are going to change sovereign lending practices.

It is useful to recall first that domestic equivalents of so-called "vulture funds" exist in practically all jurisdictions. Doubtful claims are sold well below par to firms specialised on collecting debts and trying to get full payment every day around the globe. Usually, this is seen as a useful way for creditors to get rid of doubtful claims and to recoup at least some money. In contrast to sovereign debts, though, all jurisdictions also have debtor protection in place, be it consumer protection offices or insolvency as a means to give overburdened debtors a fresh start. Although already advocated by Adam Smith as the optimal solution, insolvency continues to be denied to sovereigns. Therefore, an incentive for professional houldouts, or "vulture" behaviour, exists unlike in the case of domestic debtors. Legal changes, such as the abolition of champerty defence, have further strengthened this incentive. New York changed the law in favour of professional holdouts. The important and apparently overlooked point is that "vultures" are only able to fly because some OECD-countries and courts allow them to do so. It is extremely interesting that those campaigning against "vultures" turn a blind eye to actions of courts or legislators within creditor states. Apparently, "vultures" seem morally more rewarding targets. In any case, the "vulture" debate casts a convenient veil over the real problem of global inequality: the fact that Southern debtors and their people are denied basic rights by Northern official creditors, remaining the only type of debtor still denied insolvency protection.

On the other hand, enforcement against sovereigns is practically impossible. Getting an executory title is easy once immunity has been waived, getting the money from an unwilling sovereign is virtually impossible. Judge Griesa's decisions are seen as changing this fundamentally. As Argentina cannot be made pay what she does not want to pay, Griesa decided to take other creditors hostages, infringing on their property rights.

The facts are simple: Argentina's contracts do not have Collective Action Clauses (CACs), although these were known when contracts were signed. Technically, Argentina violated clauses she had voluntarily accepted – but without a sovereign insolvency mechanism, she had no other choice, a second best solution. It may be seen as optimisation under constraints. Griesa re-interpreted the pari passu clause in a totally unusual and apparently wrong way, an interpretation a different formulation of the clause, if chosen, could easily have excluded. Pari passu means equal rank. If equal payment had been wanted, a most favoured debt clause would have been stipulated. If "the parties meant to require a debtor to pay equally instead of representing that payments would rank equally, then they would say so and also draft a conventional most favoured debt clause" [1]. This was not done. Obviously, the contracting parties themselves did not want the clause interpreted in the way Griesa did. Treating all claims as of the same rank as well as paying equally are obligations of the debtor, not of other creditors.

Consequences immediately followed. Taiwan sued Grenada, Italy changed her debt contracts. The position of sovereign debtors that stipulated US law has worsened.

In her document seeking to institute proceedings against the United States at the International Court of Justice, Argentina objected to Griesa's decisions on several grounds. As the money deposited at the trustee was already the property of creditors, Griesa infringed on their property rights. Apparently, Griesa is aware that the money is no longer Argentina's; otherwise he would simply have had it seized, which he did not. Argentine money could be seized in order to pay hold-outs. His injunction thus is apparently a taking as prohibited by the 5th Amendment to the US Constitution, as it impairs the property of legitimate and bona fide creditors. In addition, by extending his injunction to entities outside the US he violated international law that prohibits extraterritoriality.

Griesa also ordered Argentina to do the impossible. The plaintiffs could be paid, but if she paid these holdouts, other holdouts would follow suit (some are already seeking the same injunctive relief), and the RUFO (Right upon Future Offers) clause would have forced her to treat exchange creditors equally, which means that all pre-exchange debts were also to be paid in full. Argentina would be insolvent again, thus unable to pay anyone fully. Probably Griesa was not aware of this clause or of mathematical operations (no requirement for federal judges), as he was not aware that quite a few bonds were not under New York jurisdiction. The New York Times (24 July 2014) reported that the judge "did not know much about those Argentine-law bonds", or more bluntly: "This week's hearing made clear that he had not completely understood the bond transactions that he had been ruling on for years." This explains his back and forth strategy, deciding on Citibank's Argentine subsidiary. The New York Times concluded: "It was not bad theater, but it hardly inspired confidence in the American legal system." It added that these issues had been pointed out in many legal briefs and arguments filed in this case, but that those arguments seem not to have been registered. A judge still not familiar with important facts of what he is judging on after more than a decade and unable or unwilling to read information submitted, forecloses due process and violates the most basic principles of procedural justice.

Argentina also argued that judge and court-appointed mediator were biased. Gelpern offers an explanation for Griesa's decisions: "Perhaps more importantly, a decade of judging Argentina left Judge Griesa thoroughly fed up. Something had to be done lest US courts look feckless" [2]. While one can understand the frustration of a judge caused by the fact that enforcement against a sovereign is impossible (which he should have known beforehand), especially so if public statements are

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being made during proceedings that the court's decisions would not be respected, a judge's frustration must not determine his decisions - nor, of course, his limited knowledge of facts.

Griesa went one step further by ordering all banks – world wide – to reveal Argentina's assets, another highly problematic decision. As Argentina followed the conditions of its Trust Indenture (Article 3) meticulously, paying as stipulated, one also has to discuss whether Argentina actually defaulted. The money was paid to an account held in trust for holders of debt securities – any other conduct would have been a breach of contract, thus clearly a default.

In spite of present busy discussions, repercussions on international capital markets are likely to be short-lived – and for all but the US, relatively small. By simply no longer stipulating New York jurisdiction, the problem is solved. In Britain for instance courts decided in Kensington International v Congo that third parties (other creditors) must not be taken hostage. The UK, Belgium and Jersey, e.g., have laws curtailing "vulture" activities. The power of the US government to influence court decisions (in whichever way) or courts specifically naming US interest in maintaining New York's status as one of the foremost commercial centres in the world as one relevant reason for their judgement (as, but not only, in Allied Bank International v Banco Credito Agricola de Cartago) [3] would long ago have suggested avoiding a jurisdiction where anything other but norms of contract law may prevail. Griesa's attitude to international law and property rights just makes this problem clearer. Greece has underlined most articulately that creditors should better avoid the debtor's jurisdiction, but there are enough jurisdictions outside debtor countries and the US that are acceptable to creditors.

Reformulating pari passu clauses, so that no judge can avoid understanding them (even after presiding over a case for more than a decade), and always stipulating CACs are other quick fixes. Nevertheless, old bonds subject to New York law would be around for another decade. At the moment debtors can only offer exchanging these bonds for otherwise identical bonds in other jurisdictions. Obviously, this cannot be done in practice. The mere offer would trigger understandable suspicions that the debtor wants this exchange simply to be able to default soon more easily. Rightly, creditors would not accept it. Such offers can thus only be made after default, as Argentina has done. Then creditors are even likely to prefer getting paid in Buenos Aires to not getting their money – to which they have every right - at all. By the way, Argentina's local bond issue in September 2014 was oversubscribed according to Reuters. At least not everyone sees Argentina in default.

It is advisable to move banks acting as trustees away from the US too, and to choose banks without interest in the US. Any bank within the debtor (as now offered by Argentina) is unlikely to be accepted under normal circumstances. One would either have to search for an appropriate institution or establish a new bank. The Banco del Sur could serve as a trustee for sovereign debt service (after changing its statutes), but a new bank could be established in London, Singapore or Hong Kong that only serves as a trustee for sovereign debt service and could do business only outside the US. Without any business or subsidiary in the US, illegal, extraterritorial pressure could not be applied, which is demonstrably in the interest of bona fide creditors, whose property rights are being infringed by US courts in spite of the US Constitution.

Naturally, the need for a fair and workable sovereign insolvency mechanism would remain. A glaring gap in international debt relations must be closed. The UN Resolution calling for a multilateral legal framework for sovereign debt restructuring processes did not specify details. It is necessary to draw attention to the essential and indispensable features of any procedure one can rightly call insolvency, all the more so, as proposals definitely not meeting these minimum requirements have been propagated as such. The Raffer Proposal would satisfy these conditions [4]. Adapting US Chapter 9, Title 11 insolvency, it solves the problem of sovereignty and fairness to all affected, notably also private creditors. The recent past, e.g., the Greek haircut has shown this fair insolvency procedure would also be very much in the interest of bona fide private creditors that are increasingly discriminated against by the public sector. Meanwhile a fair sovereign insolvency procedure is as much a protection for bona fide creditors as for the insolvent sovereign and its people.

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