Messing with Argentine Debt

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Imperialism never gives. The Argentine debt saga is another instance of proof of the ways in which arms of the state and private capital from the developed countries collude to extract surpluses from developing countries. As far back as 2001, after a major crisis, Argentina defaulted on more than $80 billion dollars of debt. That debt was accumulated through a process that began under the military dictatorship in the late 1970 and early 1980s and was facilitated by periodic efforts of the US Treasury and the IMF to reschedule and restructure debts in order to avoid a default that would damage the balance sheets of the banks. The shift to a neoliberal growth strategy in the 1980s and after only aggravated the Argentine debt problem, while growth remained low and the economy experienced bouts of hyperinflation. That trajectory led up to the late 1990s crisis, which in turn finally precipitated the largest debt default in history.

Subsequently, in what was then considered an infeasible move, the government of President Néstor Kirchner decided not to repay in full debt it considered illegitimate, given the circumstances in which it was incurred and expanded. The difficulty was that the debt agreement did not include any ‘collective action clauses’, which would have required all creditors to come to the table to negotiate a restructuring of the debt if a sufficient majority agreed to do so. Starting with an offer to repay just about 10 cents to every dollar, it launched on negotiations, and arrived at a deal in 2005 with holders of about three-quarters of its total debt, in which their debt was exchanged for new bonds that were valued at 25-30 cents to a dollar. The rest decided to hold out for a settlement that offered more. With time, a significant number of the so-called “holdouts” turned weary and finally holders of around 70 per cent of the un-restructured debt agreed to a debt swap and “haircut”, reducing the share of the holdouts to just 7 per cent of the total debt in default.

The remaining holdouts were of two kinds. The first consisted of a bunch of retail creditors, substantially from Italy, who were in all probability attracted by the unusually high interest rates being paid on the bonds in order to attract creditors to lend to an excessively-indebted nation. The other consisted of a set of “vulture funds”, particularly two—Elliott Management (a New York-based hedge fund) and its subsidiary NML Capital and Aurelius Capital Management—which had acquired some of the defaulted bonds for a pittance in the secondary market in the hope that they could profit by forcing the Argentine government to pay them back the full value. To realise this ambition they exploited the fact that the debt agreement made it subject to US law and filed cases in the US demanding full payment. The Argentine government, on the other hand, was insistent that it would not negotiate with these holdouts or be held to ransom by the vulture funds.

Victory in cases like this has not been the norm. Thus, an August 2012 IMF study found that there have been 186 debt exchanges with private creditors in a total of more than 600 cases of debt restructuring since the 1950s involving 95 countries. Of these 186, “57 involved a cut in face value (debt reduction), while 129 implied only a lengthening of maturities (debt rescheduling). However, both types of debt operations can involve a “haircut,” i.e., a loss in the present value of creditor claims.” However, there have been only 109 individual litigation cases since 1980s, and the number of litigation "successes" leading to settlements or attachment of sovereign assets has been even smaller. Distressed sovereign debtors did indeed have some space.

However, with the rapid growth in sovereign debt since the 1980s, and the increasing frequency of debt crises, developed country creditors, governments and courts have been working to rein in sovereign debtors. The difficulty is that enforcement of foreign law on sovereigns is difficult because there are few assets of the latter located abroad that can be easily attached, and even when such assets are available they are protected by considerations of sovereign immunity. But attempts have been underway to change or reinterpret legal doctrine to facilitate some kind of guarantee against successful sovereign restructuring involving a "haircut" for creditors.

These changes have encouraged what is now a major trend: the entry of the so-called "vulture funds". These are financial firms that buy distressed debt at a discount in secondary markets and then go to court to get the debtor to settle in full or in substantial measure. Well known among these funds is Elliott Associates, a key player in the Argentinian drama. Elliott famously won a case against Peru, when it opted for an IMF-supported, debt-restructuring programme under the Brady Plan. Elliott purchased Peruvian debt worth $20.7 million for around $11 million, refused to accept Brady bonds in exchange, then waged a long and costly legal battle for full settlement with interest to win an award of $56 million. In its case Elliott through its lawyers argued that by making payments to its creditors who had accepted the Brady bonds issued under the restructuring, Peru was violating the pari passu clause in the original loan agreement, which promised "equal footing" treatment to all its creditors. Peru it said was wrongly privileging debt that had been restructured into Brady bonds, even though the holders of those bonds had accepted a loss that the holdouts were unwilling to incur.

The judgment set a new standard also by agreeing to enforce its award through an unusual interpretation of what constituted Peruvian assets that could be attached. Elliott sought and won a restraining order on the transfer of the amounts credited by Peru to Chase Manhattan as interest payments on the Brady bonds, for which Chase was the US fiscal agent. The argument was that these sums were sill Peruvian property that can attached to enforce the court's award in favour of Elliott. It did the same against Euroclear, the Brussels clearing house that was the European intermediary for the same purpose.

Since Peru chose to settle rather than avoid default on the Brady bonds, the use of the pari passu clause as the legal basis had not been fully tested, nor was the right of a holdout creditor to attach funds remitted to third parties to enforce a legal award. This is what makes the Argentine judgment, in a case that was again led by Elliott through NML Capital, significant. In this instance too the pari passu clause was used as the basis for litigation. In February 2012, Judge Thomas Griesa of the United States District Court in Manhattan held that Argentina had, by making payments to the exchange bondholders who had accepted the restructuring, discriminated against the holdouts and thereby violated the pari passu clause. Argentina went on appeal. But in October, the Second United States Circuit Court of Appeals in New York upheld Griesa's judgment, stating that it has "little difficulty" in concluding that Argentina had, by giving holders of the restructured bonds priority, violated the "equal footing" obligation.

The appeals court then sent back the case to Judge Griesa who was asked to decide on two issues. The first was whether the force of the judgment would apply to third parties engaged (as in the Peruvian case) in intermediating between Argentina and the exchange bondholders. The second was to assess how much Argentina would have to pay holders of the older bonds when it makes the next set of payments to the exchange bondholders.

It was at this point that Judge Griesa's fundamental inclinations were made clear. He ruled in November that (i) Argentina should pay the holdouts the full $1.33 million due to them if it pays the $3 million due to the holders of the restructured bonds on December 15; (ii) while Argentina had the right of appeal it needs to keep the sum due to the holdouts in an escrow account till the matter was finally decided; and (iii) the judgment would be applicable to third parties as well, which would include the bond indenture trustee and the clearing system that are involved in managing transfers to the holders of new bonds. The last of these would imply that if Argentina did not comply with the judgment it would be forced to default on the remaining debt due to the holders of the restructured bonds as well. This despite the fact that the application to third parties is seen by many as violative of New York's Uniform Commercial Code that protects such parties from injunctions directed at institutions in foreign jurisdictions. Argentina has gone on appeal again. Griesa's judgment has been stayed. But, the same judges who were engaged in the last review would be responsible this time as well. The verdict may, therefore, validate Griesa's injunctions. If that happens Argentina may be forced to default once again on all of the remaining debt.

Sovereign debt has always been considered as involving low risk of default, attracting investors despite lower returns. That began to change in the years when a supply side driven surge in private capital flows dramatically increased the ratio of private debt to GDP in many countries, including poorer ones. As the risk of default consequentially increased, so did the interest rates offered. This was a signal to investors that they were taking on risk. And the vulture funds were obviously buying into risk at a discount in order to profit. What the Argentine judgment does is that it forecloses any restructuring because it promises to insulate investors in sovereign debt from the dangers of risk. In the process it does not give foreign debtors even the benefits that bankruptcy laws such as Chapter 11 gives corporations in the US, so as to protect debtors and allow them to ensure orderly restructuring of debt wherever feasible.

As a result, it is not Argentina alone that has cause to be worried. The holders of the restructured bonds, who stand to lose are worried. The third parties also would be, as would those responsible for a clearing system that is being interfered with. And finally, countries in Europe and elsewhere contemplating restructuring of debt they are unable to service would be, because the judgment would encourage more holdouts in any attempt at restructuring which involves a haircut. These problems may be avoided in future debt agreements by including collective action clauses. But that leaves unresolved the question of dealing with the large volume of international debt that has been accumulated globally since the 1970s at a time when a persisting recession has increased the possibility of default.

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