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Federal Reserve Bank of Chicago

**Interpreting the *Pari Passu* Clause
in Sovereign Bond Contracts:
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Interpreting the *Pari Passu* Clause in Sovereign Bond Contracts: It's All Hebrew (and Aramaic) to Me

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ABSTRACT

In this comment, we take a helicopter tour of the history of notions of “equality” and “justice” in sovereign debt restructuring in particular, and in the division of property more generally, and show that these concerns have existed for centuries, if not millennia. We argue that the issue at stake in the interpretation of the *pari passu* clause is not so much the treatment of holders of identical claims—it is now customary to treat them identically—but whether the holders of different claims should be treated differently. We show that exists a customary “principle of differentiation” that allows creditors with claims that differ in specific ways to be treated preferentially. One of these specific differences concerns debts that have been reduced in value during a previous debt restructuring or default, and based on this principle we conclude that the New York court has, if not completely misinterpreted the meaning of the *pari passu* clause, then at least misapplied it.

Keywords: Sovereign debt restructuring, *pari passu*, Argentina, inter-creditor equity.

JEL Codes: D63, F34, K12

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1 Introduction

Pari Passu: Nine letters arranged into four syllables constituting two little Latin words that translate roughly as “on equal footing”; Two little words that may have a giant effect on international capital markets, for good or for ill. For depending on whom one believes, if the interpretation of the *pari passu* clause in sovereign bond contracts by a judge in the Southern District of New York¹ is allowed to stand, these words will wreak havoc in the market for sovereign debt—by causing Argentina to default², hindering future sovereign debt restructuring operations³, and leading sovereign bond issuers to abandon the New York markets⁴—or else act as its savior—by strengthening creditor rights and allowing for less risky sovereign borrowing at lower interest rates.⁵

At issue is both the interpretation of the clause—what it means to place creditors “on equal footing”—and its implications—particularly the application of injunctive relief to third parties. Viewed in this context, the contribution of Chabot and Gulati⁶ is to further our understanding of the meaning of the *pari passu* clause. They exhibit the first known bond to use language similar in meaning to *pari passu*: holders of the Mexican Black Eagle bonds, issued in 1843, were to be treated with a “just equality”. Moreover, in documenting the context for the issue of this bond, they show that the clause was introduced in response to a debt restructuring that treated holders of identical claims differently based on their country of residence. The implication is that the language was intended to ensure that holders of identical claims would be treated identically.

¹NML Capital Ltd. et al. v. Republic of Argentina, Nos. 08 Civ. 6978 (TPG), 09 Civ. 1707 (TPG), 09 Civ. 1708 (TPG) (S.D.N.Y. Nov. 11, 2012) and NML Capital Ltd. v. Republic of Argentina, Nos. 08 Civ. 6978 (TPG), 09 Civ. 1707 (TPG), 09 Civ. 1708 (TPG) (S.D.N.Y. Nov. 11, 2012). Excellent descriptions of the case can be found in Chabot and Gulati, in this volume, Gulati GM, Scott RE. 2011. *The Three and a Half Minute Transaction: Biolerplate and the Limits of Contract Design*, and in Gelpern A. 2013. Sovereign Damage Control. *Peterson Institute for International Economics Policy Brief* 13.

²Steven M. Davidoff, Argentina Takes Its Debt Case to the U.S. Supreme Court, *New York Times*, 25th February 2014.

³Felix Salmon, Argentina’s Stunning *Pari Passu* Loss, *Reuters*, October 27, 2013.

⁴Br. Of Joseph Stiglitz in Support of Petitioner in Republic of Argentina v. NML Capital, Ltd., No. 12 - 1494 (2d Cir. Jul. 26, 2013.)

⁵Hans Humes and Diego Ferro “Why Argentina’s Behavior Must Not Be Allowed to Stand”, *Financial Times Alphaville*, 2nd April 2013, and more generally Shleifer A. 2003. Will the Sovereign Debt Market Survive? *The American Economic Review* 93: 85-90 and Dooley MP. 2000. International Financial Architecture and Strategic Default: Can Output Losses Following International Financial Crises be Avoided. *Carnegie-Rochester Conference Series* 53: 361-77.

⁶“Santa Anna and his Black Eagle: The Origins of *Pari Passu*”, in this volume.

In these brief comments, we take a helicopter tour of the history of notions of “equality” and “justice” in the division of property and show that these concerns have existed for millennia. We argue that the issue at stake is not so much the treatment of holders of identical claims—it is now customary to treat them identically—but whether the holders of different claims should be treated differently. We show that there is a customary “principle of differentiation” that allows creditors with claims that differ in specific ways to be treated preferentially. One of these specific differences concerns debts that have been reduced in value during a previous debt restructuring or default, and based on this principle we conclude that the New York court has, if not completely misinterpreted the meaning of the *pari passu* clause, then at least misapplied it. In other words, the equality of treatment of both the un-restructured and restructured creditors of Argentina that the New York Courts are determined to enforce amounts to an *unjust* equality.

2 Justice, Equity, and Equality In The Division of Property From The Talmud to Today

Credit market participants widely recognize the importance of concerns for justice, equality and equity in sovereign debt restructuring as reflected in the social norm of “inter-creditor equity”⁷. Indeed, modern sovereign bond and syndicated loan contracts routinely include a number of clauses, in addition to *pari passu*, designed to ensure that inter-creditor equity is preserved. In bonds, these include *negative pledge* clauses to ensure a debtor will not subsequently pledge its assets to future creditors⁸, *mandatory prepayment* clauses requiring *pro rata* payments to all lenders in the event of a prepayment to any lender⁹, *cross-default* clauses allowing any lender to declare a loan in default should the debtor default on any other loan and so prevent early defaulting loans from receiving better terms¹⁰, and, in the case of syndicated sovereign loans, *sharing clauses* that explicitly ensured pro-rated payments in the

⁷The Republic of Argentina, Reply Brief of Defendant-Appellant, NML Capital Ltd., Aurelius Capital Master, Ltd., — v. — The Republic of Argentina, at 2-3.

⁸Lee C. Buchheit, Negative Pledge Clauses: The Games People Play, *International Financial Law Review*, July 1990, at 10.

⁹Gulati & Scott, *supra* note 1, at 76-7.

¹⁰*Ibid*, at 26

event of a default.¹¹

As documented by Chabot and Gulati, these concerns were very much active in the early Nineteenth Century as well. Santa Anna's decree of 11th May 1843 stated that it aimed to "establish a *just equality* amongst the creditors, as much as regards the rate of interest as the order of payment" (emphasis added). Moreover, the decree refers to an "equitable . . . distribution" of funds. Although not appearing as a contract provision in the "Black Eagle" bonds of 1843, similar language did appear in the pre-amble of these bonds.

But what does "just equality" mean in the context of a sovereign debt restructuring? What does "inter-creditor equity" mean? For that matter, what does it mean to promise to place creditors "on equal footing"? Does "equality" mean that all creditors should be paid the same absolute dollar (or Euro or peso etc.) amount regardless of the size and form of their claim? Or does it mean that they should receive a payment that represents an equal proportion of their claim? And if it is to be an equal proportion, what should it be proportional to? Should it be proportional to the face value of the debt? Or to the present value calculated using some discount rate? The market values prior to the default being announced? Or does "just equality" recognize that there should be some explicit differences in treatment allowed in order to account for differences in the underlying forms of a sovereign's debt?

If all creditor claims are identical, both in size and in form, all of these alternative definitions of "just equality" are identical. But creditor claims are rarely identical, differing in both size (the value of the claim) and form (the currency of issue, maturity, security, treatment in a previous debt restructuring, and so on).

Even in the simplest case, where the only difference is in the size of each creditor's claim, disagreements as to how to distribute shares of a property amongst rival claimants have been going on for, quite literally, millennia. Perhaps the best documented examples come from the Babylonian Talmud, written (in both Hebrew and Aramaic) between the 3rd and 5th Centuries of the Common Era. The Talmud contains several examples of the disposition of rival claims of different sizes to a common property.¹² In some cases, the Talmud

¹¹Lee C. Buchheit, Changing Bond Documentation: The Sharing Clause, *International Financial Law Review*, July 1998, at 17.

¹²Kethubot 93a, describes a bankruptcy problem; Bava Metzia (2a) concerns rival claims on a garment;

specifies that all creditors should receive an equal absolute amount independent of the size of their claim. In others, the creditors were to receive a payment that was proportional to the size of their claim. In still other cases, the payments are neither equal in absolute terms, or in proportion. Whether these differences reflect special circumstances applying to each claim that are not made explicit in the Talmud,¹³ or reflect a sophisticated game-theoretic mechanism for discriminating between claims,¹⁴ they illustrate the difficulties associated with finding “just” settlements.

By contrast, in the context of sovereign debt restructuring there appears to be widespread agreement on how to deal with claims that are similar in form but different in size: each creditor should receive an amount that is an equal proportional of their total claim. This form of “just equality” between identical creditors appears repeatedly throughout history, and violations of this principle have resulted in strong protests. In the Mexican Eagle case, it was not the default by Mexico that stimulated British diplomatic intervention and threats of military sanctions; rather it was the different treatment of British bondholders from other creditors with identical claims.¹⁵ When in 1934 Germany announced plans to suspend payments on its foreign loans, the US Secretary of State expressed regret at the losses inflicted upon American investors; it was only when Germany announced plans to discriminate against holders of the American tranches of the Dawes and Young loans that both the American Ambassador to Germany and the Secretary State wrote condemn the departure from “unconditional equality” and the violation of the *pari passu* clause.¹⁶ When the Dominican Republic swapped two similar bonds paying 4% interest into bonds paying different rates of interest in 1897, the (predominantly Belgian) bondholders that were to be discriminated against protested successfully.¹⁷

Similar cases, in which there were protests against discrimination between bondhold-

the Tosefta to Bava Metzia, Yevamot (38a), concerns an estate; see Aumann RJ. 2002. Game Theory in the Talmud. *Research Bulletin Series on Jewish Law and Economics* 2002 and Aumann RJ, Maschler M. 1985. Game-Theoretic Analysis of a Bankruptcy Problem from the Talmud. *Journal of Economic Theory* 36: 195-213.

¹³Shmuel and Rabbi Yaakov from Nekhar Pkod, in the Gemara, cited in Aumann Ibid.

¹⁴See Aumann RJ ibid, and Aumann and Maschler supra n.12.

¹⁵Chabot and Gulati, at 23.

¹⁶S.J. Kim *Pari Passu: The Nazi Gambit*, in this volume, at 4-5, 8-9

¹⁷Wynne WH. 1951. *State Insolvency and Foreign Bondholders: Selected Case Histories of Governmental Foreign Bond Defaults and Debt Readjustments*. New Haven, Connecticut: Yale University Press. at 222.

ers with similar claims, were sufficiently abundant that Borchard, in his ground-breaking analysis of sovereign insolvency in 1951, could state that there was a “principle of equality” across bondholders that applied to the resolution of sovereign defaults.¹⁸ But Borchard also went on to state that the “principle of equality ... does not signify uniformity of treatment”¹⁹ particularly when creditors’ claims took different forms. That is, there was a complementary “principle of differentiation”²⁰. The grounds for differentiation, and in particular discrimination in favor of particular types of bonds, included differences in the quality of the claim (such as the existence of a security interest)²¹, the purpose of the loan (for example, short term loans to fund international trade or the basic operations of the government of the country)²², and when the creditor was an international institution like the League of Nations or the International Monetary Fund.²³ Of particular interest for the current case involving Argentina, claims that had already been reduced in value as a result of a prior default were often given preference.²⁴

In summary, there exists a centuries-long social norm among participants in sovereign debt markets that holders of similar debts should be treated similarly, which is typically interpreted to mean that they should be repaid in proportion to their holdings of the debt (measured at face value plus deferred interest). There is also a social norm that creditors with different claims should, in many cases, be treated differently. In the next section, we ask what this means for sovereign debt disputes today.

3 What Does this Mean for Argentina and Other Sovereigns Today?

While the Black Eagle bond represents the first known statement of a principle of equality in the treatment of different creditors in the event of a sovereign default, it does not use the words *pari passu*. Chabot and Gulati argue that this “just equality” clause represents

¹⁸Borchard E. 1951. *State Insolvency and Foreign Bondholders: General Principles*. New Haven: Yale University Press. at 337.

¹⁹ibid at 337.

²⁰ibid at 340.

²¹ibid at 339, 341, 356-7.

²²Ibid at 346-50.

²³Ibid at 341; Diego Saravia “On the role and effects of IMF seniority” *Journal of International Money and Finance* 10/2010.

²⁴Borchard, n10 at 338-42, 357 n.62.

the spirit of (what they call the “concept” of) the *pari passu* clause. This argument is persuasive. The term “just equality” was introduced in response to protests against discriminatory treatment that explicitly used the language “equal footing”, and hence was likely viewed as synonymous by the bondholders at the time.²⁵ Moreover, the first known *pari passu* clause in a sovereign bond was introduced under very similar circumstances to the Black Eagle bonds. In the same way that the just equality clause was introduced in response to past discrimination between holders of identical claims on the basis of their nationality, the first known use of an explicit *pari passu* clause was by Bolivia in 1872, a time in which concerns about discrimination between bondholders of different nationalities were also high following the collapse of plans to create an international bondholder body, and the rise of competing national bondholder groups like the British Council of Foreign Bondholders in 1868 (to become the Corporation of Foreign Bondholders in 1873).²⁶

But as argued above, agreeing that the *pari passu* clause is intended to ensure a just equality between creditors would only appear to imply equal treatment of creditors that are holding identical (or at least very similar) claims. When creditors are holding distinctly different claims, discrimination appears to have been the rule. In the case of *NML v Argentina*, the plaintiffs are holding bonds that are in most cases identical to the ones previously held by the restructured creditors. The restructured creditors now hold bonds that are distinctly different, most importantly in the sense that they were reduced by almost 70% of their value. Treating these creditors “equally” based on their *ex post* (after restructuring) claims, as interpreted by the New York Court as implying equal proportionate payment, requires Argentina to pay in full the un-restructured claims of NML, while paying in full the much reduced claims of the restructured creditors. This is inconsistent with an *ex ante* (pre restructuring) “principle of equality”, as creditors with identical *ex ante* claims are being treated differently. Moreover, it is inconsistent with an *ex post* “principle of differentiation”, as it does not recognize the difference between the restructured and un-restructured debts and in particular violates the custom of treating previously restructured creditors preferentially.

²⁵The language was used by both the London Times and the Chairman of the Committee of Spanish American Bondholders. Chabot and Gulati at 23.

²⁶Gulati and Scott *supra* note 1, and Wright MLJ. 2011. The *Pari Passu* Clause in Sovereign Bond Contracts: Evolution or Intelligent Design? *Hofstra Law Review* 40: 103-14

By contrast, the Republic of Argentina’s offer to give NML the same settlement terms as it agreed with the restructured creditors satisfies both an *ex ante* “principle of equality” (as holders of identical claims *ex ante* are being given the same treatment) and an *ex post* “principle of differentiation” in that the previously restructured creditors are receiving the same amounts in absolute terms as NML, but are being awarded a higher (indeed, full) proportion of their *ex post* claims.

4 Concluding Thoughts

One response to the surprising interpretation of the *pari passu* clause offered by the New York Court is to advocate that sovereigns delete the clause from their sovereign bond contracts. However, unless the clause is replaced with a similar clause guaranteeing “just equality”, this is almost certainly a terrible idea. This is because there are at least two reasons to think that concerns for inter-creditor equity will only become increasingly important in the years ahead.

The first reason is the increasingly widespread adoption of aggregation clauses in sovereign bond contracts. First introduced by Uruguay,²⁷ aggregation clauses allow a super-majority of bondholders drawn from a set of potentially very different bonds to impose a restructuring on all bonds within the set. The Eurogroup has committed to introduce aggregation clauses into all Euro area bonds starting in 2013,²⁸ which might lead to their more widespread adoption by other countries. And although these clauses often also require a super-majority of the holders of each bond to approve a restructuring, Greece used legislation to retroactively insert an aggregation clause into its own domestic law bonds that did not include this protection for each bond (nor did these bonds include a *pari passu* clause). As a consequence, the possibility that a supermajority of bondholders might impose an inequitable restructuring on a minority of bondholders has become more likely.

The second reason is that there is already a precedent for the use of aggregation clauses to impose a highly discriminatory restructuring. The recent Greek debt restructuring, which made use of aggregation clauses, involved a large number of bonds with maturities ranging

²⁷Gulati and Scott *supra* note 1 at 169.

²⁸Press Release, Eurogroup, Eurogroup Statement on European Financial Stabilization 1-2 (Nov. 28, 2010), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118050.pdf.

from the very short term up to 45 years.²⁹ The bonds were mostly similar in form, except for differences in their maturity. Despite their similarity, the degree of discrimination across these bonds was extreme: the private holders of some short term bonds had their value reduced by almost 90 percent, while the private holders of some long-dated debts had their claims reduced in value by less than 20 percent.³⁰ And bonds held by some creditors, the European Central Bank, European national central banks, and the European Investment Bank, were not reduced in value at all despite being identical to bonds held by private creditors.³¹ This degree of discrimination appears to be unprecedented.³²

In summary, the evidence shows that concerns for inter-creditor equity or the “just equality” of treatment of creditors have been around for millennia and, in the case of sovereign borrowing, at least for centuries. Recent developments in sovereign debt markets suggest that these concerns may intensify in the future, emphasizing the importance of clarifying the meaning of the *pari passu* clause. In these notes, we have argued that this clause is only intended to ensure the identical treatment of creditors holding identical claims; when creditor claims differ, as they do in the Argentina case, creditors should be treated differently, and custom dictates that the restructured creditors should be treated preferentially. After all, had the drafters of the *pari passu* clause wanted to ensure ratable payments across all creditor claims, they could have substituted two other little Latin words—*pro rata*—for *pari passu*.³³

²⁹Zettelmeyer J, Trebesch C, Gulati GM. 2013. The Greek Debt Restructuring: An Autopsy. *Petersen Institute for International Economics Working Paper* 13 at 21.

³⁰*ibid* at 21.

³¹Although loans that originated from international organizations are typically treated preferentially, there is no known precedent for loans that originated from private sector creditors and that were subsequently acquired on secondary markets by international institutions to receive preferential treatment.

³²Zettelmeyer et al, *supra* note 29, n.27 at 21-2.

³³Indeed, some modern bonds specifically require ratable payment. See Tolek Petch “NML v. Argentina in an English Legal Setting” in this volume at 6.

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