The Argentina Debt Case*

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Almost everyone now knows that the world of international finance is not a particularly robust one, nor is it particularly just or fair. But it has just got even weirder and more fragile, if this can be imagined. A recent ruling of the US Supreme Court, refusing to hear an appeal by the government of Argentine against a decision of a lower court on a case relating to its debt restructuring agreement with creditors over a decade ago, is not just a blow against the state and people of Argentina. It has the potential to undermine the entire system of cross-border debt that underlies global capitalism today.

The case has its origins in the 1990s, when the government of Carlos Menem fixed the Argentine peso at the value of one US dollar, through a currency board arrangement that restricted base money supply to the amount of external reserves and sought to increase its spending through the build-up of external debt. This was obviously an unsustainable strategy, which exploded in a financial crisis in 2001, bringing on a major devaluation of the currency and a default on around $100 billion of external debt.

In 2005, the government of Nestor Kirchner, which had then managed to revive the economy to some extent, offered its creditors debt swaps that significantly restructured the debts. Since Argentine bonds were anyway trading at a fraction of their face value in the secondary market, this deal, which reduced the value of the debt by nearly 75 per cent, was acceptable to most of the multinational banks and other creditors. (Since unpaid interest is added on to the principal and compounded, the actual face value of the debt in such cases is typically much more than the amount originally borrowed or lent out.) Indeed, creditors holding 93 per cent of government bonds participated in the debt swaps of 2005 and 2010.

However, a tiny minority of creditors held out and refused to accept the negotiated settlement. These then sold their holdings to hedge funds (in this case known as "vulture funds" that take on distressed assets in the hope of recouping a higher value from them). One of the most prominent of these funds in the Argentine case is NML Capital, a subsidiary of Elliot Capital Management, which is run by US billionaire and major Republican party donor Paul Singer. This fund has a history of using aggressive tactics to force struggling sovereign debtors to pay the full value of debts that have already been deeply discounted by the market. In the past, it has successfully sued the governments of Peru and the Democratic Republic of the Congo.

Ever since it bought Argentine bonds at around 20 per cent of the face value in 2008, it has been pursuing the case both legally and physically. In 2012, it hired mercenaries to detain and try to seize an Argentine ship where it was docked off the coast of Ghana; at another time it even attempted to grab the Argentina Presidential plane from an airport - as "collateral" for its supposed holding of debt. Legally, NML Capital and another vulture fund, Aurelius Capital Management LP, have been pursuing a case in a New York district court, demanding full payment on their debt, of the value of around $1.5 billion. It has been estimated by the Argentine government that this could amount to a return of more than 1600 per cent on the initial investment made by these vulture funds.

In 2012, US District Judge in New York Thomas Griesa ruled in favour of the hedge funds, which was both extraordinary in law and devastating in its potential implications not just for

Argentina but for finance in general. The Argentine government appealed against it, but this appeal has now been dismissed by the US Supreme Court.

Consider just some elements of this US court decision. First, it is based on a peculiar and unprecedented interpretation of the pari passu (equal treatment) clause, which holds that all bond holders must be treated alike. The courts have interpreted this to mean that a sovereign debtor must make full payment on a defaulted claim if it makes any payments on restructured bonds. So if the bondholders who agreed to restructure 93 per cent of the Argentine debt are being paid according to their agreement, then the other resisting bond holders must also be paid the full value of their debts!

The immediate effect of this would be to disable Argentina from repaying $832 million of debt to other bondholders (who have already received around 90 per cent of their debt) unless it also pays the holdouts in full, thereby forcing the country into technical default. Economy Minister Alex Kicilloff noted in a speech to the United Nations that this contradicts Argentina's own laws and its clear agreements with creditors in the restructuring process that it would not treat other creditors differently. An official statement from the Argentine government called this judgement "senseless and unheard of", and pointed out that by attempting to block the payment, the judge "has abused his power and gone outside of his jurisdiction because the holders of restructured bonds are not the object of this litigation."

This is effectively leaving the country no choice but default on its other legal obligations. "Not paying while having the resources and forcing a voluntary default is something that is not contemplated in Argentine law. It would be a clear violation of the debt prospects."

This absurd interpretation of the pari passu clause does indeed have systemic implications. It effectively makes a mockery of all debt renegotiation agreements, since there would be no incentive for any creditor to accept less than full value of the debt if some other creditor will be paid in full. It is therefore also in contradiction to the United States' own bankruptcy laws under Chapter 9 and Chapter 11. Indeed, bankruptcy laws are in place in most market economies precisely to ensure that there can be an orderly workout when debts cannot be repaid in full.

There is a reason for this. No credit system can function or has ever functioned with zero default. This possibility of default is embedded into credit contracts through the interest rate, with interest rate spreads operating as the market estimate of the probability of a default. So those who are seen as less likely to be able to repay are forced to pay higher interest rates, in both formal and informal credit transactions. A creditor who has been demanding and receiving a higher interest rate based on this probability cannot then demand full repayment as a right, since the contract reflected that very likelihood. So the ruling actually negates the basic principles upon which all credit markets function. This is one reason why even columnist Martin Wolf of the Financial Times described this case as “extortion backed by the US judiciary” (Financial Times 24 June 2014).

The US court rulings go further, saying that any third party - including banks facilitating such transactions - that attempts to pay these bondholders would be held in contempt of court. Judge Griesa even ruled that a payment by Argentina to holders of a euro-denominated restructured bond was also illegal, even though that particular bond is denominated under English law, and not under US jurisdiction.

Another extraordinary feature of the court judgment is the requirement that banks involved in handling the payments made to Argentine bond holders must turn over information to holdout bond holders on all the assets that the Argentine government holds worldwide. This is a major violation of banking secrecy laws everywhere, including in the United States. Even Justice Ruth Bader Ginsburg, a member in the Supreme Court's group of justices deciding the case, was constrained to ask: "By what authorization does a court in the United States become a 'clearinghouse for information' about any and all property held by Argentina abroad?" A press release from UNCTAD noted that this also severely erodes sovereign immunity, which can even have adverse effects on the US and may be illegal under other US laws.

It is no surprise that even the IMF and the Obama administration in the US have expressed concern over the systemic implications of this judgment on the operation of financial markets. The ripple effects of this judgment are likely to be felt for some time, affecting new (and inevitable) cases of restructuring of sovereign debt. There are unknown but probably vast amount of sovereign debt that is not governed by collective action clauses, and even such clauses cannot function if 25 per cent of creditors choose to hold out. Inability to enforce orderly restructuring is a recipe for the seizure or inaction of credit markets. Certainly it is an outcome that the already fragile global financial system can ill afford.

The obvious requirement is to move towards some internationally recognized system of debt restructuring, possibly along the lines of Chapter 9 bankruptcy laws in the US that govern municipalities, or similar arrangements that recognize and give primacy to the rights of citizens rather than only creditors. It remains to be seen whether the current travails of Argentina will be enough to concentrate the minds of those who are in a position to initiate such a process.

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