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Analysis of the role, use and meaning of *pari passu* clauses in sovereign debt obligations as a matter of English law

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ISSUE 79 – PARI PASSU CLAUSES WORKING GROUP

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1. INTRODUCTION

1.1 Background

The purpose of this report is to analyse the role, use and, most importantly, the meaning, as a matter of English law, of *pari passu*[1] clauses in sovereign debt obligations. The preparation of this report has been prompted by recent litigation in the courts of Belgium, California, New York and England concerning the interpretation of these clauses. In this litigation, creditors who had purchased sovereign debt that was in default argued, or attempted to argue, that the *pari passu* clause contained in that debt should prevent the sovereign debtor from making payments to other creditors without at the same time paying the litigating creditors on a *pro rata* basis.

The Financial Markets Law Committee (the "**FMLC**"), at a meeting on 27th November, 2003, decided that it should establish a Pari Passu Clause Working Group (the "**Working Group**") to consider these issues and publish a report which would set out its opinion on the proper meaning of *pari passu* clauses in sovereign debt obligations as a matter of English law.

1.2 Executive summary

A *pari passu* clause is a standard clause found in international syndicated bank loan agreements and bond issues. The clause is a covenant or a warranty that the bank loans and the bonds "rank *pari passu*" with all the other unsecured debt of the borrower or issuer. The clause appears in both corporate and sovereign debt obligations.

Until recently it was thought that the clause prescribed only that on the insolvency of the debtor unsecured claims, including the debtor obligations concerned, would rank *pari passu* or equally as a matter of insolvency or statutory law. The purpose was a statement, sanctioned by an event of default, as to equal ranking as a matter of law so that the creditors were assured that on competition between creditors there was no mandatory provision for unequal payment.

Recently another interpretation has found favour in court decisions in California and Belgium. This interpretation is that the clause in effect requires that, once the debtor is actually

[1] The Latin phrase "*pari passu*" means "in equal step" or "side by side".

insolvent, the debtor will in fact pay all its claims *pro rata* and could thus be prevented from paying one creditor in full if the obligations concerned went unpaid.

This report asserts that, so far as English law is concerned, the wide "payment" interpretation is incorrect and that the "ranking" interpretation is the proper construction. There are three reasons which support this assertion:

- The principal reason is that the "payment" interpretation would not be acceptable to debtors and indeed to creditors, and would be unworkable. In short, it would offend the "business commonsense" principle used by English courts when construing a contract. In particular, it would lead to the result that once the debtor actually became insolvent the debtor would not be able to make any ordinary course of business payments necessary to enable the debtor to maintain its business. Hold-out creditors in pursuit of a bargaining position against other creditors could prevent payments and bring the business to a premature halt. An action of this type could be used to seriously disrupt payment systems through which the debtor made its payments and securities settlement systems through which the debtor paid for investments. Hence if the payment interpretation were correct, the *pari passu* clause would be prejudicial not only to debtors but also to creditors by making it impracticable for all creditors to sustain the debtor's business if only one of them objected.

- Another reason is based on the principles of English rules of contract construction that the words used be given their ordinary and natural meaning and that they should be considered in the context of the entire transaction. The language itself on the most literal interpretation requires a "rank" of the claims, *i.e.* a legal rank. It does not require *pari passu* "payment". In addition, other provisions are typically found in debt obligations which do require equal payment and this suggests that the *pari passu* clause was not intended to require equal payment.

- The final reason is based on an analysis of English case law which provides persuasive authority against the payment interpretation.

The remainder of this paper provides a detailed analysis of the issues.

1.3 Structure of the report

Sections 2.1 to 2.3 of this report describe a typical *pari passu* clause and the two principal interpretations of such a clause that exist today. Because the *pari passu* clause is a contractual provision, section 2.4 then identifies the principles for construing contracts

governed by English law. The most important of these in the context of this report is the "business commonsense" principle for construing commercial contracts described by Lord Diplock in the *Antaios*[2] case although it is also helpful to analyse the actual language used. Section 2.4 also contains an analysis of the most helpful English case law on the point although this provides only persuasive authority against the payment interpretation.

Adopting the business commonsense principle of contractual construction, section 3 looks in detail at the consequences that would follow from the implementation of the payment interpretation and concludes that these would offend that principle.

Picking up on another important principle of contractual construction, section 4 provides an analysis of the actual wording used and determines that this too supports the ranking interpretation over the payment interpretation.

Finally, section 5 sets out the conclusions reached in this report.

[2] *Antaios Compania Naviera S.A. v. Salen Rederierna A.B.* 1 A.C. 191.

2. ANALYSIS

2.1 Description of a typical *pari passu* clause

Pari passu clauses are a standard feature in cross-border[3] unsecured[4] debt obligations. They are found in both loan agreements and securities issues.

In a loan agreement, the *pari passu* clause is often drafted as follows:

> "The payment obligations of the borrower under this Agreement rank at least *pari passu* with all its other present and future unsecured obligations."

In an international securities issue, the *pari passu* clause is usually found in the "status" or "ranking" condition and is often drafted as follows:

> "The bonds and the coupons are direct, unconditional and unsecured obligations of the issuer and rank and will rank at least *pari passu*, without any preference among themselves, with all other outstanding, unsecured and unsubordinated obligations of the issuer, present and future."

The standard formulation for a bond *pari passu* clause therefore has two limbs:

(i) the *internal* limb: that the bonds rank *pari passu* with each other[5]; and

(ii) the *external* limb: that the bonds rank *pari passu* with other unsecured indebtedness of the issuer.

The internal limb is not found in loan agreements.

As a matter of contractual analysis, the standard loan agreement *pari passu* clause is a representation that, as a matter of fact, the payment obligations of the borrower rank in the manner described. This clause may be complemented by a corresponding covenant under which the borrower promises that the payment obligations will rank *pari passu* as described in the representation. In the context of the standard securities issue provision, the *pari passu*

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[3] A *pari passu* clause is often omitted in domestic debt obligations.
[4] The clause is inapplicable in the case of secured lending. If a *pari passu* clause was expressed to apply to secured, rather than unsecured, indebtedness it would be a concealed negative pledge clause.
[5] One reason for the internal ranking limb was probably to deal with the argument that the ranking of bonds depended on their date of issue – a point which was pertinent in relation to secured bonds where debentures of the same series might be issued in tranches at different times but were intended to enjoy equal ranking as regards the security but which has no relevance to modern unsecured bond issues.

clause is both a representation as to the present ranking, and an undertaking as to the future ranking, of the securities. A court would therefore view the representation as a promise that the particular ranking exists as at the date of the contract and, where there is an undertaking, a promise that the future conduct of the borrower will ensure that the particular ranking will exist during the life of the contract.

There are, of course, many different ways to draft this clause and this report will consider the principal variations in more detail below. The *pari passu* clauses found in sovereign debt obligations mirror these standard formulations. Sovereign debt obligations, however, frequently limit the scope of the *pari passu* clause to "external indebtedness", which is usually defined as unsecured indebtedness denominated in a currency other than that of the sovereign debtor or by reference to the residence of the holder of the debt so that it does not capture indebtedness targeted at domestic creditors or investors.

2.2 Sample *pari passu* clauses

In preparing this report, the Working Group has conducted a survey of the *pari passu* clauses contained in a number of public sovereign bonds issued during the period beginning on 1st January, 1999 and ending on 31st January, 2004. Where a particular sovereign issued a number of bonds during this period, only one example was included in the survey. Based on this survey, this report asserts that, save in one highlighted case[6], the differences in the actual drafting used in these bonds are not material to its conclusion as to the proper meaning of the *pari passu* clause under English law. Examples of the two principal variations are set out, and analysed, in section 4.

2.3 The two principal interpretations of the *pari passu* clause

(i) Corporate debt obligations

Most jurisdictions have in place an insolvency system that provides for the orderly distribution of a company's assets once it has been liquidated. A lender is clearly interested to know where its indebtedness would rank in such a distribution if the borrower became insolvent. This explains why, as was seen in section 2.1 above, it is common for there to be a representation as to where the particular indebtedness ranks at the date of the agreement. If, for example, the borrower is an English company, a debtor who obtains a representation that its debt is "senior" knows that it will rank

after any secured indebtedness, but before any subordinated indebtedness incurred by that borrower. The current bankruptcy rule for such an English company is that, except for debts which are made preferential (as to which see the next paragraph) or subordinated by specific statutory direction, all ordinary (or "senior") debts rank equally between themselves and shall be paid in full or, in the event of a deficiency of assets to meet them, abate in equal proportions between themselves[7].

However, there may be a number of situations in which indebtedness incurred by a borrower may acquire seniority to that of the lender. For example:

(a) In many jurisdictions, taxes and wages rank in priority to the claims of other unsecured creditors in the liquidation of a corporation.

(b) In some countries retail depositors with banks or other financial institutions or the holders of insurance policies of an insurance company in liquidation must be paid out before other creditors.

(c) In the Philippines, an unsecured creditor can and, until recently, in Spain[8] could, by publicising the relevant agreement in the prescribed manner before a public official and by paying a documentary tax, achieve priority over unsecured creditors who do not publicise their agreement and, possibly, also over other unsecured creditors whose agreements are subsequently formalised.

(d) Debt securities may under local corporate laws rank for payment in liquidation according to their date of issue.

There is little that a lender can do in relation to (a) and (b) above[9], but a covenant by the borrower that the indebtedness *will* rank at least *pari passu* with all other senior indebtedness should give the lender some comfort that the borrower will not assist any other lenders in a way that would give their indebtedness priority. The Spanish notarisation procedure described in (c) above, for example, used to require the participation of the lender. Similarly, the disclosure language relating to a bond

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[6] See section 4.
[7] Gough, *Company Charges* (2nd edition) at p. 948.
[8] Under the "Ley Concursal" (Ley 22/2003) which came into force on 1st September, 2004, all unsecured creditors, whether or not their obligations are contained in a public deed, are required to be paid on a *pro rata* basis upon the insolvency of the debtor.
[9] Indeed, it is common to see an exception in corporate *pari passu* clauses for "obligations mandatorily preferred by law".

issued by the Philippines' notes that the Philippines believes that its cooperation is required in order to obtain this notarisation.

The purpose of the *pari passu* clause in corporate debt obligations, therefore, is to provide a commitment or warranty that on a liquidation or a forced distribution of assets by reason of insolvency, unsecured creditors will be entitled to a *pro rata* payment *i.e.* that unsecured creditors have in law *pro rata* claims against the assets of the insolvent borrower.

(ii) Sovereign debt obligations

The fundamental point that most commentators make when discussing the meaning of the *pari passu* clause in sovereign debt obligations is that sovereigns, unlike corporates, cannot become insolvent. In the first place a government cannot be liquidated because it has insufficient assets to meet its liabilities and, although governments may be unable to, or refuse to, pay their debts, there are no procedures equivalent to the bankruptcy procedures for a domestic corporation whereby a government's assets can be compulsorily realised and the proceeds distributed to its creditors. As a result, the purpose of a *pari passu* clause in a sovereign debt obligation must be different.

There are two principal interpretations of what the *pari passu* clause means in sovereign debt obligations. The first is a "ranking" interpretation that argues that the *pari passu* clause merely affirms that the obligations rank and will rank *pari passu* with all other unsecured debt as a matter of mandatory law and the second is a "payment" interpretation that argues that the borrower has undertaken that it will in fact pay its obligations *pro rata* when it is unable to pay all of them in full.

Until recently, the ranking interpretation was the only interpretation and, accordingly, the only purpose of the clause was believed to be to prevent sovereigns from "earmarking" revenues of the government or allocating foreign currency reserves to a single creditor or, more generally, to prevent the sovereign from adopting legal measures which have the effect of preferring one set of creditors against the others. In other words, although a sovereign cannot be subjected to a formal bankruptcy

regime, it can promise not to pass a law that would legitimise a preference given to one unsecured creditor over another[10].

However, the payment interpretation of the *pari passu* clause seems to have recently been accepted by the Cour d'Appel de Bruxelles (Brussels Court of Appeal) in a case brought by an investment fund called Elliott Associates[11], which had purchased defaulted Peruvian indebtedness. This payment interpretation is neatly summed-up in the following opinion from Professor Andreas Lowenfeld of New York University, which was obtained by Elliott Associates for the purpose of the Peru litigation. Professor Lowenfeld opined that the meaning of the *pari passu* clause was clear:

> "I have no difficulty in understanding what the *pari passu* clause means: it means what it says – a given debt will rank equally with other debt of the borrower, whether that borrower is an individual, a company, or a sovereign state. A borrower from Tom, Dick, and Harry can't say "I will pay Tom and Dick in full, and if there is anything left over I'll pay Harry." If there is not enough money to go around, the borrower faced with a *pari passu* provision must pay all three of them on the same basis.
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> Suppose, for example, the total debt is $50,000 and the borrower has only $30,000 available. Tom lent $20,000 and Dick and Harry lent $15,000 each. The borrower must pay three fifths of the amount owed to each one – *i.e.*, $12,000 to Tom, and $9,000 each to Dick and Harry. Of course the remaining sums would remain as obligations of the borrower. But if the borrower proposed to pay Tom £20,000 in full satisfaction, Dick £10,000 and Harry nothing, a court could and should issue an injunction at the behest of Harry. The injunction would run in the first instance against the borrower, but I believe

[10] For this reason, it would not make sense to insert the exception typically found in corporate *pari passu* clauses relating to "obligations mandatorily preferred by law", since this would give the sovereign an escape route for passing laws in the future that have the effect of preferring a particular creditor.

[11] *Elliott Assocs., L.P.,* General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, 26th September, 2000). Other recent litigation which has concerned the proper interpretation of the *pari passu* clause has included: *Republic of Nicaragua* vs. *LNC Investments LLC and Euroclear Bank S.A./N.V.* (litigation in Belgium); *Red Mountain Fin, Inc*. v. *Democratic Republic of Congo and Nat'l Bank of Congo* (litigation in California, U.S.A.); *Kensington Int'l Ltd*. v. *Republic of Congo* (litigation in England); and *Macrotechnic Int'l Corp* v. *The Republic of Argentina* and *EM Ltd* v. *The Republic of Argentina* (current litigation in New York, U.S.A.).

(putting jurisdictional considerations aside) to Tom and Dick as well."[12]

2.4 The English law position

Given that two different interpretations exist, this part of the report considers the principles which an English court would use to construe a *pari passu* clause in order to determine its proper meaning.

(i) Construction of contractual terms

The object of all construction of the terms in a written agreement is to discover therefrom the intention of the parties to the agreement[13]. Every contract is to be construed with reference to its object and the whole of its terms, and accordingly, the whole context must be considered in endeavouring to collect the intention of the parties, even though the immediate object of inquiry is the meaning of an isolated word or clause.

An important principle of modern English contract law to be considered when construing a commercial contract is that the words used must be given a sensible and commonsense business meaning. This principle was laid down by the House of Lords in the *Antaios*[14] case. In one part of his judgment, Lord Diplock stated "if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense." Lord Diplock's words were later approved by Lord Hoffmann in *Investors Compensation Scheme Ltd. v. West Bromwich Building Society*[15], the leading modern authority concerning the construction of commercial contracts.

Against the background of the general principles to be applied when construing a contract, there are number of "rules" of construction, which the modern law would regard as merely guidelines or assumptions as to what the court may regard as the normal use of language and which assist judges to arrive at a reasonable interpretation of the parties' intentions, though subject to examination of the relevant circumstances

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[12] Extract reproduced from version set out in Buchheit and Pam, *The Pari Passu Clause in Sovereign Debt Instruments* (working paper, draft dated 11th December, 2003).
[13] *Marquis of Cholmondeley v. Clinton* (1820) 2 Jac. & W. 1, 91.
[14] *Antaios Compania Naviera S.A.* v. *Salen Rederierna A.B.* 1 A.C. 191.

surrounding the transaction. One such "rule" of construction is "established judicial construction": where the same words or contractual provisions have for many years received a judicial construction, the court will suppose that the parties have contracted upon the belief that their words will be understood in the accepted legal sense. This rule favours the ranking interpretation.

(ii) Analysis of case law

The most important English law case in this context is *Kensington Int'l Ltd. v. Republic of the Congo*[16]. In the *Kensington* case, a fund purchased defaulted indebtedness under a loan agreement (governed by English law) made in April 1984. On 20th December, 2002, the claimant sought a money judgment against the Congo, together with a claim for specific performance (among other grounds, on the basis of the *pari passu* clause[17] contained in the loan agreement) to prevent the Congo making payments to other creditors.

The claim for specific performance was considered by Tomlinson J. The Congo was not represented at those proceedings. Counsel for Kensington noted the lack of direct English law authority on this point and then rehearsed the two basic interpretations of what the *pari passu* clause meant. He went on to assert that the *pari passu* clause contained in the loan agreement was plainly a sharing clause[18] , compelling Congo to pay the claimant on a pro rata basis when it pays other creditors. Counsel's submission was based on the following considerations:

(a) the literal meaning of the words "*pari passu*[19]" ;

(b) the decision in *Bowen v. Brecon Railway Company*[20] ,which counsel argued strongly suggests that the *pari passu* clause means that money to be distributed should be distributed or paid on a *pari passu* basis;

(c) the actual wording used, with an emphasis on the words "and priority of payment". Counsel suggested that it is difficult to "accord any sensible

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[15] [1998] 1 W.L.R. 896.
[16] 16th April, 2003, unreported. Approved by the Court of Appeal [2003] EWCA Civ 709.
[17] The relevant clause of the loan agreement contains an undertaking by the Congo "to procure that the claims of all other parties under [the loan] agreement will rank as general obligations of the People's Republic of the Congo, at least pari passu in right and priority of payment with the claims of all other creditors of the People's Republic of the Congo . . .".
[18] True "sharing" clauses are considered in further detail at section 3.6 below.
[19] See section 4 of below for a further discussion of this point.
[20] (1866-67) LR 3 Eq 541.

meaning to the emphasised words if payments are not to be made *pari passu*";

(d) the argument that as a sovereign cannot be liquidated, the meaning of a *pari passu* clause in the context of a sovereign borrower must be different to the meaning of a *pari passu* clause in the context of a corporate borrower. Counsel argued that the clause, when appearing in a sovereign loan, must be there to provide some further protection to creditors to compensate for their inability to invoke insolvency procedures against the state and that protection, according to Kensington's counsel, must be an enforceable obligation on the state to pay creditors on a *pro rata* basis;

(e) overseas authority having some indirect bearing on the point:

- *Merchant Bills Corporation Limited v. Permanent Nominees Australia Limited*[21];

- the *Red Mountain Finance*[22] case; and

- the *Elliott* case (see above).

Tomlinson J. decided that he could attach "little weight" to the decisions in the *Red Mountain Finance* and *Elliott* cases because:

- "no reasons for [the decision]" in the *Red Mountain Finance* action had been shown to him and because the Congo had not been represented in that case; and

- the *Elliott* action was an *ex parte* decision and the order was directed towards a bank (Euroclear) and not towards the Peruvian state.

Tomlinson J. also expressed reservations about the legal correctness of the broader interpretation of the *pari passu* clause on the basis of the discussion on *pari passu* clauses found in the Encyclopaedia of Banking Law.

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[21] 1972-73 Australian Law Reports 565.
[22] Case No. CV 00-0164 R (C.D. Cal. 29th May, 2001).

In the end, Tomlinson J. denied Kensington's claim for an injunction on other grounds and this was upheld on appeal. Accordingly, his views expressed on the *pari passu* clause are of persuasive authority only.

In addition, in the absence of direct English case law on a particular point, an English court might find the decisions of a Commonwealth or United States court persuasive[23]. However, having reviewed a number of other English and Commonwealth authorities[24], the Working Group concluded that the standard formulation *pari passu* clause has not received a particular judicial construction which would assist in ascertaining the intentions of the parties.

(iii) Analysis of the actual language

In the absence of clear judicial authority on the point, a careful review of the words used in the *pari passu* clause is also necessary in order to help determine its meaning. This is because the starting point in construing a contract is that words are to be given their ordinary and natural meaning. This is not necessarily the dictionary meaning of the word, but that in which it is generally understood.

An analysis of the ordinary and natural meaning of the principal variations in the actual language used in *pari passu* clauses is set out in section 4 below. This also favours the ranking interpretation.

[23] An interesting example of an instance in which an English court relied on a U.S. precedent in a sovereign context is *Crescent Oil* v. *Banco Nacional de Angola* (unreported), 28th May, 1999 Com Ct., where Cresswell J. applied *de Sanchez* v. *Banco Central de Nicaragua*, 770 F. 2d 1385 (5th cir. 1985), a decision of the United States Court of Appeals for the Fifth Circuit.

[24] See: *Bowen* v. *Brecon Railway Co* (1866-67) LR 3 Eq 541, *Murray* v. *Scott* (1884) 9 AC 519, HL, *Small* v. *Smith* (1885) 10 AC 119, *Re Midland Express*, *Limited*, [1914] 1 Ch. 41, *Merchant Bills Corporation Ltd* v. *Permanent Nominees* (*Aust*) *Ltd* 1972-73 Australian Law Reports 565.

3. CONSEQUENCES OF THE PAYMENT INTERPRETATION

3.1 Introduction

The consequences of the payment interpretation are "background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract"[25] and are therefore relevant in construing the intention of the parties at the time that they made the contract. In particular, based on the views expressed by Lord Diplock in the *Antaios* case, if these consequences would produce results which offend "business commonsense", it is unlikely that a court would be prepared to find in favour of the payment interpretation of the *pari passu* clause.

The payment interpretation of the *pari passu* clause would provide, in effect, that the borrower agrees that, once it is unable to pay all of its debts as they fall due or is otherwise insolvent, it will not pay any other unsecured indebtedness unless at the same time its pays the indebtedness in question in the same proportion by amount as that in which it pays the other indebtedness. This report asserts that the practical consequences that follow from the payment interpretation are such that the parties would not have agreed that the *pari passu* clause should have that meaning had they been presented with these consequences at the time that they entered into their contract. The principal consequences are set out below.

3.2 Effect on the borrower's freedom to run its business or economy

In times of economic distress, a company or a state will wish to prioritise payments to different lenders. Such prioritisation usually takes place for the practical reason that using its resources in this way prevents the business (in the case of a company) or the economy (in the case of a state) from grinding to a halt.

The practical need for sovereigns to prioritise payments has been noted for a number of years. In *State Insolvency and Foreign Bondholders*[26], the authors note that when a sovereign is in financial distress "[f]airness and justice in the adjustment of public debts require that all bondholders be treated alike. The principle of equality, however, does not signify uniformity of treatment. As will appear presently, the grading and grouping, according to their intrinsic merits, of claims with respect to the utilization of the available assets of the debtor have, in

[25] Per Lord Hoffmann in Investors Compensation Scheme Ltd v. West Bromwich Building Society [1998] 1 W.L.R. 896.
[26] Borchard, *State Insolvency and Foreign Bondholders* Vol. 1, General Principles (1951) (Yale University Press).

fact, been expressly recognized in some of the major adjustment plans. All that the principle implies is that preferential treatment shall not be accorded to particular classes of bondholders without valid cause"[27]. The authors go on to argue that a principle of differentiation exists when a sovereign becomes insolvent:

> "While the private law of bankruptcy is governed by the principle of equality of claims in the distribution of the debtor's assets . . . differential treatment of the holders of foreign government bonds in case of default is the ordinary rule. The reason therefor lies in the semipolitical nature of government loans and in the great variety of forms and purposes for which such loans are issued"[28].

The authors then cite examples of how sovereign debtor rescheduling plans have differentiated between various creditors. One example is where the obligations are secured. Another is that "the significance of a loan for the economic or political life of the country may provide the reason for granting [that indebtedness] a priority or preference. Thus, the League Loans Committee claimed priority for the post-war loans issued under the auspices of the League, on the ground that these loans had been devoted to the economic and financial rehabilitation of the countries concerned".

An analogy can clearly be drawn here with the indebtedness granted by the World Bank and International Monetary Fund in modern times.

The consequence of the payment interpretation, however, is that if the borrower is a sovereign state unable to service its foreign currency debt as it falls due, it will not be allowed to pay any of its senior creditors in full. These include the IMF, the World Bank and any of the other multilateral organisations that may have lent it money. The restriction potentially bites even wider than this and would prevent the borrower from paying in full creditors who have sold it commodities or licensed it intellectual property rights or from paying in full its government ministers, civil servants, police force, armed forces, judges and state teachers.

It is argued that if the parties were presented with these consequences of the payment interpretation of the *pari passu* clause at the date that they entered into their contract, they would have concluded that this meaning does not make commercial sense and would have

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[27] *Ibid* at pp. 337-338.
[28] *Ibid* at p. 340.

provided for extensive exemptions from its application. Accordingly, it is submitted that the parties could not have intended the *pari passu* clause to have the payment interpretation.

3.3 Lender liability

Creditors do not readily agree to lend money to debtors on terms that could potentially expose them to liability to third parties. This is not a risk that they agree to assume as part of the commercial deal to lend money to a debtor. However, lender liability is a potential consequence of the payment interpretation of the *pari passu* clause.

As will be seen at section 3.6 of this report "sharing clauses", which are intended to require a *pro rata* distribution of recovery proceeds and "most favoured debt clauses", are usually substantially longer than the typical *pari passu* clause and are often heavily negotiated. One reason for extensive negotiation and detailed drafting of such clauses is that lenders do not wish to be exposed to potential liability to third parties as a result of the obligations that they have agreed to in a loan agreement. When negotiating sharing clauses and most favoured debt clauses, lenders are mindful that they may be exposing themselves to liability in tort or otherwise for interfering in third party contracts. The payment interpretation of the *pari passu* clause could expose lenders to the same potential liabilities. If the payment interpretation is correct, lenders may also be exposing themselves to liability as constructive trustees if they are on notice that there are other unpaid lenders of the same debt or other debt incurred by the sovereign borrower.

It is submitted that the lenders in a standard international syndicated loan or bond issue would not have intended the *pari passu* clause to expose them to such liabilities. Indeed, potential liability as a consequence of a particular construction was relied upon by Lord Diplock in the *Miramar*[29] case as a reason to favour a different construction. In that case he said: "Mr Lords, I venture to assert that no business man who had not taken leave of his senses would intentionally enter into a contract which exposed him to a potential liability of this kind; and this, in itself, I find to be an overwhelming reason for not indulging in verbal manipulation of the actual contractual words used.".

This consequence provides further support to the argument that the payment interpretation is not correct because it would not make business sense for a lender to agree to such potential liabilities to third parties.

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[29] *Miramar Maritime Corporation v. Holborn Oil Trading Ltd* [1984] A.C. 676 at 685.

3.4 Implications for payment and settlement systems

Actions by creditors based on the payment interpretation of the *pari passu* clause could be used to interfere with international payment and securities settlement systems by stopping payments by the borrower to the system or payments by the system to the borrower. Indeed, such action was taken against Euroclear in the *Elliott* litigation. Commercial banks are integrated into the world's payment and settlement systems so that attacks on them as innocent bystanders could have systemic consequences in upsetting the requirement for finality in systems which deal with very high volumes at high speeds in circumstances where liquidity is essential. As an operational matter it would be extremely difficult to try to administer payment instructions which may be the subject of a court injunction along the lines of that obtained by Elliott Associates in the Peru litigation.

In addition to these practical reasons for not favouring the payment interpretation, the public policy objective of preventing this sort of disruption is mirrored in the Directive of the European Parliament and of the Council of 19th May, 1998 on settlement finality in payment and securities settlement systems, 98/26/EC, OJ L 166, 11/06/1998, p.45 (the "**Settlement Finality Directive**"). The preamble to the Settlement Finality Directive outlines the policy of the European Union in this area. The recitals note, among other things, that the Settlement Finality Directive aims at contributing to the efficient and cost effective operation of cross-border payment and securities settlement arrangements in the European Community, and that the reduction of systemic risk requires in particular the finality of settlement. It is noted that the provisions of the Settlement Finality Directive do not prohibit the kinds of attachment proceedings pursued in the *Elliott* case[30].

3.5 Implications for restructuring sovereign debt

One particular mischief caused by the payment interpretation is the implications that follow from it in the context of restructuring sovereign debt. As is noted from the facts of the *Elliot* case, a sovereign debt restructuring is usually effected through an exchange offer whereby existing debt obligations are exchanged for new debt obligations on terms more favourable to

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[30] Under Article 9 of the Belgian Act of April 28, 1999, (EU settlement finality directive), as modified by Article 15 of the Belgian Act of November 19, 2004, no cash settlement account with a settlement system operator or agent *nor any transfer of money to be credited to such cash settlement account, via a Belgian or foreign credit institution,* may in any manner whatsoever be attached, put under trusteeship or blocked by a participant (other than the settlement system operator or agent), a counterparty or a third party. The amendment, which is reflected in italics, was published in the Belgian State gazette of December 28, 2004 and entered into force in January 2005. As noted by the European Central Bank (ECB) when consulted on the draft Belgian legislation, "the draft law enhances legal certainty in relation to payments through payment and settlement systems and thus fosters the safety and efficiency of payment and settlement systems". See Opinion of the European Central Bank of 16 March, 2004 at the request of the Belgian Ministry of Finance (CON/2004/9), para 9, published on the ECB's website at www.ecb.int.

the debtor. Those creditors who decline to accept the exchange offer are referred to as "holdout" creditors.

A theme that pervades throughout this area is that the orderly and expeditious resolution of sovereign debt crises in a manner beneficial to both debtors and creditors is a policy objective to be pursued (see, for example, the Statement of Interest filed by the United States in the *Argentina* litigation). In this regard, recent statements have been published by the G-10 and G-7 regarding the important contribution which appropriately drafted terms and conditions included in sovereign debt instruments can play in the resolution of sovereign debt crises[31].

From the sovereign debtor's perspective and from the perspective of the majority of the creditors who wish to restructure the defaulted indebtedness in order to maximise the dividend they will receive as a class, the use of the *pari passu* clause as a tool to disrupt the process does not make business sense. Time and valuable resources would need to be expended defending actions based on the payment interpretation of the *pari passu* clause. Accordingly, it is again asserted that the parties to the agreement, if presented with this consequence of the payment interpretation of the *pari passu* clause, could not have intended it to have that meaning.

3.6 The *pari passu* clause in the context of the contract as a whole

When considering what the parties to an agreement intended a particular clause in a contract to mean, it will be highly relevant to consider other clauses in that agreement and what the parties meant by them as this may assist in determining the meaning of the clause in question. In this context, there are examples of clauses which are designed to achieve *pro rata* payment and, significantly, are often found along side the standard *pari passu* clause. The most important for these purposes are the "sharing clause" and the "most favoured debt" clause.

A sharing clause is typically found in a syndicated loan agreement and is designed to ensure that any disproportionate payment received by one member of the syndicate will be shared rateably with all the rest[32]. It is important to note that:

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[31] "See, for example, Statement of G-7 Finance Ministers and Central Bank Governors, Washington DC, 27th September, 2002; Communiqué of the Ministers and Governors of the Group of Ten, Washington DC, 27th September, 2002; and Report of the G-10 Working Group on Contractual Clauses, September 2002, published on the website of the Bank for International Settlements at http://www.bis.org/publ/.

[32] It should be noted that sharing clauses (or even the concept) would never have been put in an early eurobond as those bonds were invariably issued in definitive bearer form and the clearing systems did not exist at the time. As a consequence, neither the issuer nor the bondholders would have been able to identify the other holders and so, as a practical matter, sharing would not have been possible. The bearer nature of the bonds would also create difficulties if the effect of knowingly receiving more than one's correct share were to create a constructive trust of the moneys: neither the trustees nor the beneficiaries would be readily identifiable. It is understood that a sharing clause could not be included even today since the clearing systems will not accept securities which impose or purport to impose obligations

(a) syndicated loan agreements with sharing clauses often include *pari passu* clauses too; and

(b) sharing clauses are designed to protect a narrowly defined set of creditors whereas a *pari passu* clause potentially applies to a broad range of unsecured debtors.

These two considerations suggest that the two clauses aim to achieve different ends and, consequently, that the *pari passu* clause should not be given the payment interpretation.

A "most favoured debt" clause is typically found in a work-out agreement for rescheduling a borrower's debt. A "most favoured debt" clause usually provides that if any other foreign currency debt having the same maturity as the rescheduled debt is paid out more quickly, then the borrower must repay the rescheduled debt. The clause will then go on to exclude certain categories of debt which can be paid in priority, for example IMF debt, trade debt, public bonds and other agreed categories. The reason for these exceptions is to allow the sovereign to run its economy and it is submitted that the absence of such exceptions from the standard *pari passu* clause tends to suggest that, properly construed, it is not intended to require equal payments.

The clauses examined in the previous paragraph are rarely expressed to apply to all senior indebtedness in the way that would follow if the payment interpretation of the *pari passu* clause was correct. Where a wider equality is desired, creditors can and do draft an appropriate clause – a most favoured debt clause, a negative pledge, a *pro rata* sharing clause, a provision for payment to a trustee of a bond issue on default who then pays bondholders on a *pro rata* basis, or a cross-default clause. Neither the sharing clause nor the most favoured debt clause prohibits all unequal payments. It must therefore be questioned why, if the *pari passu* clause already achieves *pro rata* payment, parties would wish to include "sharing", "*pro rata* distribution of recovery proceeds" or "most favoured debt" clauses. Their inclusion strongly suggests that the *pari passu* clause was never intended to require *pro rata* payment.

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on the holders. However, where bonds are issued under a trust structure, the obligation imposed on the trustee to pay bondholders pro rata has some consequences which are similar in effect to a sharing clause.

4. ANALYSIS OF SAMPLE CLAUSES

Further support for the ranking interpretation can be gained through an analysis of the actual wording used in two sample clauses identified from the survey referred to in section 2.2 above. It is concluded that the language itself requires a "rank" of the claims, rather than requiring *pari passu* payment in fact. The two clauses relate to bond issues by the Republic of Estonia (in June 2002) and the Republic of Croatia (in February 2001) and are set out below:

Republic of Estonia:

> "The Notes and Coupons rank and . . . will rank *pari passu*, without any preference among themselves, with all other outstanding unsecured and unsubordinated obligations of the Issuer, present and future."

Republic of Croatia:

> "The Notes and Coupons rank *pari passu*, without any preference among themselves, and at least *pari passu* in right of payment with all other present and future unsecured obligations of the Republic, save only for such obligations as may be preferred by mandatory provisions of applicable law."

The Republic of Estonia clause does not contain any reference to the word "payment" in the final sentence. This report therefore asserts that the operative words are "rank *pari passu*". The word "rank" means:

> "Arrange . . . in a rank or in ranks; arrange in a row or rows, set in line . . . Assign to a certain rank in a scale or hierarchy; classify, rate; include within a specified rank or class (foll. by *among, with,* etc.) . . . Occupy a certain rank in a hierarchy; belong to a specified rank or class (foll. by *among, with,* etc.); be on a par *with* . . ."[33]

There is nothing within this definition that suggests *pro rata* payment in fact. Accordingly, this report concludes that the clause merely asserts legal ranking and does not require *pro rata* payment.

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[33] Definition found in Shorter Oxford English Dictionary.

Turning to the Republic of Croatia's clause, it will be noted immediately that this clause contains the additional words "in right of payment" after the words "*pari passu*". It is important, therefore, to examine whether or not these additional words justify this clause being given the payment interpretation. It is submitted that they do not for the following reasons.

(i) The words are similar to the formulation Professor Lowenfeld opined upon in the Nicaragua litigation, which contained the phrase ". . . ranking at least pari passu in priority of payment and in rank of security". They are also similar to the words used in the *Kensington* case, which read ". . . *pari passu* in right and priority of payment". It is worth considering Professor Lowenfeld's arguments here as he characterises his view as the "plain meaning" of the clause. Professor Lowenfeld's principal argument is that the words "rank" and "pay" are used interchangeably in the relevant *pari passu* clause: "By agreeing to rank all the holders of its debt pari passu in priority of payment, the issuer of the debt obligates itself not to rank one creditor higher and another lower, i.e., not to pay one creditor while declining to pay another"[34]. The dictionaries do not support the contention that to say that one will not rank one creditor higher or lower than another is the same thing as saying that one will not pay one creditor while declining to pay another. The key words, again, are "rank *pari passu*" and not "payment".

(ii) It can be argued that the addition of the words "in right of payment" is only meant to clarify that other rights attached to the indebtedness (such as maturity date, interest rate, etc.) are irrelevant to the *pari passu* ranking of the obligations. It follows, therefore, that the addition of the words does not require *pro rata* payment in fact.

(iii) The *Kensington* case involved a clause that referred to "payment". As has already been seen, Tomlinson J. did not seem to be persuaded by counsel's argument that looking at the actual wording used, with an emphasis on the words "and priority of payment", suggested that it was difficult to "accord any sensible meaning to the emphasised words if payments are not to be made *pari passu*".

(iv) The Working Group discovered only one issue of bonds as part of its survey where the drafting appears to favour the payment interpretation. This bond was issued by

[34] Professor Lowenfeld's declaration in the Nicaragua litigation, at p. 7.

the Philippines and contains the additional words "and shall be discharged in such manner" at the end of the status condition. It is submitted that the use of these specific words suggests that the draftsman consciously intended something other than the ranking interpretation, otherwise the additional words would be redundant. This tends to suggest that clauses without these additional words in them are understood to have the ranking interpretation.

(v) There is one further argument that can be made in the context of an issue of debt securities (including the two sample clauses). As noted in Section 2.1, the standard formulation for a *pari passu* clause in an issue of debt securities clause has two limbs:

(a) the *internal* limb: that the bonds rank *pari passu* with each other and without any preference among themselves; and

(b) the *external* limb: that the bonds rank *pari passu* with other unsecured indebtedness of the issuer.

The internal limb imposes broader obligations on the issuer than the external limb. In relation to the treatment of the bondholders themselves, the issuer's obligations must both rank *pari passu* and so rank without preference among themselves. In the context of the ranking interpretation, the language in the internal limb can be explained as no more than another example of surplusage. Proponents of the payment interpretation, however, would argue that the latter part of the language implies an obligation to treat the bondholders equally and, if insufficient funds are available, to pay them on a *pro rata* basis. This is logical given that in a normal securities issue the various lenders are all making the same credit decision at the same time and on identical terms, even though they may actually lend different amounts. In these circumstances, lenders might reasonably expect their securities to be treated equally.

The external limb, however, only requires that the bonds rank *pari passu* to other indebtedness. Since it is only the bonds themselves which must be paid equally (or "without preference") it follows that that the mere *pari passu* language itself cannot confer a similar right to absolute equality of treatment – it must confer something less. If no equality in right of *payment* applies, then there can only be equality in right of *ranking*.

5. CONCLUSION

The purpose of this report has been to analyse the role, use and meaning, as a matter of English law, of *pari passu* clauses in sovereign debt obligations. This report has noted that there appear to be two basic interpretations as to their proper meaning. The first interpretation, which is referred to in this report as the "**ranking**" interpretation, is that the clause is merely an assertion of how particular debt will rank in the insolvency of the debtor, and the second, which is referred to in this report as the "**payment**" interpretation, is that the clause operates to prevent a debtor from paying one of its creditors ahead of any other when it is not in a position to pay all of its creditors in full.

This report has found that the **use** of the *pari passu* clause in sovereign debt obligations is widespread. The survey conducted of the *pari passu* clauses found in contemporary sovereign bond issues has also revealed a diversity in the actual language used in these clauses.

In attempting to determine the **role** and **meaning** of *pari passu* clauses in sovereign debt obligations, this report started with the English law principles laid down for construing contracts. As has been seen, this requires both a careful review of the actual words used in the clause and an examination of the consequences that would follow if the payment interpretation was correct.

This report has concluded that the consequences of the payment interpretation are such that both debtors and creditors would be prejudiced by such a construction. Sovereign borrowers would be prevented from prioritising which creditors they pay first thereby restraining their freedom to prioritise payments to creditors during times of economic distress. Creditors may find themselves exposed to potential liability to third parties and, when attempting to negotiate a restructuring of the sovereign's indebtedness, could suffer at the hands of hold-out creditors seeking to deploy an argument based on the payment interpretation of the *pari passu* clause.

This report concludes, therefore, that as a matter of English law the ranking interpretation is the proper interpretation of the *pari passu* clause in sovereign debt obligations. The key word within the clause is "rank" and not the words "*pari passu*". Given the lack of formal insolvency procedures in the context of a sovereign debtor the meaning of the clause is limited to an obligation on the sovereign not to involuntarily subordinate one class of creditors by the enactment of new legislation or otherwise. Where a broader equality of payment is desired in a particular instance, creditors can and often do include appropriate clauses to this effect in sovereign debt instruments governed by English law. It is therefore strongly asserted that the payment interpretation of the *pari passu* clause is unsupportable as a matter of English law except where the clause is very clearly drafted to achieve this effect.

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