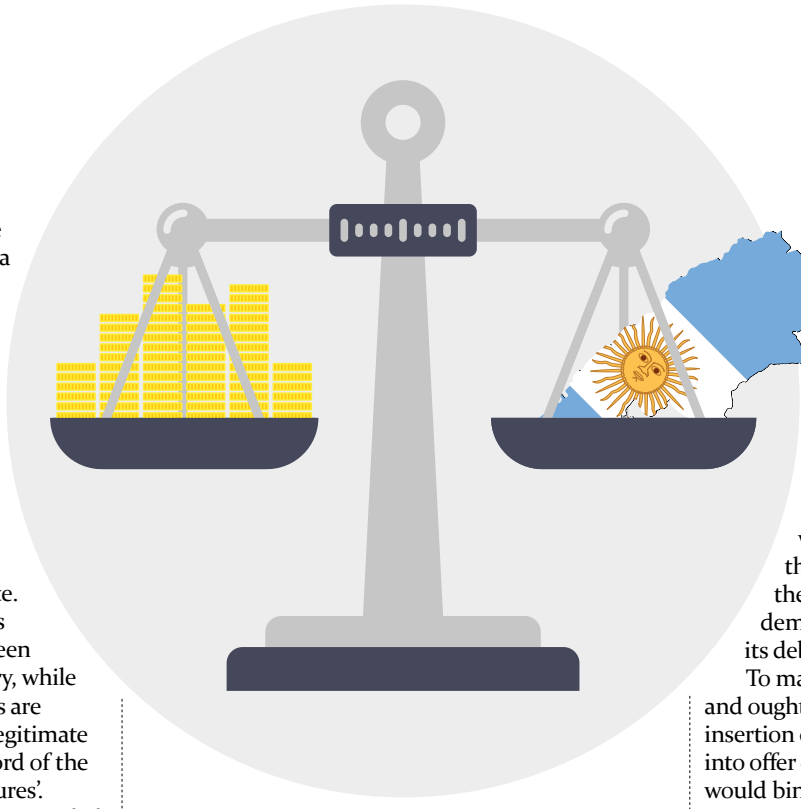
COURTROOM DRAMA

In July 2014, Argentina defaulted on a $539m interest payment on its sovereign debt in the latest round of its ongoing legal dispute with bondholders. Andrew Wilkinson explains



By any usual standards, the dealings between Argentina and a minority of its bondholders ought to have been a low-key last act to the drama of the country's 2001 default. Instead, it is turning into a morality play in which both sides claim the high ground and questions of national sovereignty and security of contract clash noisily in what is becoming an increasingly acrimonious dispute.

As sides are taken, Argentina's reluctance to negotiate can be seen as either principled or incendiary, while the activities of the bondholders are presented as either an entirely legitimate line of business or, to use the word of the moment, the behaviour of 'vultures'.

Amid the sound and fury, a fair-minded assessment of the whole affair – in which Argentina is now grappling not only with its creditors, but with the US legal system – is essential. Such an assessment would concede that changes might well be needed to the system of bond issuance to ensure that all bondholders support efforts at restructuring. It would concede also that Argentina has probably overplayed its hand through failing to recognise where the power ultimately lies in debt negotiations.

A history lesson

First, however, some history. The New York courtroom dramas of recent months can be traced back to 2001, and the debt default that followed Argentina's ultimately unsuccessful attempt to use a fixed exchange rate to the US dollar as an external discipline on its economic management.

The subsequent restructuring of $100bn of Argentina's debt in 2005 and 2010 saw a majority of creditors agree to swap the distressed debt for bonds with a much lower value, taking a 'haircut' on their investments of about 70%. These are the so-called exchange creditors.

As a result of the restructuring, the country's debt as a percentage of GDP fell from 166% in 2002 to 45% in 2012.

But about 7% of the creditors – now known as the 'holdout creditors' – did not accept the restructuring offer; indeed, they bought *more* distressed Argentinian debt. These are hedge fund specialists that focus on buying distressed sovereign debt cheaply and turning a profit, either by finding a buyer willing to pay more or by suing the debtor for full payment. And the holdout creditors subsequently demanded that Argentina repay its debt.

To many, this behaviour is offensive, and ought to be prevented by the insertion of collective action clauses into offer documents for bonds, which would bind creditors to abide by the majority decision. Objectors would also like to see amendments to the *pari passu* provisions that treat holdouts equally with other creditors. Such changes would undoubtedly be desirable. But they have been talked about for many years, and little beyond talk has been achieved.

Whether people like it or not, under the current dispensation, the holdout creditors were entirely within their rights to demand full payment totalling about $1.3bn on their investment, a right upheld by a US federal court in 2012. The court also prohibited any payments to the exchange creditors until the holdout creditors were paid in full.

Critics of the authorities in Buenos Aires suggest their flat refusal to negotiate drove the holdout creditors to law. This, in turn, they say, has had an entirely predictable courtroom outcome. Argentina's refusal to sit down with the holdouts has, say critics, given these minority creditors far more publicity and negotiating leverage than the position warranted.

Infringement on national sovereignty

But Argentina believes the court has infringed its national sovereignty, not least because the 'rights upon future offers' (RUFO) clause inserted into Argentine bonds prohibits paying the holdout creditors on better terms than the exchange creditors.

It is quite correct that Argentina, as a sovereign state, does not fall within US jurisdiction in its own territory. But the pivotal role of New York – and friendly jurisdictions such as London – in the world financial system means the banks through whose settlement systems Argentina would need to route payments to exchange creditors, in defiance of the US courts, most certainly do fall within US jurisdiction.

As a result of this 'long arm' of the American law, Argentina had to miss a $539m interest payment to the exchange creditors on 30 July. Rating agency Standard & Poor's declared the country to be in 'selective default'.

Since then, Argentina has clashed with the court again, by denying that it is, in fact, in default, and the court is threatening to find the country in contempt. It has also done little to endear itself to US judges by floating the idea of a scheme to make the payments to exchange creditors initially through its own central bank and then routed through various financial centres so as to skirt America's long legal reach.

Attractive though this outright defiance may be to Argentina and its supporters, there are real practical problems. A century ago, this 'financial bypass' of the US may have been relatively easy to achieve. It would be harder now, when capital markets are tied closely to the US, not least because of the key reserve-currency role of the dollar and the comfort provided to investors by the country's legal system.

Furthermore, even were this to be achieved, for Argentina to have set up a sort of parallel or 'grey' financial market for its own purposes may not put investors in the right frame of mind when the country next seeks to drum up international capital for economic development.

Grand finale

How will it all end? It is very difficult to say, and harder still to see how the pieces can be put back together.

While the issue continues to progress through the court of industry opinion, the market has already seen genuine change. The International Capital Markets Association recently announced changes to sovereign bond contracts, in a direct attempt to avoid similar disputes in the future. Under new terms, collective action clauses have been introduced, which allow a majority of bondholders to agree changes to bonds that are binding on all investors, preventing any minority from disrupting the restructuring process.

One possible end game would be a deal with the holdout bondholders, but there is no sign of this. Another would see the Argentine government sit tight and wait for the RUFO clause to expire next year. The trouble is, there has been a default in the meantime.

Thirdly, Argentina could go back to the exchange bondholder to try to change the terms of the bonds.

Whatever the rights and wrongs, it is hard to escape the conclusion that Argentina would have been better advised to have negotiated a deal right from the start. The exchange bondholders would have been more sympathetic had Argentina tried to strike a bargain with the holdout creditors, albeit on more generous terms. They would very likely be less sympathetic now.

The plain fact is that, in the world of restructuring, refusal to negotiate simply isn't practical. During the eurozone crisis, the Greek and Irish governments realised they had to negotiate directly with bondholders, when it came to the restructuring of their bank and sovereign debt, however unpalatable that may have been. In doing so, they ensured the capital markets would eventually welcome them back.

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LESSONS FROM THE GREEK AND IRISH DEBT RESTRUCTURING

There are two lessons here for all debtors, sovereign or corporate.

- **First, creditors ultimately hold all the cards. You have to negotiate, cut a deal and move on.**
- **Second, conflict with your creditors – whatever the apparent provocation and however strongly you believe you are in the right – is usually a bad idea, both for companies and countries, and ought to be avoided whenever possible.**

The real sadness is that Argentina, having put in so much hard work after 2001, ought now to be turning its economy around and starting to enjoy the fruits of its efforts. Instead, it is mired in a legal dispute that, as yet, shows no sign of being resolved in its favour.

This concern, fairly or unfairly, may result in investors thinking twice as Argentina comes looking for funds, not least to exploit a potentially huge shale gas field.

Argentina's history of expropriating both domestic- and foreign-owned assets makes it just that bit harder for the country to present itself as a reliable business partner that respects property and contractual rights.

Note: Argentina was due to make another interest payment to bondholders on 30 September, after this issue of *The Treasurer* went to press.

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