PERSPECTIVE ON SOVEREIGN DEBT LITIGATION

BY BRAD JOHNSTON, ESQ.

The Second Circuit recently issued a decision in *NML Capital, Ltd. v. The Republic of Argentina* that was the subject of several reports in the business news.[1] Although the case, in its simplest terms, involved bondholders trying to collect from an issuer that had defaulted, the case involved novel legal issues and other complicating factors, because the issuer was a foreign sovereign. The following passage from the Second Circuit's decision, which affirmed injunctive relief enforcing Argentina's pari passu covenants, highlights the fact that the case was no ordinary collection case:

> **"[A]t the February 27, 2013 oral argument, counsel for Argentina told the panel that it 'would not voluntarily obey' the district court's injunctions, even if those injunctions were upheld by this court."**

The panel's resulting scorn for Argentina is apparent throughout the opinion; yet, the Second Circuit concluded its opinion with caution, staying the injunctions against Argentina "pending resolution by the Supreme Court of a timely petition for writ of certiorari." The Second Circuit accordingly handed the bondholders a victory, but no immediate ability to enforce it, and gave the recalcitrant Argentina a loss but no immediate obligation to pay (or obey). While such a ruling, coupled with a party's admitted intent to disobey court orders, may seem extraordinary, such occurrences can be expected in sovereign debt litigation. This is something I learned as a young associate called into service for The Republic of Nicaragua, its Central Bank and its state-owned telephone company.

Just a few weeks after completing my clerkship and entering private practice, a judgment creditor of Nicaragua served a restraining notice on the New York Federal Reserve, restraining the account of the Nicaraguan Central Bank. The judgment creditor, much like the bondholders in *NML Capital*, had purchased sovereign debt at steep discounts on the secondary market, refused to participate in exchange or buyback programs and was seeking to collect the face value of the debt it held. Little did I know the effect this collection effort would have on my years as a young lawyer, resulting in my introduction to the Foreign Sovereign Immunities Act (FSIA), multiple trips to Managua and practical lessons learned during the course of these rather unique proceedings.

The first lesson I learned was that whenever a foreign sovereign (i.e., a foreign state or an instrumentality or agency of a foreign state) is involved, the FSIA severely limits the jurisdiction of the federal courts. Sovereign immunity from suit and execution is the general rule, subject to limited exceptions; more importantly, a waiver of sovereign immunity does not have the substantive effect that one might expect. Turning back to my first assignment under the FSIA, Nicaragua's creditor argued that it could execute on the assets of the Nicaraguan Central Bank at the Federal Reserve because the republic expressly waived the sovereign immunity of its Central Bank in the original loan documents. The district court rejected this argument because the waiver of the Central Bank's sovereign immunity only subjected the Central Bank and its assets to the

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jurisdiction of the federal courts. It did not render the bank liable for the debts of its parent government, because the FSIA is only and purely a jurisdictional statute. Accordingly, absent a showing that the Central Bank was independently responsible for the debt (e.g., as an obligor or guarantor), or the alter ego of the republic, the creditor could not execute on the Central Bank's assets to satisfy the judgment it obtained against the republic. The creditor never seriously pursued its alter ago theory, and the district court quashed the restraining notice.[2] The legal precedent and lesson learned from this collection effort was that, while a waiver of sovereign immunity can force a foreign sovereign to litigate in a federal court, the waiver will not, in and of itself, provide any substantive remedy.

As a young associate, I was quite excited to read the district court's opinion quashing the creditor's restraining notice, but my excitement was short-lived because the district court stayed its decision pending an appeal to the Second Circuit. While we had won on the facts and the law on this issue of first impression, the Central Bank's account at the Federal Reserve was still frozen. As one might expect, this was a difficult result to accept and to explain to a foreign client. Luckily, the Second Circuit, after a briefing and a hearing on whether the stay should be lifted, expedited the appeal and ultimately affirmed the district court's decision on the merits. Victory was finally in hand, but I realized that a win at the trial-court level, while important, is only the initial step in the sovereign debt litigation process, because both sides will pursue their claims and defenses at all costs.

Indeed, the context in which sovereign debt issues are litigated is unique because, "in contrast to distressed private debtors... there are no bankruptcy protections for financially impaired sovereign states."[3] As a result, when a foreign state finds itself litigating over its debt obligations, the plaintiff is generally a "vulture fund" that purchased the debt at a steep discount when the foreign state was near or already in default, with the premeditated plan to sue the foreign state in an effort to collect the face value of the debt for a substantial profit.[4] This business plan is only available because a foreign state cannot seek bankruptcy protection, and the lawsuits that are part of the plan generally occur after other creditors participate in exchange or buyback programs. Foreign states must accordingly use sovereign immunity as an imperfect bankruptcy substitute to fend off the collection efforts of creditors that refuse to settle because:

1. Bankruptcy is not an option;
2. The foreign state cannot afford to pay the face value of the plaintiff's debt; and
3. If the foreign state does not vigorously defend against the plaintiff's efforts, or if it agrees to a settlement on terms better than its original restructuring, it would encourage creditor holdouts and jeopardize the success of any future debt restructurings.

The plaintiff, in contrast, is trying to score a substantial profit that justifies the significant litigation costs it incurs, resulting in rounds of litigation concerning immunity from suit, liability and immunity from execution. Principle, precedent, poverty and profit are accordingly critical driving forces in sovereign debt litigation.

This was all reinforced when the same judgment creditor of Nicaragua that unsuccessfully sought to execute on the Central Bank's account at the Federal Reserve tried to execute on the payments American Airlines and Continental Airlines made to the Nicaraguan government for their flights in and out of Managua.[5] In contrast to their attempt to execute on the Central Bank's account at the Federal Reserve, this collection effort was directed specifically at a revenue stream paid to the republic. The creditor argued that the payments were subject to execution because the republic had agreed to a blanket waiver of its sovereign immunity in the underlying loan documents. This argument was rejected, however, because the FSIA only allows a creditor to execute on the commercial assets of a foreign sovereign used for commercial purposes, and the taxes American and Continental paid to Nicaragua were "public" rather than commercial in nature. Although Nicaragua did waive its sovereign immunity, the waiver could not expand the jurisdiction of the federal courts to reach non-commercial, public assets such as tax revenues. The taxes American and Continental paid were, therefore, absolutely immune from execution under the FSIA, despite Nicaragua's blanket waiver of sovereign immunity. Thus the creditor was left with little ability to collect on its judgment against the republic unless it could find commercial property in the United States used for a commercial purpose. This is no easy task when the debtor is a foreign state.

This perhaps explains why the creditors of Argentina in *NML Capital* sought injunctive relief enforcing Argentina's pari passu covenants. By seeking enforcement of pari passu covenants, the creditors are, arguably, not executing on any assets of Argentina, but rather obtaining a court order that directs Argentina to treat its creditors equally in accordance with its contractual obligations when payments to any one group of creditors are made. Of course, Argentina maintains that this type of injunctive relief violates the FSIA because the injunction effectively forces Argentina to forfeit assets that are absolutely immune from execution under the FSIA in order to satisfy the court's order. The Second Circuit has now, on two occasions, held that this type of injunctive relief does not violate the FSIA because it does "not attach, arrest or execute upon any property." The Second Circuit did, however, cautiously stay its decision, and it remains to be seen whether the Supreme Court will grant certiorari. But going forward, the stakes are unquestionably high for the plaintiffs and the Republic of Argentina regarding how, if at all, sovereign immunity and the FSIA limit the power of a federal court to fashion injunctive relief.

In the several rounds of litigation I participated in for Nicaragua, I certainly realized the serious nature of the disputes and the significant consequences an adverse ruling might have. Liability was contested when it could be, and additional collection efforts, in addition to those mentioned above, were challenged.[6] But, when I was asked to assist what was then Nicaragua's state-owned telephone company, ENITEL, with certain third-party obligations, I was able to see firsthand what was really at stake. For this round of work, I was dispatched to Managua for the first but not last time, to prepare for meetings that would occur in Costa Rica with a creditor. The creditor was not willing to travel to Nicaragua, claiming that they might be mistreated in some manner by Nicaraguan authorities upon their arrival.

At the time, Nicaragua was one of the poorest countries in the Western hemisphere, and its newly-elected leaders were trying not only to restore some form of democracy to the country, but also to overcome the legacy of debt and conflict that they inherited from prior regimes. Traveling through Managua from the airport to the hotel quickly revealed the poverty and other problems plaguing this small country. The infrastructure was crumbling, people were living in squalor and the country was saddled with external debt. (I found, however, that the Nicaraguans were some of the nicest people I have ever met, and the food, spirits and hand-rolled cigars were all a treat.) In the end, I realized, after seeing the extreme poverty first-hand, that fights over sovereign debt obligations are motivated by real-life political and social issues, not simply stubborn desires to avoid payments on lingering debt. The disdain recently expressed toward Argentina should, accordingly, be considered in the appropriate context of the limited options available to foreign states, the problems they face and the professional litigants that sue them. ■

1. *NML Capital, Ltd. v. The Republic of Argentina,* ___ F.3d ___, Case No. 12-105, 2013 WL 4487563 (2nd Cir. Aug. 23, 2013).
2. *LNC Investments, Inc. v. The Republic of Nicaragua,* 115 F. Supp. 2d 358 (S.D.N.Y. 2000), affirmed by *LNC Investments, Inc. v. Banco Central de Nicaragua,* 228 F.3d 423 (2nd Cir. 2000).
3. Jonathan I. Blackman & Rahul Mukhi, The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna, 73 Fall Law & Contemp. Probs. 47, 48 (2010).
4. *See id.*
5. *See LNC Investments, Inc. v. The Republic of Nicaragua,* No. 96 Civ. 6360 JFK, 2000 WL 745550 (S.D.N.Y. June 8, 2000).
6. *See, e.g., GP Hemisphere Assoc., LLC v. The Republic of Nicaragua,* No. 99 Civ. 10302 WHP, 2000 WL 1457025 (S.D.N.Y. Sept. 28, 2000).

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