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CORPORATE RESTRUCTURING AND BANKRUPTCY

'Pari Passu' Means What Now?

With respect to international loans, this once boilerplate clause is likely to continue having an important bearing on restructurings and insolvencies.

BY CHARLES G. BERRY

FIVE YEARS AGO, international debt markets were stunned by an ex parte decision from an appellate court in Belgium that precipitated an unprecedented settlement by a foreign sovereign debtor. The court's ruling in that case, *Elliott Associates v. Peru,*[1] turned on a novel interpretation of a provision that has appeared in cross-border lending instruments, corporate trust indentures and other loan agreements since the 19th century.

Known as the "pari passu" clause, various forms of that provision had been understood by lenders for decades as simply requiring equal treatment in bankruptcy for holders of an issuer's unsecured and unsubordinated debt. The *Elliott* case, however, introduced a new interpretation, namely, that even prior to bankruptcy, an issuer of debt governed by a pari passu clause could not make any payment to any unsecured creditor without making a pro rata payment to all other creditors of the same class.

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Prior to the novel ruling in the *Elliott* case, there was a dearth of published authority, in the United States or any other jurisdiction, on the meaning and intent of pari passu clauses. Since then, a small but significant body of case law and secondary authority has developed. These put the conflicting interpretations of the clause in sharp focus.

On the one hand, hedge funds that have invested in distressed corporate or sovereign debt have tried, with limited success, to use the interpretation articulated in the *Elliott* case to obtain injunctive relief or other remedies in an effort to secure par value recoveries on their debt holdings.

On the other hand, bank lenders and industry groups have espoused more visibly and vocally the traditional interpretation of the pari passu clause as merely requiring equal treatment of creditors in the insolvency context. Of particular note was the publication of a report last year by the Financial Markets Law Committee of the Bank of England analyzing the role and meaning under English law of pari passu clauses in sovereign debt obligations.[2]

Recent cases in New York, California,

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the Netherlands and England illustrate the continuing efforts of "holdout" creditors to use the pari passu clause as a sword, not a shield, in securing advantageous treatment as holders of both corporate and sovereign debt issues.

Although no definitive court rulings have emerged, it has become increasingly apparent that a court's interpretation will depend in large measure on the particular language of the clause and its contractual context. Particularly with respect to international loans, the meaning of this once seemingly boilerplate clause is likely to continue having an important bearing on restructurings and insolvencies.

The Historical Context

The phrase pari passu is legal Latin meaning "in equal step" or, simply, "equally."[3] It came into usage in 19th century secured debt instruments, for the purpose of confirming that secured creditors would share ratably in the security.[4]

After cross-border lenders in emerging markets learned the hard way not to rely on collateral, they insisted upon other contractual protections, such as the negative pledge, prohibiting a borrower from pledging assets to subsequent lenders.

As international commercial banks came to dominate the sovereign debt market, however, they became concerned that negative pledges might not furnish adequate protection against procedures available to certain favored creditors in some foreign jurisdictions (such as Spain, Argentina and the Phillipines) that could cause secured bank claims to become subordinated without the creditor's consent or even notice. The pari passu clause was revived to address the threat of involuntary subordination.[5]

The 'Elliott' Decision

The decision in the *Elliott* case arose out of the purchase by the prominent distressed debt fund, Elliott Associates LLP, of loans from two Peruvian banks that were guaranteed by the government of Peru.

Elliott's purchase, of nearly $20.7 million in face value of loans for a reported $11.4 million, came a few months after Peru announced its Brady Plan restructuring of the debt of those two banks.[6] Refusing to participate in that restructuring, Elliott obtained a judgment in New York for the full face value of the loans it held, plus interest, for a total of $55.7 million. It then sought to enforce that judgment.

Facing the common problem of locating assets against which to enforce a judgment against a foreign debtor (whether sovereign or corporate), Elliott devised a novel and ultimately successful strategy. It brought an ex parte proceeding in the court of Belgium, where Peru planned to used the international clearing system of the clearing bank, Euroclear, to distribute payments in accordance with the Brady Plan to participating correspondents.

After failing to obtain an ex parte injunction from the Brussels Commercial Court restraining Euroclear (and its then-manager, Morgan Guaranty Trust Company) from accepting payment from Peru or making payment to the other creditors, Elliott bought a prompt ex parte appeal to the Court of Appeals of Brussels. That court issued the requested injunction. Because the deadline for payment under the Brady Plan was imminent, Peru settled with Elliott for the full amount of its judgment plus post-judgment interest.[7]

The Brussels Court of Appeal explained the basis for its ruling as follows:

> The basic agreement regulating the reimbursement of the Peruvian foreign debt also indicates that the different creditors enjoy a "pari passu clause", which has as a result that the debt should be diminished equally towards all creditors in proportion to their claim. From this, one seems to have to conclude that, in case of the payment of interests, no creditor can be excluded from its proportional part.[8]

That interpretation of the pari passu clause was espoused by Elliott's expert, Professor Andreas F. Lowenfeld of New York University Law School. In a declaration stating his opinion, submitted in support of the judgment Elliott had obtained in New York and again in support of its application to the Brussels Court of Appeal, he concluded that

> the pari passu clause in the Guaranty [given by Peru for the debt of the defendant Peruvian bank] entitles each Lender to share equally and ratably with any other holder of External Indebtedness as defined. I have no doubt that the Brady Bonds described above constitute External Indebtedness of the Republic of Peru. Accordingly, if the Republic pays principal or interest to holders of the Brady Bonds or some of them, it is obligated to make a payment of a proportionate amount to all holders of Affected Debt…including [Elliott].[9]

In other words, the interpretation put forth by Elliott and Professor Lowenfeld, which the Brussels Court of Appeal endorsed, is one that required equal treatment of creditors of equal rank, not just in the context of a bankruptcy or liquidation but whenever payment to any such creditor is made.

Litigation Fallout

In the wake of the *Elliott* decision, a few courts in different jurisdictions have wrestled with the interpretation of pari passu clauses.

"Holdout" creditors have tried to replicate Elliott's success in invoking that clause in a pre-bankruptcy context to exert leverage in enforcing judgments or obtaining some advantage in negotiations with the debtor. To date, such creditors have had only limited success.

At the same time, institutional lenders concerned about the effect of the *Elliott* decision on foreign debt markets have been prompted to more active advocacy of the traditional interpretation of the pari passu clause as requiring equal treatment only in the context of bankruptcy or liquidation.

Emblematic of this struggle is a series of related cases that arose out of efforts of the

Republic of Congo to restructure its debt.

In May 2001 the U.S. District Court for the Central District of California entered an order in favor of a judgment creditor enjoining Congo and its central bank from making or authorizing payments with respect to any external debt without making a "proportionate payment" to the judgment creditor, Red Mountain Finance, Inc.[10] There is no indication, however, that the judgment creditor plaintiff in that action was able to implement the relief granted by the California court against the African republic.

In the leading case in the English courts, in fact, a contrary result was reached, although the court's discussion of the pari passu clause was dicta.

In *Kensington Int'l Ltd. v. Republic of the Congo*,[11] the assignees of various debts due from the Republic of the Congo sought an order in aid of judgment enforcement to compel the Republic to specifically perform the alleged payment obligations under the clause. Although the English court declined the relief on separate grounds that were upheld on appeal, it expressed strong reservations about the plaintiff's pari passu argument. Justice Tomlinson found the precedent of the *Elliott* and *Red Mountain Finance* cases unpersuasive.

One of the few decisions of a U.S. court on the meaning of a pari passu clause—although not officially reported—was by former Chief Judge John Martin in the Southern District of New York.[12]

The issue arose in a procedurally complex context. Judgment creditors of a Mexican construction company called Tribasa had intervened in an action brought by a Mexican bank, Nacional Financiera (or Nafin), which was also a judgment creditor of Tribasa. Both the intervening parties and Nafin had invested in Tribasa's medium term notes (MTNs).

The intervenors claimed, however, that the pari passu clause in the fiscal agency agreement governing the MTNs had been violated when Tribasa had rolled over the MTNs held by Nafin (that is, paid them at maturity and issued new notes), at a time when the MTNs held by the intervenors were in default. The intervenors sought to amend their complaint to add a cross-claim against Nafin, arguing, among other things, that Nafin's receipt of payments from Tribasa under the MTN program violated the pari passu clause.

Judge Martin rejected the intervenors' argument and declined to entertain the amended pleading. He ruled that the pari passu clause

> did not create contractual rights and obligations between Nafin and the other holders of Tribasa's unsecured notes. The above provision does no more than guarantee that in any insolvency proceedings, all of the MTN creditors will share pari passu in the unencumbered assets of the estate. There is nothing in the language of the provision that would suggest that before accepting payment from Tribasa, Nafin had an obligation to ensure itself that other note holders were receiving similar payments.[13]

Judge Martin proceeded in dicta to cite the *Elliott* decision and note the possibility that the fiscal agency agreement might have given the intervenors the right to obtain an injunction barring Tribasa from making preferential payments. He concluded, however, that "absent such an injunction, the [fiscal agency agreement] created no obligation on any note holder to refuse payment of money that it was owed until it had received assurances that other note holders were receiving proportionate payments."[14]

Thus, although the decision in *Nacional Financiera* endorses the interpretation of pari passu as merely ensuring equal treatment of creditors "in any insolvency proceedings," its citation to *Elliott* creates continued uncertainty as to the extent to which U.S. courts may find persuasive the reasoning of that ex parte ruling from the Belgian appellate court.

One of the few other known cases from any court construing the meaning of a pari passu clause arose in the Netherlands and concerned a provision in a corporate trust indenture governing a loan syndicated by Amsterdam-Rotterdam Bank N.V., a predecessor of ABN-AMRO Bank.

The proceeds of the loan were designated for and used by operating subsidiaries of a Dutch company called DAF, a manufacturer of military vehicles and aviation components that had merged with the British company Leyland Trucks and others. The relevant provision of the trust deed stated: "The debtor shall not, as long as not all debentures of this loan have been repaid, give any security…in respect of any current or future debentures, loans, debts or other obligations of itself or a third party unless such security is simultaneously given in respect of these debentures."[15]

A group of noteholders who had purchased from the original syndicate members argued that this was a pari passu clause that should be broadly interpreted. They also pointed to the following language in a letter from DAF's then-chairman, included in the prospectus for the underwriting: "[I]t is not the intention to enter into any new financing transactions with related specific security. Insofar as this nevertheless turns out to be necessary, the holders of the debentures to be issued now will rank pari passu in respect of such security."[16]

After DAF entered bankruptcy proceedings, a dispute arose as to whether the noteholders under this debenture were entitled to recover certain security that had been conveyed to banks that were creditors of DAF subsidiaries pursuant to a separate facilities agreement.

The Supreme Court of the Netherlands explained at length the conflicting rulings of the District Court and the Court of Appeal. The District Court had found that the language of the trust indenture was determinative and that the prospectus and the letter from the board chairman set forth therein did not alter the interpretation.

Noting that "[i]n its common meaning, a pari passu clause is a clause whereby the debtor undertakes in advance to give his creditor the same security which the debtor

will give to other creditors," that court had nevertheless ruled that the noteholders had no claim to recover the security given to the DAF subsidiaries because only DAF itself and not its subsidiaries had been the obligor under the indenture.

The Court of Appeal had reversed, giving the pari passu clause a broader reading. It found that from the "perspective of DAF and the average prudent investor" the pari passu clause (and the representations in the prospectus, which the court found relevant) would enable the noteholders to share ratably "in security to be given—in the future—to creditors in the framework of group financing," i.e., including DAF's operating subsidiaries.[17]

The Dutch Supreme Court reversed and remanded, finding that "the Court of Appeal applied an inappropriate criterion in determining the meaning of the pari passu clause."[18] The highest court declined, however, to address the ultimate question of whether that clause should be interpreted broadly or narrowly.

It noted with approval the general proposition put forth by the Court of Appeal "that the pari passu right, regardless of whether it must be interpreted narrowly or broadly, is intended to protect the debenture holders against dilution of the certainty which they derive from the equity of their debtor as a result of the future giving of security for either existing or future debts." It concluded, however, that "[i]t can be left undiscussed whether a broad interpretation of the pari passu right could in the given circumstances entail a prevention of the hollowing out of the recovery options of the debenture holders."[19]

The Court of Appeal, upon remand, concluded that a "narrow interpretation" of the pari passu clause was mandated by a strict interpretation of the contractual language: It ruled against the debenture holders and rejected their claim to collateral given to lenders of DAF's subsidiaries.[20] Its ruling, however, does not make clear whether or not the pari passu clause might apply in a pre-bankruptcy context with respect to security pledged by the debtor itself.[21]

Thus the DAF decisions of the Dutch courts show that the pari passu clause has caused as much difficulty and uncertainty in civil law jurisdictions as it has in the United States and England.

Guidance for the Future

The body of case law on the meaning and application of pari passu clauses continues to be sparse. No holdout creditor appears to have replicated the success of Elliott, at least not in as public a fashion.

There still remains doubt, however, as to whether other courts, in the U.S. or abroad, will follow the interpretation adopted by the Belgian appellate court in that ex parte proceeding, namely, that instruments containing pari passu clauses require ratable payments to all creditors of the same class, whether or not the debtor or issuer is in formal bankruptcy or liquidation proceedings.

In the meantime, the slack has been taken up by academic commentators and concerned financial institutions, who have championed the interpretation that pari passu treatment of creditors applies only when actual insolvency proceedings have commenced. Most notable of the publications of this sort has been the white paper by the Financial Markets Law Committee of the Bank of England.[22]

Authored by prominent practitioners from many of the leading English firms, this publication is likely to be seen as authoritative not only with respect to English law-governed clauses and sovereign debt instruments, but also for corporate obligations governed by U.S. or other law. The comprehensive analysis of the history and application of the pari passu clause there underscores the importance of applying principles of contract construction to the different variants of the clause. Those that speak in terms of "ranking" instead of "payment" are likely to be more readily interpreted as limited to the context of bankruptcy proceedings.

Practitioners in New York confronted with these issues of interpretation should bear in mind the overarching policy recognized by New York courts that, at least in the absence of any pari passu provision, "a conveyance which satisfies an antecedent debt made while the debtor is insolvent is neither fraudulent nor otherwise improper, even if its effect is to prefer one creditor over another."[23]

Despite the remarkable success achieved by the holdout creditor in *Elliott*, such creditors will likely face an uphill fight in future efforts to overcome this established policy.

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1. *Elliott Assocs., L.P.*, General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, 26th Sept. 2000) (the Brussels Decision).
2. Financial Markets Law Committee, Issue 79—Pari Passu Clauses Working Group, "Analysis of the role, use and meaning of pari passu clauses in sovereign debt obligations as a matter of English law" (March 2004).
3. Lee C. Bucheit and Jeremiah S. Pam, "The Pari Passu Clause in Sovereign Debt Instruments," 53 Emory L.J. 869, 871 (2004) ("Bucheit and Pam").
4. Id. at 894.
5. Id.
6. *Elliott Assocs., L.P. v. Banco de la Nacion*, 194 F.3d 363, 366 (2d Cir. 1999); Joshua Chaffin, "Investor 'Vultures' Come Under Scrutiny," Financial Times, Oct. 25, 2000, at 19.
7. G. Mitu Gulati and Kenneth N. Klee, "Sovereign Piracy," 56 Bus. Law. 635, 636 (2001).
8. The Brussels Decision (unofficial translation), p. 3.
9. Declaration of Prof. Andreas F. Lowenfeld, dated Aug. 31, 2000, filed in *Elliott Assocs., L.P. v. Banco de la Nacion*, U.S.D.C., S.D.N.Y. 96 Civ. 7916 (RWS).
10. *Red Mountain Finance, Inc. v. Democratic Republic of Congo and National Bank of Congo*, U.S.D.C. C.D. Cal. Case No. CV 00-0164 R (May 29, 2001).
11. *Kensington Int'l Ltd. v. Republic of the Congo*, Commercial Court, 2002 No. 1088, April 16, 2003 (Tomlinson, J.) (unreported), approved by the Court of Appeal [2003] EWCA Civ. 709. See also Decision of May 6, 2003, reported at 2003 WL 23145131 (denying ex parte Mareva injunction application).
12. *Nacional Financiera, S.N.C. v. The Chase Manhattan Bank, N.A.*, 2003 WL 1878415 (S.D.N.Y.).
13. Id. at 2003 WL 1878415*2.
14. Id.
15. *Nederlandsche Trustmaatschappij B.V. et ano. v. ABN AMRO BANK N.V.*, Supreme Court of The Netherlands, First Chamber No. C99/056HR (23 March 2001), p. 4 (unofficial translation of judgment). See also *Leyland DAF Ltd. et ano. v. Nederlandsche Trustmaatschappij B.V. and Stichting Ofasec*, Supreme Court of The Netherlands, First Chamber No. C99/048HR (23 March 2001) (related case).
16. Id., p. 5.
17. *Leyland DAF Ltd. et ano. v. Nederlandsche Trustmaatschappij B.V. and Stichting Ofasec*, Supreme Court of The Netherlands, First Chamber No. C99/048HR (23 March 2001), pp. 6-7.
18. Id., p. 7. Consistent with practice of civil law jurisdictions, the DAF rulings do not cite to precedent in other cases that might be viewed as authoritative in common law jurisdictions.
19. Id., p. 10.
20. *Nederlandsche Trustmaatschappij B.V. et ano. v. Stichting Ofasec et al., etc.*, Court of Appeal in the Hague, Netherlands, Second Civil Section, Cause No. 02/516 (29 June 2004) (judgment after referral).
21. Id., sec. 7 (c), p. 5 ("According to the text, Article 7, Section 2 of the trust deed [the pari passu clause] therefore means nothing more than that DAF is to provide any security interests, which it is to furnish or extend in respect of other obligations of its own or third parties, at the same time and on the basis of equal ranking in respect of the present bonds.").
22. See n. 2.
23. *Ultramar Energy Ltd. v. Chase Manhattan Bank, N.A.*, 599 N.Y.S. 2d 816 (1st Dept. 1993).

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