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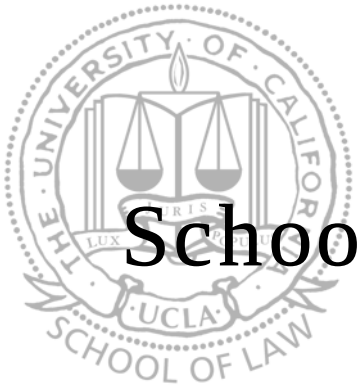
Sovereign Piracy

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By G. Mitu Gulati and Kenneth N. Klee*

INTRODUCTION

In October 1995, Peru announced its Brady Plan debt restructuring of guaranteed Banco de la Nacion and Banco Popular del Peru bank loans.[1] Approximately four months later, Elliott Associates, LP (Elliott), a well-known vulture fund, purchased nearly $20.7 million face amount of loans from two international banks for about $11.4 million.[2] The restructuring went forward with Elliott holding out. Instead, Elliott filed suit in New York against the bank and Peru demanding full payment on the bank loans and guaranty. In June 2000, Elliott obtained a judgment against Peru for $55.7 million.[3]

The problem for Elliott, however, was the standard problem that arises when a creditor sues a sovereign. Often, especially if the state is the debtor, there is little in the way of assets that can be attached.[4] Elliott's lawyers, however, came up with a creative solution. They intercepted and attached the payments that were about to be made to the other creditors, i.e., the ones who had agreed to the Brady Plan debt restructuring.

Elliott did two things to put this strategy into effect. First, it obtained a restraining order against The Chase Manhattan Bank in New York (Chase), the New York fiscal agent for the Brady bonds, after successfully arguing that the funds were still the property of Peru (Chase being the agent for the debtor).[5] This tactic was thwarted temporarily because Peru got word of

the order just in time to stop the transfer of funds to Chase. Elliott next sought *ex parte*, but did not get, an order from a Brussels Commercial court restraining Euroclear from either accepting money from Peru or paying it to the other creditors. Elliott quickly appealed *ex parte* to the Court of Appeals of Brussels, which issued the restraining order the next day.[6] By this time, Peru was getting close to defaulting on its Brady payments--the thirty-day grace period was close to ending--and it chose to settle by paying Elliott $56.3 million.[7]

Central to Elliott's victory in Brussels was its success in arguing that Peru was contractually barred from paying one group of creditors (here, the creditors who had agreed to the restructuring) before paying it (the holdout). The basis for the argument was a device called the *pari passu*[8] clause–a standard clause found in almost all sovereign bond indentures.[9] The clause typically states (as it did in this case) that the debtor represents and warrants that ``[t]he obligations of the Guarantor hereunder do rank and will rank at least *pari passu* in priority of payment with all other External Indebtedness of the Guarantor, and interest thereon.''[10] Professor Andreas Lowenfeld of New York University explained Elliott's argument in a declaration to the court.[11] Elliott argued that the meaning of the *pari passu* clause was clear.[12] What the clause says, according to Lowenfeld's opinion, is that if the debtor does not have enough money to pay its creditors in full,[13] they all have to be paid their pro rata shares.[14] The debtor is not allowed to pay one creditor in full and leave the others unpaid. In vivid, Tom-Dick-Harry terms, Lowenfeld explains:

A borrower from Tom, Dick, and Harry can't say ``I will pay Tom and Dick in full, and if there is anything left over I'll pay Harry.'' If there is not enough money to go around, the borrower faced with a *pari passu* provision must pay all three of them on the same basis:

> Suppose, for example, the total debt is $50,000 and the borrower has only $30,000 available. Tom lent $20,000 and Dick and Harry lent $15,000 each. The borrower must pay three fifths of the amount owed to each one--i.e., $12,000 to Tom, and $9,000 each to Dick and Harry. Of course the remaining sums would remain as obligations of the borrower. But if the borrower proposed to pay Tom $20,000 in full satisfaction, Dick $10,000 and Harry nothing, a court could and should issue an injunction at the behest of Harry. The injunction would run in the first instance against the borrower, but I believe (putting jurisdictional considerations aside) to Tom and Dick as well.[15]

At a first cut, the Lowenfeld position may make sense to some. After all, the *pari passu* clause explicitly states that creditors are to rank equally in priority of payments. Ranking equally must mean that, if there is not enough money, all the *pari passu* creditors get paid pro rata out of whatever funds are available. Our contention, however, is that one does not have to dig deep into the context of sovereign borrowing and the guaranty documents to realize that the above articulation is not quite so clear. For one, whatever else the *pari passu* clause may mean, ``it does not force the solvent borrower to make pro rata payments to all its creditors.''[16] Moreover, we do not think it clear at all that the clause means that a sovereign that has

inadequate funds to pay all its creditors is required to pay all of its creditors ratably.

Prior to the issuance of the Brussels opinion, the problem of holdouts was considered to be one of the primary barriers to orderly sovereign debt restructurings and, hence, one of the sources of global financial instability causing the need for bailouts and the sort.[17] What the Brussels decision does is to put a large hammer in the hands of holdout creditors,[18] thereby enabling them to cause even more disruption in restructurings. Those inclined to be holdouts have a stronger position, and it encourages others to hold out. For the sovereigns and, we argue, for the majority of creditors, this is a nightmarish situation. The result is likely to be that the *threat* of Elliott and its brethren being able to attach payment streams to creditors will force sovereigns in distress to turn to more extreme forms of renegotiation. This might include exit consent offers that would amend the terms of bonds held by the holdouts to prevent such disruptions.[19]

The Brussels court made its interpretation on the basis of an *ex parte* motion by Elliott.[20] Had Peru had an opportunity to respond, we think that the court would not have leapt quite so easily to its conclusion. The court did not reference the market understanding of the standard *pari passu* clause. It concluded that the clause meant something different than the market understanding. The danger now is that some later court will look to the Brussels court's interpretation and hold that as the standard interpretation. Our purpose is to argue that the Brussels court's interpretation was wrong and should be disregarded. Elliott managed to extract

one windfall, but things should stop there.

This Article proceeds in four parts. First, this Article explains why, from an *ex ante* bargaining perspective, sovereign debtors would be loathe to agree to *pari passu* clauses with the interpretation given by the Brussels court. Next, the Article looks to the literature and case law construing sovereign and corporate debt and demonstrates why the Brussels interpretation is wrong, results in a windfall to holdout creditors, and harms the majority of other creditors. The Article then discusses New York bond interpretation law and the need for the Brussels interpretation to be challenged. Finally, a brief conclusion is provided.

NEGOTIATING THE *PARI PASSU* CLAUSE

The thrust of Lowenfeld's argument on the meaning of the *pari passu* clause is twofold. First, Lowenfeld argues that the clause is clear and unambiguous.[21] Second, he argues that the clear meaning is all payments on all the debts that are ranked *pari passu* must be made pro rata.[22] There is some superficial appeal to his interpretation. After all, for a creditor, what else does ``ranked equally'' mean other than being paid on a pro rata basis? In other words, what would be the point of being ``ranked'' equally if that did not mean that one was going to be ``paid'' pro rata along with everyone else at the same rank? The above interpretation of this *standard* term is not so obvious. Indeed, the above interpretation is precisely what the clause does *not* mean. Debtors, and especially sovereign debtors, would be crazy to agree to such a term with all of their creditors. To the extent that sovereigns do agree to give creditors the *pari passu* payment rights--

rights that the Brussels court held that they already have under the *pari passu* clause[23]--this is likely to result in a lower interest coupon for the creditors who receive it, to be granted only after hard negotiations, and to be given to only a few creditors.

The first question is that if the *pari passu* clause does not mean what Lowenfeld says it means, what does it mean? After all, the thrust of Lowenfeld's argument seems to be that it *must* mean pro rata payment. The purpose of this clause,[24] however, is to ensure that the borrower does not have, nor will it subsequently create, a class of creditors whose claims will rank senior in priority to the lending claims of the current creditors.[25] In the corporate debt context, this means that no other lender will enjoy a priority in a liquidation distribution of the borrower's assets.[26]

In the sovereign debt context, where there is no liquidation, the *pari passu* clause works as a covenant by the borrower that it will not bestow a legally senior priority status on certain lenders.[27] This protects against the temptation for the sovereign to enact laws affecting the legal ranking of creditors.[28] ``Ranking'' *pari passu*, therefore, is about insolvency payouts (in the corporate context) or about the alteration of payment priorities by law (in the sovereign context).[29] It is an equal ranking, but it applies to specific contexts.[30] The point here is that there is a well-established, alternate ``clear'' interpretation of the clause.

Providing an alternate and milder interpretation for the clause does not by itself mean that this interpretation trumps the one given by the Brussels court. Why would all lenders not also want to be paid pro rata and, therefore, negotiate for that additional right? The answer lies in the

interests of the sovereign debtor.

Consider the case of a sovereign debtor, Fredonia. Fredonia is a small developing country that faces a realistic possibility of having occasions where it will not have enough funds to pay all its debts. In such a situation, Fredonia is unlikely to pay all its unsecured creditors, with their standard *pari passu* clauses,[31] pro rata. Fredonia will want to be able to pay its most important unsecured creditors first. Those are the international financial institutions like the International Money Fund (IMF), the Asian Development Bank (ADB), and the World Bank,[32] workers and police or military personnel who protect public health and safety, and trade creditors who provide much needed supplies. Indeed, the Brussels decision is likely to have sent a shock to the IMF and World Bank who are accustomed to assuming that countries can and will pay them first.[33] A sovereign that is short of cash will not wish to make payments pro rata, thereby defaulting on all its debts and bringing upon itself the ire of every creditor. Instead, a sovereign will want to be able to pay the important creditors first so that they continue to provide support. Given the sovereign's strong interest in being able to make payments to some creditors over the others, and given that there are at least two plausible interpretations of the *pari passu* clause, it makes sense to interpret the clause more likely to reflect the parties' bargain *ex ante*.[34]

In addition, there is the holdout problem that the broad interpretation of the *pari passu* clause exacerbates. For a sovereign like Fredonia that is negotiating its debt clauses, there is always the possibility that the day will come when the debt has to be restructured and the

creditors have to be asked to extend the maturity or take less. Creditors will not likely renegotiate if they know that someone like Elliott can grab onto payments that are supposed to go to their restructured debt. Unlike corporate debtors, sovereigns cannot declare bankruptcy and rely on the law to force a restructuring on recalcitrant creditors.[35] Holdout problems, therefore, are a major issue for sovereigns. This is illustrated by the recent discussions over whether the standard unanimity provisions in sovereign debt contracts governed by New York law can and should be replaced by super-majority action clauses.[36] The last thing that a sovereign, already worried about holdouts, desires is to give potential holdouts even more leverage. The Brussels decision, however, does just that. This leverage is not a power that the sovereigns are likely to have bargained, *ex ante*, to give away.

Indeed, giving the holdouts such power is something that the majority of creditors are unlikely to want themselves. To the extent renegotiation of distressed sovereign debt serves to further the interests of both the debtors and creditors, a holdout results in costs to both sides.[37] In other words, the pie becomes smaller if the holdout is able to extract a premium for itself. To the extent that some creditor is given the power that Elliott claimed the basic *pari passu* clause gave it, it is likely that the debtor will be very careful that this creditor is not one who will turn out to be a professional holdout.[38]

Having discussed why hypothetical sovereign debtors are unlikely to give the entire range of unsecured creditors rights of the type that the Brussels interpretation gives them, this Article

now turns to describe the contractual language that is used when such powerful rights are given.

MARKET UNDERSTANDING

New York law defers to standard market understanding of what the terms mean, as opposed to going into what the specific parties to the deal might have intended in a specific transaction.[39] The underlying rationale here is that if everyone in the market understands and knows what the standard terms mean and knows that the courts will follow these standard understandings, that provides certainty, which in turn promotes efficiency.[40] To the extent that these sophisticated parties do not like the boilerplate terms, they are free to include specific terms to contract around them. Given the foregoing, the question that arises is: What was the market's understanding of the standard *pari passu* term?[41]

There are at least two ways to attack this question. First, we can look at the case law and academic commentary.[42] Second, we can look to see whether there are other clauses for which parties negotiate alongside the standard *pari passu* clause that would be rendered meaningless by one interpretation of the clause.[43] As best we can tell, there are no cases interpreting the *pari passu* clause. At least, there is none on the question whether the basic clause grants a creditor the right to pro rata payments as a routine matter. In terms of the academic literature, however, there has been writing on the meaning of the *pari passu* clause. Specifically, there have been several pieces by Lee Buchheit tackling the sovereign context.[44] As the Lowenfeld opinion correctly points out, Buchheit argues that there is a lack of clarity in the market about what exactly the

pari passu clause means.[45] Lowenfeld's opinion then goes on to explain that despite Buchheit's difficulty in figuring out what the *pari passu* clause means, the meaning is clear, i.e., that the creditors have to be paid pro rata.[46] Buchheit's article, however, does go on to explain what he does *not* think the clause means: it does *not* compel a sovereign borrower to pay all of its external debt on a ratable basis.[47]

Further, both Buchheit and Philip Wood are clear that, at least in the corporate context, the clause is not violated if the solvent borrower pays one creditor before the other. Buchheit argues:

[A] lender who remains unpaid at a time when other creditors are current on their loans may articulate his grievance in terms of liberty, equality or fraternity, but he should not invoke his *pari passu* covenant as the legal basis for his disappointment. This provision assures the creditor that its loan will not be subordinated to the claims of other creditors in the event of the borrower's bankruptcy, but it does not force the solvent borrower to make pro rata payments to all its creditors.[48]

And Wood argues ``[i]t should also be observed that the *pari passu* clause has nothing to do with the time of payment of unsecured indebtedness since this depends upon contractual maturity. The *pari passu* undertaking is not broken merely because one creditor is paid before another.''[49]

Despite the foregoing, as even Buchheit acknowledges, there are at least some bankers and borrowers who read the clause and think (Buchheit argues, incorrectly) that the *pari passu* clause,

in the *sovereign context,* ``is there to compel the borrower to pay all of its external debt on a ratable basis (either in terms of the amount, or the timing, of debt service payments).''[50] Further, at least one commentator, although agreeing with Buchheit and Wood on the interpretation of the clause in the corporate context, disagrees with Buchheit (and agrees with Lowenfeld) on its meaning in the sovereign context.[51]

Acknowledging the above difference of opinion vis-à-vis the sovereign context, the question is, given the clarity of what the *pari passu* clause means, or better, does not mean in the *corporate context,* whether the identical language is to be interpreted any differently in the *sovereign context.* If so,[52] such a different reading cannot be a function of the plain language--because, as observed above, this is not what the plain language means in the corporate context.

As opposed to answering the question through quotes from commentators, an alternative solution is to look to other clauses in the bond contracts that provide for ratable payments or its equivalent. The presence of such clauses--which would be rendered meaningless by an interpretation of the basic *pari passu* clause as providing pro rata payments for all creditors as a routine matter--should lend weight to the position that the basic *pari passu* clause means something else (or less).

First, there are clauses where the standard language, ``rank, and will rank, *pari passu,*'' is supplemented with something like ``and will be aid as such''[53] or ``and will be serviced on a *pari passu* basis.''[54] It seems that this additional language does what Elliott argued the standard

clause already did.

Second, and more important, however, there are other clauses that are occasionally found alongside the *pari passu* clause. There are at least five. They are: (i) the ``mandatory prepayment clause'' that restricts non-ratable prepayments to others; (ii) the ``turnover clause'' that says that creditors who receive preferential prepayments have to turn it over to the others; (iii) the ``sharing clause'' that says that whatever one lender receives has to be shared ratably with the others; (iv) the ``negative pledge clause'' that says that other lenders are not to be given a functional preference by having assets pledged to them; and (v) the ``acceleration clause,'' where a creditor who holds debt in default gets to ask for all of the debt to be paid immediately.[55] Under the Elliott interpretation, the foregoing clauses would be rendered superfluous. If everyone gets paid ratably under the basic *pari passu* clause itself, then there is no need for these additional clauses.

This analysis yields three points. First, in the corporate context, the standard *pari passu* clause does not take the meaning that Elliott ascribes to it. Second, in the sovereign context there is at least disagreement about the meaning of the clause. Third, there are other clauses, and supplemental language to the basic *pari passu* clause itself, that are rendered meaningless if Elliott's interpretation of the *pari passu* clause is taken.[56] When put together with the economic interests described above, serious doubt is cast upon the Brussels court's interpretation.

NEW YORK BOND INTERPRETATION LAW

Although New York is the undisputed choice of law in corporate bond contracts, it is used somewhat less so in sovereign bond contracts.[57] Nevertheless, New York governs a large fraction of bonds, both corporate and sovereign.[58] Interpretation of sovereign bond contracts begins, however, as a matter of basic contract law. Looking at interpretation of bond contracts under New York law is instructive.

New York's rules of contractual construction require that the entire bond contract be considered and that any ambiguities be resolved to fit with the contract as a whole and to make every part of the contract meaningful.[59] Although New York courts have not interpreted the *pari passu* clause, we can learn much by studying opinions that interpret other boilerplate provisions in bond contracts governed by New York law. The federal courts located in New York have a specific approach to interpreting standard or ``boilerplate'' terms, such as the *pari passu* term, in bond contracts.[60]

Remarkably, perhaps because the issues arise in federal bankruptcy or securities class action cases, many of the cases interpreting boilerplate New York bond law do not involve New York courts. For example, the United States Court of Appeals for the Fifth Circuit construed New York bond law and held that a ``large degree of uniformity in the language of debenture indentures is essential to the effective functioning of the financial markets . . . .''[61] The most influential case is *Sharon Steel*[62] in which the United States Court of Appeals for the Second Circuit underscored the need for uniform interpretation of boilerplate provisions, irrespective of

the intent of the parties, based on public policy interests in protecting the efficiency of financial markets:

> Whereas participants in the capital market can adjust their affairs according to a uniform interpretation, whether it be correct or not as an initial proposition, the creation of enduring uncertainties as to the meaning of boilerplate provisions would decrease the value of all debenture issues and greatly impair the efficient working of capital markets. Such uncertainties would vastly increase the risks and, therefore, the costs of borrowing with no offsetting benefits either in the capital market or in the administration of justice.[63]

Even if a non-New York court has interpreted a boilerplate provision in a manner with which a New York court might disagree, the paramount interest in market certainty supports uniform interpretation. For example, in *Franklin Life Insurance Co. v. Commonwealth Edison Co.*, a U.S. district court in Illinois interpreted a boilerplate provision in a preferred stock prospectus governed by Illinois law to permit equity financing to fund early redemption of preferred stock.[64] Later, when a United States District Court for the Southern District of New York faced a similar issue construing redemption under an indenture governed by New York law, one of the litigants contended that *Franklin* was incorrectly decided and should be limited to its facts.[65] Adopting the interpretation in *Franklin*, the New York district court noted the importance of uniformly interpreting boilerplate for the reasons set forth in *Sharon Steel*.[66]

Recently, the United States Court of Appeals for the Eleventh Circuit considered whether

New York law embraced a rule of construction for public indentures similar to the federal Rule of Explicitness.[67] Out of an abundance of caution, the Eleventh Circuit certified the question to the New York Court of Appeals, but not before speculating that it thought the New York high court would be loath to upset market expectations:

> [W]e wonder whether the New York courts would disturb the heretofore uniform treatment of this question, particularly given the evidence that the capital markets appear to have adjusted to the Rule of Explicitness. . . . Given New York's role as the nation's financial capital and our intuition that a sizeable proportion of outstanding indenture agreements include clauses that invoke New York law, as well as the importance of standardization in indenture agreements generally, we suspect that the courts of New York, as a practical matter, would be loath to depart from prior practice and thus radically reduce the current value of debt held subject to the condition of subordination until the senior creditor receives ``payment in full.'' *See generally, Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir.1982) (``Uniformity in interpretation is important to the efficiency of capital markets. . . . Whereas participants in the capital market can adjust their affairs according to a uniform interpretation, whether it be correct or not as an initial proposition, the creation of enduring uncertainties as to the meaning of boilerplate provisions would decrease the value of all debenture issues and greatly impair the efficient working of capital markets.''); *Broad v. Rockwell Int'l Corp.*,

642 F.2d 929, 943 (5th Cir. 1981) (en banc) (construing an indenture agreement governed by New York law and noting that ``[a] large degree of uniformity in the language of debenture indentures is essential to the functioning of the financial markets . . . .''); *accord Leverso v. SouthTrust Bank of Al., N.A.*, 18 F.3d 1527, 1534 (11th Cir.1994) (same).[68]

Indeed, the New York Court of Appeals decided unanimously that New York law would adopt a Rule of Explicitness identical to the federal rule.[69] To be sure, the court analogized to the New York Rule of Expressness it had adopted previously construing New York general assignments for the benefit of creditors.[70] But the impact of the ruling on market expectations was raised at oral argument and surely must have been a factor that influenced the outcome of the decision. The court of appeals was painfully aware that investors want certainty. To alter the Rule of Explicitness would have changed the rules of interpretation after bonds were issued, disrupted bond markets, and created huge financial windfalls for senior creditors and harm for junior bondholders.[71]

The situation that the New York Court of Appeals avoided in *Southeast Banking* is precisely the situation created by the Court of Appeals of Brussels in *Elliott Associates*. Specifically, large institutional creditors holding sovereign debt now face the prospect of lower returns and increased risk of sovereign default due to the ability of holdout creditors to enjoin payments based on *pari passu* clauses. Holdouts win, and institutional creditors and sovereign

debtors lose.

This disruptive result will not eventuate if the New York Court of Appeals and other courts interpret the standard *pari passu* clause to permit preferential payments. Indeed, in the absence of a payment clause to preclude preferences or a negative pledge clause to prevent collateralization, this is the result that would comport with market expectations. Anything less will encourage holdouts and lead to sovereign piracy.

CONCLUSION

The Brussels court has interpreted the *pari passu* clause in a manner that will disrupt sovereign debt restructurings. Unless other courts construe the clause to grant parity of priority rather than payment, speculators will snap up defaulted sovereign debt and hold out for full payment.

In addition to the mischief that it has caused, and may continue to cause, in the sovereign market, the Brussels decision has the potential to disrupt life in the corporate lending world as well. Assume, for a moment, that the Brussels interpretation of the basic *pari passu* clause is allowed to stand. Then there is a meaningful risk that a domestic court interpreting the clause as a matter of first impression (domestically) will be guided by *Sharon Steel* to look to and follow the Brussels interpretation. Such an interpretation (indeed, in terms of market price, just a high enough likelihood of such an interpretation will suffice) will provide a windfall to those

bondholders holding securities with the basic *pari passu* clause and take value away from those who negotiated for specific protective clauses that produced the same effect.

As things stand today, what we have as a result of the Brussels decision is a great deal of added uncertainty. Parties will overcome this uncertainty in new debt issues by negotiating new language to limit the scope of the basic *pari passu* clause. Put differently, if we are correct that the Brussels decision has seriously altered existing market expectations, one should see the markets adapt.

Take the sovereign context first. Restructurings of existing obligations will be coupled with exit consents that gut the ability of the holdouts to use the *pari passu* clause. This strategy will then probably be tested in the courts. With respect to new issues, sovereigns and their underwriters will adapt in at least three ways. First, they can alter the *pari passu* clause to state ``*pari passu* with respect to priority but not payment.'' Second, they can make the *pari passu* clause explicitly subject to amendment in an exit consent. Third, they can move to the practice that is standard in English Law governed bonds, which is to use the super-majority rule rather than the unanimous consent provision for modifications to payment terms.[72] If this happens, business will migrate from New York to London as sovereigns select English solicitors and underwriters to handle new issues. If so, a Brussels court's interpretation of New York law will have caused a European Union member to gain business at New York's expense.

In the corporate context, if bond lawyers perceive that the risk of the Brussels interpretation prevailing is high enough, one should see similar changes. Specifically, the standard *pari passu* clause will be altered in the manner suggested above to make clear that the right is with respect to priority and not payment. In terms of costs, there are the costs involved in altering each new document. But the real costs of the Brussels decision are in the increased uncertainties and added complications, especially with respect to sovereign restructurings, that have been added to almost all the corporate and sovereign debt contracts that are out there already. That is, unless in the corporate context there is a strong and quick rejection of the Brussels interpretation, at least three costs will materialize. First, because the Brussels interpretation increases hold out leverage, the uncertainty whether domestic courts will adopt the Brussels interpretation should depress prices of distressed corporate bonds. Stated differently, once the market becomes aware of the Brussels interpretation and the risk it poses to corporate restructurings, the spread between investment grade domestic corporate bonds and junk bonds should widen. Second, litigation should increase as opportunistic vulture investors acquire debt and litigate the Brussels interpretation.[73] Third, parties engaged in corporate restructurings will incur increased legal costs as a result of the Brussels opinion. Although some of the costs will involve litigation, others will involve legal opinions and drafting services. Thus, the sooner an authoritative domestic court rejects the Brussels interpretation the better for the health of the distressed corporate bond market.

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1. Elliott Assocs., L.P. v. Banco de la Nacion, 194 F.3d 363, 366 (2d Cir. 1999).

2. *See id.* at 366-67; *see also* Joshua Chaffin, *Investor `Vultures' Come Under Scrutiny*, Financial Times, Oct. 25, 2000, at 19.

3. *See* Elliott Assocs., L.P. v. Banco de la Nacion, 2000 U.S. Dist. Lexis 14169, at *2 (S.D.N.Y. Sept. 29, 2000). For descriptions of these recent events involving Elliott and Peru, see ERIC LINDENBAUM & ALICIA DURAN, MERRILL LYNCH & CO., DEBT RESTRUCTURINGS: LEGAL CONSIDERATIONS (Oct. 30, 2000). S*ee also* GABRIELLE LIPWORTH & JENS NYSTEDT, INTERNATIONAL MONETARY FUND, CRISIS RESOLUTION AND PRIVATE SECTOR ADAPTATION (paper presented at the First Annual IMF Research Conference, Nov. 9-10, 2000).

4. The reason for this is that generally only property used for the commercial activity in question inside the jurisdiction where the suit is brought may be attached. *See, e.g.*, 28 U.S.C. § 1610 (1994 & Supp. IV 1998). Given that most of the sovereign's assets relating to the borrowing are likely located within the sovereign's own boundaries, this leaves few assets for the creditors to reach. *See* MOODY'S INVESTOR SERV., SPECIAL COMMENT, HOW TO SUE A SOVEREIGN: THE CASE OF PERU (Nov. 2000); *see also*

MOODY'S INVESTOR SERV., SPECIAL COMMENT, SOVEREIGN DEBT: WHAT HAPPENS IF A SOVEREIGN DEFAULTS (July 2000).

5. *See* Elliott Assocs., L.P., General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000) (unofficial translation on file with *The Business Lawyer*, University of Maryland School of Law) [hereinafter Brussels Opinion].

6. *Id.*

7. The settlement includes post-judgment interest. *See* Lindenbaum & Duran, *supra* note 3, at 2.

8. ``[T]he term `*pari passu*' is adopted from the Latin for `with equal step,' or `side by side.''' Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection*, 84 CORNELL L. REV. 305, 309 n.6 (1999).

9. *See* Brussels Opinion, *supra* note 5.

10. *See* Declaration of Professor Andreas Lowenfeld at 8, Elliott Assocs., L.P. v. Banco de la Nacion, 2000 U.S. Dist. LEXIS 14169 (S.D.N.Y. Sept. 29, 2000) and Elliott Assocs., L.P. v. Republic of Peru, 2000 U.S. Dist. LEXIS 368 (S.D.N.Y. Jan. 18, 2000) (executed Aug. 31, 2000) (on file with *The Business Lawyer*, University of Maryland School of Law).

11. *Id.*

12. As noted in footnote 10, we have a copy of Professor Lowenfeld's opinion that was submitted in the New York cases. As of the date of the publication of this Article, we do

not know whether the same memorandum was submitted in the Brussels case. For purposes of the arguments in this Article, however, we will assume that it was. We do so because the point of the Article is to question both the interpretation of the clause given by the Brussels court and the arguments made by Professor Lowenfeld.

13. Professor Lowenfeld limits his opinion to the context where there is ``not enough money to go around,'' or the debtor is insolvent in the equity sense of inability to pay debts as they become due. In the current case it is unclear whether Peru had enough money to go around. After all, ultimately it paid Elliott in full. Moreover, it is not clear based on its plain meaning that the *pari passu* clause is restricted to instances where the borrower is insolvent. For example, in theory, the clause could apply to a solvent debtor that was flush with cash but chose not to pay a particular debt. Alternatively, the clause could apply to require ratable payment of all outstanding debts even if a particular debt was not yet due. The authors believe that the basic *pari passu* clause applies whether or not the borrower is insolvent, but only to guarantee ratable priority, not ratable payment.

14. *See* Lowenfeld Declaration, *supra* note 10, at 12.

15. *Id.* at 11-12.

16. *See, e.g.*, LEE C. BUCHHEIT, HOW TO NEGOTIATE EUROCURRENCY LOAN AGREEMENTS 83 (2d ed., 2000); PHILIP WOOD, LAW AND PRACTICE OF INTERNATIONAL FINANCE 156 (1980) (``The *pari passu* undertaking is not broken merely because one creditor is paid before another.'').

17. *See, e.g.*, BARRY EICHENGREEN & ASHOKA MODY, INTERNATIONAL MONETARY FUND, BAIL-INS, BAILOUTS, AND BORROWING COSTS 5-6 (paper presented at the First Annual IMF Research Conference, Nov. 9-10, 2000) [hereinafter EICHENGREEN & MODY]; Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 62 (2000); Barry Eichengreen, *Bailing in the Private Sector: Burden Sharing in International Financial Crisis Management*, 23 FLETCHER F. WORLD AFF. 57 (1999); Samuel E. Goldman, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring*, 5 UCLA J. INT'L L. & FOREIGN AFF. 159, 164-65 (2000); Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956 (2000). Elliott's strategy against Peru is not an isolated occurrence. In fact, in 1996, Elliott successfully obtained a $57 million judgment and attachment order against Panama. *See* Elliott Assocs., LP v. Banco de la Nacion, 194 F.3d 363, 366 (2d Cir. 1999).

18. Remember, these *pari passu* clauses are standard.

19. Ecuador's recent Exit Consent offer had in place a couple of provisions that might have worked to thwart the attachment strategy. For one, the restructured bonds had payments coming in through a Trustee (who was technically the agent of the creditors) and not through a Fiscal Agent (who is typically the agent of the debtor). And second, the bonds provided for the time and place of the payments to be altered if the circumstances called for it (i.e., so that the vultures would not know where the payments were coming in). On

the Ecuador offer, see REPUBLIC OF ECUADOR: OFFER TO EXCHANGE (June 27, 2000).

20. *See* Brussels Opinion, *supra* note 5.

21. *See* Lowenfeld Declaration, *supra* note 10, at 11-12.

22. *Id.*

23. *See* Brussels Opinion, *supra* note 5.

24. The phrase, ``ranks, and will rank, *pari passu.*''

25. These current creditors are protected by the standard *pari passu* clause.

26. In this sense, the *pari passu* clause is the flip side of a subordination agreement. It is an agreement not to subordinate debt that is the beneficiary of the clause to other debts of the borrower. There are two basic kinds of subordination agreements: complete and inchoate. An inchoate subordination agreement becomes operative only when an insolvent debtor makes a distribution of its assets. A complete subordination agreement operates immediately to preclude the borrower from paying principal or interest on the subordinated debt so long as the senior debt remains unpaid. *See* Dee Martin Calligar, *Subordination Agreements*, 70 YALE L.J. 376, 377-78 (1961). Just as ``subordination'' has two meanings, so too does *pari passu*. If the *pari passu* clause is complete, it requires all payments by the borrower to be ratable. On the other hand, if it is inchoate, it only precludes the borrower from creating a new class of senior debt or subordinating the existing debt.

27. As a general matter, a debtor cannot legally subordinate a lender unless it obtains her

consent. *See* Buchheit, *supra* note 16 at 83. The concern with a sovereign, however, is that the sovereign will simply alter the law to subordinate the disfavored lender.

28. *See* Buchheit, *supra* note 16, at 84 (``[S]overeign borrowers, because they have it within their power to enact laws affecting the legal ranking of creditors, are thought to be appropriate objects of a *pari passu* covenant.''); *see also* Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships*, 1988 U. ILL. L. REV. 493, 497 (``[T]he borrower violates [the *pari passu*] undertaking only by attempting to create a class of senior indebtedness in preference to that outstanding under the loan agreement in which the clause appears.''). On this point, the Lowenfeld opinion itself quotes William Tudor John to say of the clause:

> [I]t is primarily intended to prevent the earmarking of revenues of the government towards a single creditor, the allocation of foreign currency reserves, and generally against legal measures which have the effect of preferring one set of creditors against the others or which discriminate between creditors.

Lowenfeld Declaration, *supra* note 8, at 10 (quoting William Tudor John, *Sovereign Risk and Immunity Under English Law and Practice*, in 1 INTERNATIONAL FINANCIAL LAW 71, 96 (Robert S. Rendell, ed., 2d ed. 1983)). The clause also protects against a law subordinating existing debt to new debt issues.

29. Indeed, it would be interesting to look at the historical evolution of the clause in sovereign lending agreements. Consistent with Lowenfeld's quote from Tudor John, the original

goal of the clause may have been to keep sovereigns from earmarking particular revenue streams for favored creditors. At the time (most likely in the early part of the 20th century), there were no sovereign security interests and, hence, no negative pledge clauses. The *pari passu* clause, therefore, probably served as something of a substitute because the primary risk to guard against was not collateralization but subordination.

30. Whether the context is corporate or sovereign debt, however, the function of the clause is to assure equality of rank. Inevitably there are recognized senior claims to which the debt will be subordinated. Examples include secured claims, claims of favored creditors such as depositors, and the like. A commentator, writing about the giving of *pari passu* opinions by counsel, explains: ``In many cases, it is suggested that the opinion recipient recognize that preferred claims may exist and that a general exception should be read into the *pari passu* opinion.'' Michael Gruson & Stephan Hutter, *International Bar Association Project on Legal Opinions in International Business Transactions*, 10 U. PA. J. INT'L BUS. L. 71, 85 (1988). As discussed *infra* notes 39-56 and accompanying text, when the parties' intent is for the equal ranking to be broader than priority status and to have the meaning attributed to the clause by the Brussels court, the debt instrument either contains additional language that is used to supplement the standard clause or includes other clauses.

31. As the Lowenfeld opinion explains: ``A clause such as Section 11(c) [the basic *pari passu* clause] is a standard clause included in virtually all loan or debt restructuring agreements.''

Lowenfeld Declaration, *supra* note 10, at 9. Implicit in that statement is the assertion that the rights granted by that clause are ones that the sovereign debtor has agreed to give *all* of its creditors.

32. The IMF and World Bank are a crucial source of continuing credit for a sovereign in trouble.

33. On the effectively preferred creditor status of the international financial institutions such as the World Bank, the IMF, and the ADB, see Lee C. Buchheit, *Of Creditors, Preferred and Otherwise*, INT'L FIN. REV., June 1991, at 12-13.

34. In his classic bond contract interpretation opinion in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, Judge Winter explains:

Where contractual language seems designed to protect the interests of both parties and where conflicting interpretations are argued, the contract should be construed to sacrifice the principal interests of each party as little as possible. An interpretation which sacrifices a major interest of one of the parties while furthering only a marginal interest of the other should be rejected in favor of an interpretation which sacrifices marginal interests of both parties in order to protect their major concerns.

35. With respect to new debt issues, however, the sovereign can select English law rather than New York law. *See infra* note 57.

36. *See, e.g.*, BARRY EICHENGREEN & ASHOKA MODY, WOULD COLLECTIVE ACTION

CLAUSES RAISE BORROWING COSTS? AN UPDATE AND ADDITIONAL RESULTS (May 2000), *available at* <http://elsa.berkeley.edu/users/eichengr/research.htm>; EICHENGREEN & MODY, *supra* note 17, at 5-6; Liz Dixon & David Wall, *Collective Action Problems and Collective Action Clauses*, FIN. STABILITY REV., June 2000, at 142.

37. A recent Moody's Investor Service Special Comment makes the same point with respect to a different issue in the Elliott versus Peru proceedings. What Elliott succeeded in doing was attaining: ``post-judgment attachment of all assets of the sovereign's agent, Banco de La Nacion, in the United States.'' SPECIAL COMMENT, HOW TO SUE A SOVEREIGN, *supra* note 4, at 1. The Special Comment further explains:

> That an entity closely related to the sovereign can conceivably be held financially liable and that all of its assets in the jurisdiction where the suit is brought may be attached to make good on defaulted debt opens a door that had hitherto not been considered available. . . . [And it turns the investor's] suit from an academic and avenging ``I told you so'' exercise to a more lethal weapon lending this disconsolate investor's bark a bit more bite.

This case has also raised concerns that proliferation of such suits by aggressive investors could realign incentives of sovereign and other creditors. After all, when a sovereign settles out of court for a substantial sum with one litigious creditor it will adversely impact, however marginally, the claims of its other creditors. It is possible, and indeed probable, that to protect their interests these creditors will attempt to somehow

hinder their uncooperative brethren.

Id.

38. *See* Buchheit & Gulati, *supra* note 17, at 83 (making the point that protections against holdouts serve not only the debtor's interests, but also those of the non-holdout creditors).

39. For example, in the recent Southeast Banking bond contract interpretation case, the New York Court of Appeals explicitly talked about the importance, in commercial matters, of giving deference to market understandings. *See* Chemical Bank v. First Trust of New York, N.A. (*In re* Southeast Banking Corp.), 710 N.E. 2d 1083, 1086 (N.Y. 1999). Doing so, the court explained, provides for ``reliance, definiteness and predictability,'' which enables the parties to ``intelligently negotiate and order their rights and duties.'' *Id.*

40. *See* Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982); *see also* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting* (``*or the Economics of Boilerplate*''), 83 VA. L. REV. 713, 718 (1997) (describing the ``learning'' and ``network'' benefits of standardization in corporate contracts).

41. Of course it is possible that the market's understanding has changed over time. For example, from 1890 until 1966 New York had a preference law that imposed personal liability on officers of an insolvent corporate debtor that paid one creditor in preference to another. *See* N.Y. Stock Corporation Law ¶ 15 (McKinney 1940) (historical note

referring to previous similar laws dating back to 1890). During this era, the market might have assumed that the *pari passu* clause also prohibited preferential payments. But New York repealed its preference law in 1966, and since then the markets could well assume that the *pari passu* clause likewise does nothing to deter preferences in the absence of a specific contractual covenant to the contrary. *See* 1966 N.Y. Laws, c. 664, sec. 16.

42. *See Southeast Banking*, 710 N.E.2d at 1086 (looking to commentary and case law).

43. *Cf.* Chase Manhattan Bank v. Traffic Stream (BVI) Infrastructure Ltd., 86 F. Supp. 2d 244, 257 (S.D.N.Y. 2000) (``In construing a contract, one of a court's basic goals is to avoid an interpretation that would leave contractual clauses meaningless.'').

44.

45. Lowenfeld's opinion quotes the following language from one of Buchheit's articles: ``The fact that no one seems quite sure what the [*pari passu*] clause really means, at least in a loan to a sovereign borrower, has not stunted its popularity among drafters of loan agreements and debt restructuring agreements.'' Lowenfeld Declaration, *supra* note 10, at 11 (quoting Lee C. Buchheit, *The Pari Passu Clause sub specie aeternitatis*, INT'L FIN. L. REV., Dec. 1991, at 11 [hereinafter *Pari Passu Clause*]). The latest version of Philip Wood's treatise expresses a similar agnosticism about the precise meaning of the *pari passu* clause in the sovereign context. Wood writes,``[i]n the state context, the meaning of the clause is uncertain because there is no heirarchy of payment which is legally enforced under a bankruptcy regime.'' PHILIP R. WOOD, PROJECT FINANCE,

SUBORDINATED DEBT AND STATE LOANS 165 (1995) [hereinafter 1995 Wood].

46. Lowenfeld Declaration, *supra* note 10, at 11-12.

47. *See Pari Passu Clause*, *supra* note 45, at 12.

48. *See* Buchheit, *supra* note 16, at 83.

49. *See* Wood, *supra* note 16, at 156; *see also* 1995 Wood, *supra* note 45, at 165.

50. *See Pari Passu Clause*, *supra* note 45, at 12.

51. According to Brian Semkow:

=xtIn the event that the corporate laws governing the borrower will rank the unsecured claims, however, the covenant will not prevent the lending banks from being discriminated against [(citing Wood, supra note 16, at 156)]. In the context of the sovereign borrower, the *pari passu* covenant has a different effect. This provision will prevent sovereign borrowers from discrimination against the lending banks in the payment of creditors out of general revenues or foreign currency reserves.=ft

Brian W. Semkow, *Syndicating and Rescheduling International Financial Transactions: A Survey of the Legal Issues Encountered by Commercial Banks*, 18 INT'L LAW. 869, 899 (1984).

52. As noted earlier, there is a meaning that commentators do give to the *pari passu* clause in the sovereign context (relating to the sovereign making laws that alter priority) that has nothing to do with making ratable periodic payments.

53. *See* Buchheit, *supra* note 16, at 84.

54. *See* Buchheit & Reisner, *supra* note 28, at 497.

55. *See* Buchheit, *supra* note 33, at 12 (noting three of these five terms). *See also* Bjerre, *supra* note 8.

56. In addition, if the *pari passu* clause were to have the meaning that Elliott attributes to it, one would expect to see bond contracts to contain "negative" *pari passu* clauses akin to negative pledge clauses. After all, many lenders (especially those such as the IMF and the World Bank who are used to receiving preferential payments) will, before lending, want to make certain that the sovereign borrower has not promised the Elliott type *pari passu* treatment to others. As things stand today, we do not see such negative *pari passu* clauses. That suggests that the reading of the clause that Elliott advocates is inconsistent with the market's understanding of the clause.

57. In sovereign debt issues New York shares the majority of the market with the United Kingdom. ``There is a fundamental difference between English Law bonds and New York Law bonds. English Law bonds generally have a super-majority collective-action-clause (CAC) which enforces the new terms of the exchange instrument on all debt-holders.'' MOODY'S INVESTOR SERV., SPECIAL COMMENT, HOW TO SUE A SOVEREIGN: THE CASE OF PERU 3 n.7 (Nov. 2000).

58. New York law governed the Peruvian bonds at issue in the Elliott case. *See* Lowenfeld Declaration, *supra* note 10, at 13.

59. *See* Laba v. Carey, 277 N.E.2d 641, 644 (N.Y. 1971).

60. *See, e.g.,* Sharon Steel v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982) (defining ``boilerplate'' provisions as ``contractual provisions which are standard in a certain genre of contracts'' such as bond indentures); Chase Manhattan Bank, N.A. v. Traffic Stream Infrastructure Ltd., 86 F. Supp. 2d 244, 256 & n.19 (S.D.N.Y. 2000).

61. *See* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 943 (5th Cir. 1981) (en banc), *cert. denied,* 454 U.S. 965 (1981).

62. Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039 (2d Cir. 1982), *cert. denied,* 460 U.S. 1012 (1983).

63. *See id.* 691 at 1048. Interpretation of boilerplate provisions such as those at issue here does ``not depend upon particularized intentions of the parties to an indenture.'' *Id.*

64. *See* Franklin Life Ins. Co. v. Commonwealth Edison Co., 451 F. Supp. 602, 614-15 (S.D. Ill. 1978), *aff'd per curiam*, 598 F.2d 1109 (7th Cir.), *cert. denied*, 444 U.S. 900 (1979).

65. *See* Morgan Stanley & Co. v. Archer Daniels Midland Co., 570 F. Supp. 1529, 1539 (S.D.N.Y. 1983).

66. *See id.* at 1542 (``to cast aside the holding in *Franklin* would . . . result in the very situation the Second Circuit sought to avoid in *Sharon Steel,*'' i.e., ``intolerable uncertainty in the capital markets.'').

67. The federal Rule of Explicitness requires explicit language in a junior indenture alerting junior noteholders to the risk that senior noteholders will get postpetition interest in a bankruptcy case before juniors get principal. Otherwise senior noteholders will not get

such interest even though the terms of the subordination agreement require them to be ``paid in full'' before juniors share. *See* Continental Ill. Nat'l Bank & Trust Co. v. First Nat'l City Bank (*In re* King Resources Co.), 528 F.2d 789, 791-92 (10th Cir. 1976); *In re* Time Sales Fin. Corp., 491 F.2d 841, 844 (3d Cir. 1974); Bankers Life Co. v. Manufacturers Hanover Trust Co. (*In re* Kingsboro Mortg. Corp.), 379 F. Supp. 227, 231 (S.D.N.Y. 1974) (originating the name ``Rule of Explicitness''), *aff'd per curiam*, 514 F.2d 400, 401 (2d Cir. 1975). *Accord In re* MCorp Fin., Inc., 160 B.R. 941, 959 (Bankr. S.D. Tex. 1993); First Fidelity Bank, N.A. v. Midlantic Nat'l Bank (*In re* Ionosphere Clubs, Inc.), 134 B.R. 528, 535 n.14 (Bankr. S.D.N.Y. 1991).

68. Chemical Bank v. First Trust of New York, N.A. (*In re* Southeast Banking Corp.), 156 F.3d 1114, 1124-25 (11th Cir. 1998) (footnote omitted).

69. *See* Chemical Bank v. First Trust of New York, N.A. (*In re* Southeast Banking Corp.), 710 N.E.2d 1083, 1087 (N.Y. 1999).

70. *See id.* at 1087 (citing *In re* Pavone Textile Corp., 97 N.E.2d 755 (N.Y. 1951), *aff'd per curiam sub nom.*, United States v. Bloom, 342 U.S. 912 (1952)).

71. In *Southeast Banking*, Elliott was a junior bondholder that benefited when the New York Court of Appeals adopted the Rule of Explicitness in accordance with *Sharon Steel*.

72. *See* Andrew Yianni, *Resolution of Sovereign Financial Crises--Evolution of the Private Sector Restructuring Process*, FIN. STABILITY REV., June 1999, 78, 80-81.

73. To avoid claims of "champerty" or "maintenance" the vultures cannot admit that they

acquired the debt for purposes of instituting litigation.