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Implications of Argentina's Deal with "Super holdouts": Need for an Urgent Revision to Bond Contracts and a Debt Workout Mechanism

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Argentina signed an agreement in principle on 29 February 2016 with four "super holdout" hedge funds including NML Capital Ltd, Aurelius Capital, Davidson Kempner and Bracebridge Capital. Buenos Aires would pay them a total of about $4.65 billion, amounting to 75 percent of the principal and interest of all their claims of Argentina's bonds that were defaulted on during the 2001 debt crisis. The payment is to be made in cash before 14 April 2016, provided that Argentina's Congress approves the repeal of Argentina's domestic laws, namely the Lock Law and the Sovereign Payment Law, which prohibit the country from proposing terms to the holdouts that are better than those Argentina offered to its creditors in earlier restructurings. This deal would allow the return of Argentina to the international capital market after more than 15 years of exclusion, something that is imperative for the government to try to put the economy on a more sustainable path even though this would mean having to use a substantial part of its foreign currency reserves to pay off the holdout bond holders. Nevertheless, there are systemic implications of this deal to future sovereign debt restructurings which deserve careful examination and remedial actions.

The reason to call the four hedge funds as "super holdouts" is because they are the largest, the most combative and the most tenacious holdout creditors. Argentina floated exchange bonds in 2005 and then again in 2010 after it defaulted during the 2001 debt crisis on its bonds that were valued at nearly $100 billion. Ninety-three percent of the holders of Argentine restructured sovereign bonds accepted the exchange proposals at a considerable “haircut” (i.e. discount rate) of about 65% (that is, they agreed to receive only 35 cents for each dollar of the face value of the restructured bonds). The remaining 7% of the bond holders turned down the offers.

In 2003, NML Capital Ltd which is managed by Elliott first sued Argentina for repayment of 100% of the face value of the bonds they hold. As a result of the suit, U.S. District Judge Griesa issued his *pari passu* ruling which prohibited Argentina from servicing its bonds before paying the holdouts. This led Argentina to default on its debt again in 2014. With it the thirteen year-long litigation saga – considered to be among the most publicized, the ugliest and the most divisive legal battle in history for sovereign debt restructuring – came to a stalemate with both sides refusing to move.

To end the stalemate, the newly elected President of Argentina, Mauricio Macri, made resolving the holdout dispute a priority and in February 2016 offered to pay $6.5 billion to the group of six hedge fund holdouts. Two of the funds accepted the offer but not NML and three other funds which asked for better terms. Hence, we see different degrees of tenacity among holdouts, resulting essentially in different levels of payment to them and compromising inter-creditor equity. Clearly, the deal is a great victory for the “super holdouts”. In addition to the 75% payment in principal and hefty interest accumulated over the years, thirteen years of hefty legal bills will also be picked up by Argentina. Estimates on the returns that the “super holdouts” will make on their investment in Argentina’s bonds range from three to five times what they paid for the bonds in the first place.

The business model of these hedge funds is well known. They seek and buy sovereign bonds issued by States that are going through economic distress for a fraction of the bonds' face value and then holding out by refusing discounted repayment of such bonds when offered by the issuing State, seeking instead to getting paid in full or as close to full as possible for the principal plus interest through litigation or other means including seizing assets. Although the precise information on the prices paid by these “super holdouts” for the Argentinian bonds is not easily available, based on data from the Ministry of Finance of Argentina, Bloomberg[1] estimated that payment on principal would equal to about four times the face value of bonds Elliott holds. Elliott will get back, under the terms of the deal struck on 29 February 2016, $2.28 billion on its $617 million investment in principal.

However, the payment from the deal struck with Argentina may not be the only profit the “super holdout” funds get from their Argentina bonds. It is common for these funds to purchase CDSs (Credit Default Swaps) against the distressed bonds they hold. CDS is a credit derivative which ensures creditors get paid of the premium as well as the interest in times of default and other credit events. This creates a win win business situation for the hedge funds and lose lose dilemma for the sovereigns. With CDSs, the hedge funds would get paid if the borrowers default or the bond prices suffer from a deep decline. They would get paid twice if a defaulted borrower loses legal battle and is forced to pay the hedge funds.

In the case of Argentina, further to the *pari passu* injunction, a “failure to pay” credit event triggered the payment of the CDS on Argentina’s debt. Yet, it is not possible to get the CDS positions of the hedge funds involved in the litigation against Argentina. Some observers have suggested that relevant hedge funds against Argentina may also hold CDS on these bonds and thus profit from a default scenario. When being probed at the court room, Elliott’s lawyer chose to give an evasive answer.

However, purchasing large quantities of CDSs is the business model of such kind of hedge funds. This creates a conflict of interest as the hedge funds holding CDSs on the particular bond they are litigating in court are in a very good position to trigger default or push the prices of the litigated bonds lower through their litigation tactics. In return, these hedge funds can get paid for their CDS holdings because of the default and sharp price decline. Subsequently, because of the desire to return to the international market, the bond issuers would have to resume negotiation with the same hedge fund which would not give up until they squeeze as much as possible from the sovereign bond issuers.

Nevertheless, it is understandable that the new government of Argentina moved fast to tackle the impasse of the bond holdout problem. The country is facing many severe economic challenges at the moment. Inflation is about 25% and the primary fiscal deficit is more than 5.8 percent of GDP.

To make up the fiscal shortfalls, the government has been borrowing from the central bank, leading to a big drop in its foreign reserves. In the current global economic environment of low aggregate demand and declining commodity prices, it is not very realistic to pin hope on increasing trade revenue to replenish its foreign reserves, especially when its two largest export products - soya and petroleum - are subject to worsening terms of trade and drastic price fluctuation. To mitigate the severe liquidity shortage, Argentina has already utilized its currency swap arrangements with China. The government also has the option of cutting expenditure in order to ease the liquidity crunch, but embarking on a Greek-style austerity programme would be highly unpopular. Inflation has already eroded the real take-home pay of the wage earners and demonstrations for wage increase have been going on for years. To regain access to the capital markets to raise new money is important for mitigating the severe shortage of liquidity and smooth out economic bottlenecks.

The last hurdles to Argentina being able to return to the international capital market to obtain financing are these “super holdouts” as well as the injunction from the U.S. District Court. The deal would therefore clear both obstacles as Judge Griesa has granted the lifting of the injunction upon the repeal of the Argentine domestic laws. As the injunction is an important leverage for the “super holdouts” to get paid, they requested the injunction be lifted after they get paid. The country has already settled some major arbitration cases and disputes in previous years.

However, can we collectively utter a sigh of relief and celebrate the coming to an end of the longest and the most high profile holdout case in the history? Before doing so, we need to contemplate the impact and the implications of such a publicised legal battle that would end by the payment of billions of dollars to “super holdouts”.

Firstly, it would not be surprising for creditors involved in future debt restructurings to first look around and find out whether there are big institutional creditors with strong financial and legal positions involved in the same case. If so, the tendency could be to wait for a “me too” chance instead of examining the creditors' own economic positions and decide whether or not to be cooperative and accept the restructuring proposals. This will then most likely result in a delayed and disorderly debt workout and undermine the objective to quickly rescue the financially distressed governments and restore debt sustainability.

Secondly, huge financial gains for the “super holdouts” could lead to the birth of more “baby NML” making this much specialised profession a more crowded market. With this litigation case being so dramatic and traumatic that even a ship was seized[2], some creditors could be more combative and more uncompromising in the future. As a result, creditor coordination would turn out to be more difficult than before.

Thirdly, it is highly likely that these hedge funds would look for more weak links in the bond contracts further than *pari passu* and prepare themselves for the next target. The tremendous influence of these hedge funds, their legal tactics and the demonstrated tenacity have already led to efforts to strengthen the contractual clauses to reduce chances of holdout and rushing to the court. These include the tightening of the language of the collective action clause (CACs) and *pari passu* clause as well as the strengthening of sovereign immunity. However, there are other boilerplate/general clauses which could be subject to innovative interpretations like what happened to pari passu.

Fourthly, even though the legal battle between NML and Argentina is coming to an end, the impact of the powerful 2012 injunction on pari passu may still linger on. The question on whether the conditional lifting of the injunction granted by Judge Griesa would make the injunction disappear for good remains to be seen. The injunction prevents Buenos Aires from servicing its bonds until it settles with the holdouts. As Professor Anna Gelpern mentioned, this is a powerful financial weapon. It would certainly favour the holdouts if the borrower does not have close to infinite financial resources to fight lengthy legal battles. If holdouts can still use this injunction as recourse, chances of borrowers to win the legal battle would be significantly diminished. Outstanding bonds without improved language of CACs and pari passu is eye boggling. The newly revised CACs and pari passu clauses will take a long time to phase in depending on the maturity of the bonds. With the slow recovery from the global financial crisis and low commodity prices, some developing countries are facing debt sustainability challenges, making them eventual easy targets for litigation-oriented hedge funds.

How can the potential negative systemic impact from this case be mitigated and make future debt workout timely and orderly?

Current efforts have concentrated on making it more difficult for holdouts to rush to the court room through strengthening current contract clauses. This is necessary and welcome. However, this may be far from sufficient. The financial incentives to be “super holdouts” are immense. Additionally, NML and other holdout hedge funds have done everything within the law. The “super holdouts” have every right to purchase bonds at the secondary market as bonds are transferable and the secondary market is needed to make bonds liquid. Herding behaviour can make bonds undervalued. But buying them at a fraction of their face value is not a crime.

While the purchase of sovereign bonds on the secondary market at discount rates may be legal, one can say that the business model of specializing in purchasing hugely undervalued bonds for the purpose of resorting to litigation and other means to force the distressed governments to pay the full face value is not ethical because it is at the expense of the ordinary tax payers and the well being of a sovereign state.

Academia and institutions have used the strategy of “name and shame” hoping the “super holdouts” would give in. Apparently, it has not had much impact. Argentina’s unsuccessful pleadings in the U.S district and supreme courts were supported by the Pope, Nobel Prize winners, countries like France, Mexico and Brazil, international intergovernmental institutions like the IMF, the United Nations and the South Centre, NGOs and ordinary citizens. None managed to persuade the hedge funds to give up.

Three approaches may be of value to consider for the purpose of reducing the recurrences of the NML-style “super holdouts”.

One approach is to reduce incentives for holdouts. It is common business practice for goods and services bought at huge discount in retail stores or via internet to have clear stipulations that they are either not refundable or cannot be changed or returned. People take it for granted that it is a lawful and correct business practice. To buy things at Christmas sales and go back to the stores and request for refund of the full original price of the products would be considered as unethical. Why then is it so unlawful to reject the request of the “super holdout” to get paid 100% when the bonds were bought at a fraction of their face value? Because sovereign bond contracts often do not explicitly mention that bonds bought at a discount will be redeemed by the government at the discounted rate rather than at face value, the issuing State then gets bound to respect the bond contract and pay it at face value.

In the absence of a multilateral legal framework on sovereign debt restructuring mechanism, reducing incentives may be done through revising the contractual terms for the bonds. In the case when the bonds were bought at a steep discount, there could be a contractual clause to limit the margin of returns to minimize the likelihood of litigating for 100% repayment. Consideration could be given to add a clause to bond contracts to the effect that “in case of a debt restructuring, the bondholders would be paid back no higher than X% of the purchase price of the bond.” The percentage could be a range and take into consideration the past holdout cases together with haircut levels of historical debt restructuring incidences. The range or specific percentage should allow sufficient profit margin and avoid the possibility of moral hazard of strategic default. In this way, secondary market operations would not be disrupted and hopefully the incentives for super holdout could be diminished.

Other ways of reducing incentives for super holdout should be examined. For instance, the statutory penalty interest rates of some of the bonds Elliott holds are exorbitantly high. According to the Wall Street Journal, these bonds would bring 10-15 times of return to Elliott.[3] These kinds of arrangements give insane incentives to holdout bond holders.

Another way out is to explore whether it is really beneficial for the stability of the international financial market not to regulate hedge funds specialized in debt holdout. At a time of increased social responsibilities for the institutions of the real economy, more regulations in the banking sector and more specific codes of conduct for various business sectors, should there also be some regulations and codes of conduct with respect to these hedge funds? Apparently, conflict of interests and lack of transparency do exist in their purchases of CDSs, hence, there should be efforts to investigate into this relatively closed and opaque business.

Finally, there have been repeated international efforts to establish an international debt workout regime or legal framework to cope with systemic issues relating to the “too late and too little” phenomenon for debt restructurings as well as the holdout problem. The IMF tried in 2003. The United Nations General Assembly set up an Ad Hoc Committee mandated to create a multilateral legal framework for sovereign debt restructurings in September 2014.

As one outcome, in 2015 the Committee formulated the ‘Basic Principles on Sovereign Debt Restructuring’ based on years of research and consensus building in UNCTAD. However, political resistance from the developed countries has made it difficult for the United Nations to push the work to a more inclusive and substantive phase. The Argentina case has proved once again the need of a debt workout mechanism.

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[1] Bloomberg, *Singer Makes 369% of Principal on Argentine Bonds in Debt Offer*, by Katia Porzecanski, 29 Feb. 2016, http://www.bloomberg.com/news/articles/2016-03-01/singer-makes-369-of-principal-on-argentine-bonds-in-debt-offer

[2] The holdout hedge funds persuaded Ghana to detain an Argentinian naval ship with more than 200 crew on board as collateral.

[3] Wall Street Journal, *How Elliott Earned Billions on Argentine Bonds at 101% Interest*, by Julie Wernau , 3 March 2016, http://blogs.wsj.com/moneybeat/2016/03/03/how-elliott-earned-billions-on-argentine-bonds-at-101-interest/

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