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A gathering of eagles

John V. Orth*

Key points

- The problem of preferential payment is generic to borrowers, not specific to sovereign borrowers. Equal payment to creditors of equal rank is secured by domestic bankruptcy law; in sovereign borrowing the private law of contract must substitute for the public law of bankruptcy.
- The *pari passu* clause that is included in most sovereign debt instruments has a plain meaning; the problem is its application to sovereigns in breach.
- Historical research demonstrates that the problem of preferential payment emerged contemporaneously with international capital markets.
- When sovereigns borrow, they offer an array of contractual clauses such as the *pari passu* clause; when they default, they deny the enforceability of their contractual undertakings. Until there is an enforceable sovereign debt resolution mechanism, unenforceable promises will continue to proliferate.

For whosoever the carcase is, there will the eagles be gathered together.

Matt 24:28 (KJV)

*NML Capital v Argentina*¹ has concentrated the minds of sovereign debtors and creditors on the *pari passu* clause that appears in most sovereign debt instruments: ‘The bonds will rank *pari passu*’—or, ‘equally in right of payment’—‘with all the sovereign’s other indebtedness’. The purpose of this clause is obvious. Debtors time out of mind have been tempted when in financial distress to make preferential payments. Favoured creditors include friends or family, or businessmen with whom (or for whom) the debtor hopes to work in future. The unjust steward in the gospels explained that he discounted his master’s bills in order to ingratiate himself with the debtors, so that ‘when I am put out of the stewardship, they may receive me into their houses’.² But fundamental fairness requires that like cases be treated alike; if full payment to all creditors is not possible, all who rank equally should at least be paid proportionally. Before the federal Bankruptcy Act of 1898, an insolvent debtor in New York made a ‘general assignment without preference’, and creditors who suspected fraud sought evidence to upset it.³ Orderly resolution of the affairs of a bankrupt obviates the need for Dickensian-style debtors’ prisons (or their equivalents) and offers the debtor a chance for a ‘fresh start’.

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1 699 F3d 246 (2d Cir 2012).

2 Luke 16:3 (KJV).

3 For the account of one knowledgeable participant in the late nineteenth-century New York credit market, see *The Autobiographical Notes of Charles Evans Hughes* (DJ Danelski & JS Tulchin eds, Harvard University Press 1973) 76–79.

Although it is unlikely that a sovereign's debts ever truly exceed its resources, a sovereign is subject to constraints on its ability to raise revenue or liquidate assets and may face difficult choices in allocating such funds as are available. Sovereign borrowers in distress for whatever reason may default just like any other debtor, and the problem of preferential payment by sovereign debtors is not inherently different. They, too, are tempted to favour some creditors over others; with the sovereign borrower it is likely to be powerful supporters of the government of the day or well-connected foreigners. Of course, sovereign borrowers are different in that they cannot be put in receivership and their assets liquidated like ordinary borrowers, but they can be denied a fresh start, at least in the sense of being shut out of the global capital markets until they reach a composition with their lenders.

In the private debt market, bankruptcy laws incorporate the principle of equal treatment for all creditors with the same priority; the *pari passu* clause must do the work in international financial markets. But, as recent litigation has shown, the application of the clause to the sovereign borrower has proved difficult. The problem has not been what the words of the clause mean. They are plain enough. The problem has been how to apply them to the sovereign borrower. Unlike the operation of frequently recurring clauses in ordinary loan contracts, the operation of the *pari passu* clause has not been clarified by judicial decisions over the years, precisely because of the difficulty of hauling sovereign debtors into court.

In the absence of instructive precedent, Chabot and Gulati⁴ have taken seriously the oft-told tale that the *pari passu* clause is simply boilerplate, always there and noticeable only in its absence; they have endeavoured to discover when it first came to be included in sovereign debt instruments and what it meant at the time. Returning *ad fontes*, they hope to find in its origin a clue to how the clause is supposed to operate today. The product of the authors' detective work is fascinating, at least to the small world of those interested in the history of international finance. Chabot and Gulati, with the assistance of an energetic team of Duke Law students, take the reader on a tour through the troubled financial history of the early Mexican republic.

Mexico listed its first bonds on the London Stock Exchange in 1824–1825, a good time to go to market, as one of the periodic upturns of the business cycle meant that optimism and money were in plentiful supply.⁵ According to Walter Bagehot, the speculative mania rivalled that surrounding the South Sea Bubble a hundred years earlier.⁶ In the next decade, sovereign borrowers throughout the Western Hemisphere experienced the inevitable downturn. When faced with a shortfall in revenue, Mexico tried serial restructuring, qualified by preferential payments to favoured bondholders; finally, like

4 B Chabot and M Gulati, 'Santa Anna and his Black Eagle: The Origins of *Pari Passu*?' (2014) 9 CMLJ 216.

5 See WW Rostow, 'Trade Cycles, Harvests, and Politics 1790-1850' in *The British Economy of the Nineteenth Century* (OUP 1948) 116.

6 W Bagehot, *Lombard Street* (1873) 136.

many American states at the time, it defaulted.⁷ The career of the brilliant London merchant Charles Morrison, the ‘Napoleon of shopkeepers’, was almost cut short by American bank failures and wild fluctuations in the commodities market.⁸ In his novels and travel writings from the 1830s, Charles Dickens lambasted defaulting sovereigns.⁹

To make its restructured bonds more attractive, Mexico made the coupons on debt contracted in London payable in custom tax certificates, a limited form of legal tender. Virginia did something similar after the American Civil War when it restructured its debt in 1871, issuing bonds with coupons ‘receivable at and after maturity for all taxes, debts, dues, and demands due the state’. But Virginia was subject to the jurisdiction of federal courts, making future restructuring almost impossible.¹⁰ The value of the Mexican custom certificates, even assuming the willingness and ability of local courts to enforce them, depended upon the remote English bondholder’s Mexican tax liability—or ability to find a Mexican taxpayer willing to purchase them, usually at a discount.

Finally, in 1843 Mexico consolidated its debt to English creditors in the so-called ‘Black Eagle’ bonds, incorporating a commitment ‘to establish a just equality amongst the creditors, as much as regards the rate of interest as the order of payment’—*pari passu avant la lettre* (to mix languages). Perhaps suggesting the later pedestrian metaphor, *The Times* had been demanding that Mexico put holders of the same issue on ‘a perfectly equal footing’.¹¹ Chabot and Gulati reasonably suggest that it was the implicit threat of British military—or rather, naval—intervention that prompted the undertaking. Only a few years earlier, France had blockaded and bombarded Veracruz, and a few years later the British blockaded the Greek port of Piraeus in support of compensation for a British subject known to history as Don Pacifico.¹²

This account of the financial difficulties that led the Mexican republic to issue the Black Eagle bonds is informative and the details colourful: that the bonds’ name was suggested by the sobriquet of Mexican President Antonio López de Santa Anna, ‘the Eagle’; that Santa Anna had commanded the Mexican troops at the siege of the Alamo, where the legendary ‘Davy’ Crockett met his end; that Santa Anna had lost his leg in the bombardment of Veracruz; and that the resourceful Martinez del Rio family, who eventually profited from the Black Eagle settlement, later hired the young JRR Tolkien to tutor their scions. ‘There is’, as Dr Johnson once remarked, ‘nothing so minute or

7 For the American experience, see JV Orth, *The Judicial Power of the United States: The Eleventh Amendment in American History* (OUP 1987) 30–46.

8 C Dakers, *A Genius for Money: Business, Art and the Morrisons* (Yale University Press 2011) 125–45.

9 For citations, see JV Orth, ‘Charles Dickens & the Sovereign Debt Crisis’ (2012) 16 Green Bag 2d 35–41.

10 For a discussion of why this provision made Virginia’s repudiation more difficult than repudiation by other American states and the colourful history of the Virginia ‘coupon killers’ and ‘coupon crushers’, see Orth, *Judicial Power* (n 6) 90–105.

11 Quoted in Chabot and Gulati (n 4) fn 52.

12 EL Woodward, *The Age of Reform, 1815–70* (2nd edn, OUP 1962) 246–47. The Don Pacifico Affair was the occasion of British Foreign Secretary Lord Palmerston’s famous claim: ‘As the Roman, in days of old, held himself free from indignity, when he could say, “*Civis Romanus sum*”, so also a British subject, in whatever land he may be, shall feel confident that the watchful eye and the strong arm of England will protect him from injustice and wrong.’

inconsiderable, that I would not rather know it than not'.¹³ But just how useful are these incunabula in understanding the modern effect of the *pari passu* clause?

The details are local, but the problem is ubiquitous. From English investors in Mexican bonds in the nineteenth century to the Elliott hedge fund (dba NML Capital) and the Argentine bonds in the twenty-first, the story is the same: unequal payments to creditors of equal rank. There is no call here to repeat the economic argument concerning the contribution that 'speculators'—not to mention 'vultures'¹⁴—make to the efficient operation of capital markets, but one must recognize and discount the pejorative connotations attached to the name(s) if one is to seek instruction from the record. In like manner, 'gunboat diplomacy' is freighted with imperialist and racist meanings, and while it may be amusing to describe the bombardment of Veracruz by the French as an 'out-of-court settlement'—or to call British threats of force against defaulting sovereigns 'extra-judicial enforcement'—it is questionable usage in a context in which there is no possibility of in-court settlement or judicial enforcement.¹⁵

Participants in capital markets know that any borrower may default and that all defaulting borrowers are tempted to make preferential payments. Sophisticated investors also know that collecting from a sovereign and preventing preferences by a sovereign are particularly difficult. When going to market, sovereign borrowers seek to allay concerns by offering to bind themselves with an ever-lengthening list of contractual undertakings, not just *pari passu* clauses: hypothecation clauses, negative-pledge clauses, waiver of immunity clauses, choice-of-law clauses, acceleration clauses, etc. Some even put their promises of repayment in the solemn form of constitutional provisions.¹⁶ But when defaulting, sovereign borrowers seek to slip the bonds. Nowadays contractual resolution mechanisms are offered. Collective action clauses have become particularly popular.¹⁷ But the fundamental problem of preferential payments cannot be solved by contractual provisions unless they are enforceable. What will happen on the day when 'holdouts' deny the necessary majority for voluntary resolution according to a CAC and the sovereign still defaults? Promises, all ultimately unenforceable, will continue to multiply until there is an effective resolution regime for sovereign defaults.

13 J Boswell, *The Life of Samuel Johnson* (repr, Folio Soc 1968) 1:533.

14 Modern biblical translators correct the epigraph to this article: 'Wherever the carcass is, there the vultures will be gathered.' See eg, *Anchor Bible: Matthew* (WF Albright and CS Mann tr, Doubleday 1971) 294.

15 Participants in international credit markets without judicial enforcement mechanisms—just like participants in markets for banned substances or parties to illegal gambling contracts—have no option but 'extra-judicial' means of enforcement.

16 See eg, Puerto Rico Const, art VI, § 8 (in case of a shortfall in revenue, 'interest on the public debt and amortization thereof shall first be paid'); NC Const, art III, § 5(3) (similar). See also JV Orth and PM Newby, *The North Carolina State Constitution* (2nd edn, OUP 2013) 94–96.

17 Since 2005 collective action clauses have been included in a large majority of sovereign bonds issued under New York law. *NML Capital*, 699 F3d at 264.