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Hedge Fund Law Report
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Sovereign Debt

Second Circuit Decision Addresses the Ability of Hedge Funds to Attach Sovereign Property

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In 2001, Argentina stopped paying interest on roughly $80 to $100 billion in sovereign debt, resulting in "the largest default of a foreign state in history." As a result of this default, a number of creditors, including hedge funds that invest in sovereign or distressed debt, filed lawsuits against Argentina. See "If a Hedge Fund Holder of Defaulted Sovereign Debt Obtains a Judgment Against the Defaulting Sovereign, What Assets Can the Hedge Fund Go After to Satisfy the Judgment?," Hedge Fund Law Report, Vol. 4, No. 21 (Jun. 23, 2011). Capital Ventures International (CVI), the plaintiff in this action, was one such creditor. It chose to sue Argentina in the New York federal courts rather than accept Argentina's offer to exchange its defaulted debt for new debt, and sought to attach its judgment on Argentina's interests in the collateral securing other defaulted debt. CVI succeeded. It obtained an attachment to Argentina's reversionary interest in the collateral securing a series of its other bonds, called "Brady bonds," which had been issued in 1992 as part of the United States-backed Latin American debt-relief program. On legal issues in connection with trading European sovereign corporate debt, see "The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans (Part Two of Two)," Hedge Fund Law Report, Vol. 4, No. 38 (Oct. 27, 2011).

This litigation arose when Argentina subsequently obtained an order modifying CVI's attachment so Argentina could commence a second defaulted bond exchange. CVI appealed from that order to the United States Court of Appeals for the Second Circuit. There, a panel of three circuit judges reversed the modification order, holding that CVI is entitled to maintain its attachments, notwithstanding that their opinion exposed a "quirk" in the contract underlying the Brady bonds which would "effectively block" any future proposed exchange between Argentina and the holders of those defaulted bonds. One circuit judge, in a concurrence, "unhappily" joined in that conclusion, due solely to Argentina's failure to raise potentially meritorious arguments on appeal. *Capital Ventures Int'l v. Republic of Argentina*, Docket No. 10-4520-cv(Lead) 2d Cir. (Jul. 20, 2011). We detail the background of the action and the Court's legal analysis. See also "United Kingdom's High Court Finds Argentina's Sovereign Immunity Doctrine Cannot Prevent a Hedge Fund from Seeking to Enforce an American Judgment against Argentina in English Courts," Hedge Fund Law Report, Vol. 4, No. 25 (Jul. 27, 2011).

Background

In 1992, Argentina replaced tens of billions of dollars' worth of foreign debt with "Brady bonds," due to mature in 2023. The Latin American debt-relief program provided Argentina with United

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States and German securities as collateral to secure payments on these new bonds, with the Federal Reserve Bank of New York, as the "Collateral Agent," holding a first-priority security interest in the collateral on behalf of the bondholders. A Collateral Pledge Agreement (Agreement) governed the payment schedule and disposition of the bonds.

The Agreement provides that, on the maturity date, Argentina will repay the bondholders, or the bondholders will get the collateral. Until then, Argentina cannot transfer the collateral. The appeal focused on the application of Section 6.01 of the Agreement, which provides:

> If . . . Argentina redeems . . . or purchases or exchanges . . . any . . . Principal Bond and surrenders such [] Bond . . . for cancellation . . ., upon [Argentina's] request . . . for the Release of Principal Collateral . . . [the Federal Reserve] shall . . . deliver . . . [the collateral in corresponding amount]. Upon such . . . delivery, the Lien . . . in favor of the Holders . . . shall terminate, such [collateral] shall be free of the Lien . . . and all rights with respect to such [collateral] shall revert to Argentina.

As stated, in 2001, Argentina stopped paying interest on billions in sovereign debt, including the Brady bonds. In 2005, Argentina offered to exchange certain defaulted bonds for the proceeds of the collateral securing them plus new debt that Argentina would issue. For holders of Brady bonds, a "quirk" existed that endangered this exchange. Since Section 6.01 of the Agreement allowed for early release of the collateral to Argentina, free and clear of the lien (the reversionary interest), that right opened the collateral to attack by creditors in the time it took for Argentina to obtain it, liquidate it and pay out the proceeds.

CVI, a holder of defaulted non-Brady bonds, refused to participate in the exchange. Instead, it sued Argentina, and sought to attach its judgment to Argentina's reversionary interest in the Brady collateral. The district court initially denied the attachment. CVI appealed to the Second Circuit, while an exchange of approximately $62.3 billion in bonds (with $2.8 billion worth of Brady bonds) took place. Though mooting the attachment, CVI maintained its appeal to govern if Argentina offered "another exchange someday" for the remaining Brady bonds.

In *Capital Ventures Int'l v. Republic of Argentina*, 443 F.3d 214 (2d. Cir. 2006) (CVI 1), the Second Circuit held that CVI could attach Argentina's reversionary interest in the remaining, unexchanged collateral securing the Brady bonds. It did so, notwithstanding the court's recognition that it would have the practical effect of forcing Argentina "to stay in default and wait until" 2023 "to give up the collateral to the Brady bondholders, rather than entering into another exchange." CVI then obtained an order of attachment in the district court.

In 2010, Argentina proposed another exchange for approximately $100 million in Brady bonds. Argentina sought to modify the CVI attachment by obtaining a court order permitting the "Federal Reserve . . . to liquidate the pro rata share of the Brady principal collateral attributed to the tendered Brady bonds and transfer those proceeds directly" to the bondholders. The district court granted the modification, but stayed its order pending appeal. CVI then appealed to the Second Circuit, and several similarly situated creditors joined in the appeal.

Legal Analysis

A three-judge panel of the Second Circuit, with one judge concurring in the outcome but expressing strong disagreement with the majority opinion's reasoning, reversed the district court's modification of CVI's attachment. The majority found that under New York law, which Argentina and its creditors had elected to govern their agreements, the attachments blocked the

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proposed exchange, and the district court had abused its discretion by modifying the attachment.

To begin, the Second Circuit reiterated its prior decision, that CVI could attach its judgment to Argentina's reversionary interest. That attachment, it explained, applied to two such interests: Argentina's receipt of the collateral in 2023 upon full payment of the outstanding debt, or when, pursuant to Section 6.01 of the Agreement, a pre-2023 exchange (or redemption) lifts any lien in favor of the Brady bondholders and returns the collateral free and clear to Argentina (whereupon CVI's attachment would take hold of the collateral before it could be used to provide collateral for substitute bonds). The modification obtained by Argentina, which would liquidate the pro rata share of the collateral and transfer the proceeds directly to the bondholders "would destroy this second reversionary interest," the Court said, because the collateral would not revert to Argentina. Thus, the Court held this modification would violate N.Y. C.P.L.R. § 6214(b), which bars "any sale, assignment or transfer of, or any interference with" the attached property.

Next, the Second Circuit rejected Argentina's arguments that the exchange would not infringe on CVI's attachment. First, it found the Federal Reserve's senior security interest in the collateral, which it held on behalf of the Brady bondholders, had no bearing on its analysis. That interest, it explained, would undisputedly make it impossible for CVI to foreclose on, or to obtain, the collateral if Argentina failed to pay the bondholders in full by 2023. But, it would not affect a disposition of the collateral before that date. Instead, the terms of Section 6.01 would control in those circumstances, and that provision authorizes the disposition of the collateral free of any security interest on behalf of the bondholders in the event of an exchange before 2023. Second, the Court found no other specific provision of the Agreement, including the general provisions cited by Argentina that discuss the endurance of the lien, addressed what happens in the event of an exchange prior to 2023. And, third, the Court rejected Argentina's attempt to utilize another provision of the Agreement, which provided for amendment by mutual agreement with the bondholders, because any attempt by Argentina to approve of an amendment that erased its reversionary interests would, itself, violate the attachment.

Finally, the Court held that, under New York law, Argentina had failed to meet the specified grounds for modification or vacatur of an attachment. See N.Y. C.P.L.R. § 6223. The Court noted that it was not addressing "technical modifications of an attachment"; instead, the district court's order effectively vacated CVI's attachment to Argentina's pre-2023 reversionary interest. It stated, as it had in CVI I, that a "district court's 'discretion does not permit denial of the remedy [of attachment] . . . absent extraordinary circumstances and perhaps even then.'" CVI I, 443 F.3d at 222. The Court found no such circumstances. The Brady bondholders, it explained, would not face dire consequences due to the attachment. They still get what they bargained for (i.e., full payment by 2023 or the collateral), and they could still sell their bonds in the secondary market for distressed debt, "a market," it said "with which many [of the] players here are, no doubt, already familiar." The Court also found no reason to believe the attachment would affect the finances or access to capital markets of Argentina, as a sovereign country, given the relatively small nature of the bond exchange. As a result, it held that no extraordinary circumstance exists that would justify a discretionary modification of the attachments.

Concurrence

The concurrence addressed two arguments which it felt "might [] rebut the reasoning of the majority opinion," but said it could not adopt them because they "ha[d] not been advanced" by

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Argentina. Argentina, it noted, had only contended that other provisions of the Agreement override Section 6.01. The concurrence agreed with the majority that these arguments failed.

Instead, the concurrence focused on the seniority of the competing claims. It did not believe Section 6.01 could mean the collateral reverts to Argentina "free and clear" of the liens, because the new exchange agreement commits it as a continuing security for the bondholders. In other words, "Argentina would not be free to grab the collateral and run," because if it did so, a court would enforce the exchange agreement and bar the collateral's diversion. Thus, the concurrence, as an equitable matter, did not see the lien securing the substitute bonds as a new lien, but rather a continuation of the preexisting lien since the collateral remains reserved for the sole purpose of paying the originally secured debt.

The Court acknowledged, however, a weakness in that argument since the exchange could arguably create an "alteration of terms regarding the schedule of payment," which would affect the attachment. Specifically, the immediate use of part of the collateral to pay part of the principal on the bonds diminishes the chance that Argentina pays off the bonds prior to the maturity date from a source other than the collateral, leaving the more valuable collateral, upon reversion, subject to attachment. The Court was unsure whether this difference should have any pertinence, however. Instead, the crucial question should be whether Argentina uses the collateral for its own purposes, not whether the new arrangement diminishes the likelihood of the fruition of the attachment.

The stronger argument presented by the concurrence, but never raised by Argentina, related to the intention of the parties in drafting Section 6.01 of the Agreement. The provision's aim, it explained, was "clearly apparent." It was meant to apply if Argentina chose to purchase, redeem, exchange or cancel the bonds, employing resources other than the collateral, which would allow the collateral to revert to Argentina. The Court thought "it questionable" that the parties to the Brady bond Agreements ever intended or understood that this provision applied to any substitute agreement between them which remained financed by the collateral. In support of this reading, the concurrence pointed to the fact that, by its terms, the reversion in Section 6.01 only applies when Argentina makes a "Request for the Release of Principal Collateral," which would not occur under the exchange agreement. The concurrence took no position on this question, however, because Argentina had not litigated it. Tellingly, in a footnote, the majority opinion had stated that it also had "no occasion" to discuss these issues, because Argentina had simply failed to advance an interpretation of Section 6.01 which would support the conclusion that, upon exchange, the collateral would not revert to Argentina free and clear of the lien. As a result, this question remains open for future litigation involving any nation with Brady debt.

It appears that Argentina is having no success defending its defaults to foreign private creditors on the grounds of protecting its sovereignty. The Second Circuit found nothing exceptional in the effect its decision would have on Argentina's financial condition as a basis to modify the attachment. In a similar outcome, recently reported on by the Hedge Fund Law Report, the United Kingdom's High Court rejected Argentina's plea of sovereign immunity to prevent attachment of its property there. See "United Kingdom's High Court Finds Argentina's Sovereign Immunity Doctrine Cannot Prevent a Hedge Fund from Seeking to Enforce an American Judgment against Argentina in English Courts," Hedge Fund Law Report, Vol. 4, No. 25 (Jul. 27, 2011).

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