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THE *PARI PASSU* CLAUSE IN SOVEREIGN DEBT INSTRUMENTS

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WORKING PAPER

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ABSTRACT

The pari passu *clause found in most cross-border lending instruments contains the borrower's promise to ensure that the obligation will always rank equally in right of payment with all of the borrower's other unsubordinated debts. The international financial markets have long understood the clause to protect a lender against the risk of legal subordination in favor of another creditor (something that can't happen under U.S. law without the lender's consent, but that can occur involuntarily under the laws of some other countries). In 2000, however, a new interpretation of the* pari passu *clause was advanced by a judgment creditor of a sovereign borrower as a purported legal basis for preventing the sovereign from paying its other creditors without making a ratable payment to the judgment creditor. If this "ratable payment" interpretation of the clause is correct (and it has now been advanced in a number of other lawsuits against both sovereign and corporate borrowers), it would significantly change the patterns of international finance. The authors argue that the ratable payment theory of the* pari passu *clause is a fallacy. They trace the origin of the clause back to its usage in nineteenth century credit instruments and then follow its evolution into the standard cross-border credit agreements used today.*

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THE *PARI PASSU* CLAUSE IN SOVEREIGN DEBT INSTRUMENTS

This is the story of the *pari passu* clause, a provision that appears in most cross-border credit instruments. The clause itself is short; usually a single sentence occupying no more than three or four lines of text. With that brevity, however, comes a measure of opacity.

For several decades, lenders and borrowers in the international capital markets have, by their behavior, demonstrated a collective understanding of the import of the clause. But it is difficult to corroborate that understanding based solely on the text of the provision. Inevitably, there was a risk that the oracular nature of the clause would tempt someone to speculate about alternative meanings. That risk has recently materialized, with potentially serious consequences for both lenders and borrowers.

I. THE CLAUSE

A. The Text

Here is a typical formulation of the *pari passu* clause in a modern cross-border credit instrument:

> The Notes rank, and will rank, *pari passu* in right of payment with all other present and future unsecured and unsubordinated External Indebtedness of the Issuer.

The Latin phrase "*pari passu*" means "in equal step" or just "equally." The phrase *pari passu* was often used in equity jurisprudence to express the ratable interest of parties in the disposition of equitable assets.[1] As explained by an English commentator in 1900:

> There is no special virtue in the words "*pari passu*," "equally" would have the same effect, or any other words showing that the [debt instruments] were intended to stand on the same level footing without preference or priority among themselves, but the words *pari passu* are adopted as a general term well recognized in the administration of assets in courts of equity."[2]

[1] *See* Joseph Story, COMMENTARIES ON EQUITY JURISPRUDENCE, Vol I, 590 (1873), ("[I]n equity, it is a general rule that equitable assets shall be distributed equally, and *pari passu*, among all creditors, without any reference to the priority or dignity of the debts . . . .").

[2] Francis B. Palmer, COMPANY PRECEDENTS, 109-10 (8th ed. 1900) [hereinafter Palmer, *Company Precedents*].

B. The Context

The conventional explanation of the *pari passu* covenant is that this provision prevents the borrower from incurring obligations to other creditors that rank legally senior to the debt instrument containing the clause.[3]

The practical significance of equal ranking is most clearly visible in the event of a bankruptcy or insolvency of a corporate debtor: any legally senior obligations would enjoy a priority claim against the debtor's assets in a liquidation,

[3] For examples of commentators that describe the function of the clause as preserving the legal ranking of the debt, see Keith Clark & Andrew Taylor, *Conditions precedent and covenants in Eurocurrency loan agreements*, INT'L FIN. L. REV., Aug. 1982, at 18, ("The negative pledge ensures that the banks' right to be repaid is not subordinated to the rights of secured creditors: a *pari passu* covenant will ensure that they are not subordinated to any unsecured creditors."); Richard Slater, *The Transnational Law of Syndicated Loans – A Hopeless Cause?, in* THE TRANSNATIONAL LAW OF INTERNATIONAL COMMERCIAL TRANSACTIONS 329, 335 (Norbert Horn and Clive M. Schmitthoff, eds., 1983) [hereinafter *Slater*], ("Typical examples [of undertakings in international syndicated loan agreements] are undertakings by the borrower . . . to ensure that the loan ranks equally with all its other unsecured indebtedness (the '*pari passu* clause',) . . . ."); Qamar S. Siddiqi, *Some Critical Issues in Negotiations and Legal Drafting*, in SOVEREIGN BORROWERS: GUIDELINES ON LEGAL NEGOTIATIONS WITH COMMERCIAL LENDERS 44, 57 (Lars Kalderén and Qamar S. Siddiqi eds., 1984) [hereinafter *Sovereign Borrowers*], ("For a sovereign borrower, the covenants in a general term loan should normally be restricted to . . . the following: 1. The ranking of the borrower's obligations, which aims to ensure that the loan will rank '*pari passu*' with all other present or future unsecured and unsubordinated indebtedness of the borrower; this is likely to have little practical significance in the case of a sovereign borrower, where there may not be an occasion for a forced distribution of the assets to unsecured claimants following the bankruptcy, insolvency or liquidation of the borrower . . . ."); K. Venkatachari, *The Eurocurrency Loan: Role and Content of the Contract*, in *Sovereign Borrowers*, *id.* 73, 92 [hereinafter *Venkatachari*] ("[A *pari passu* clause] in the case of a corporate borrower is directed towards ensuring that other unsecured creditors are not given rights of priority of payment over the lender, leaving, perhaps, insufficient assets available to satisfy the claims of the lender either in full or, in the event of bankruptcy, insolvency, liquidation or forced distribution of assets of the borrower, to the same extent as all other unsecured creditors."); Mark A. Walker and Lee C. Buchheit, *Legal issues in the restructuring of commercial bank loans to sovereign borrowers*, in SOVEREIGN LENDING: MANAGING LEGAL RISK 139, 146 (M. Gruson, R. Reisner, eds., 1984) [hereinafter *Restructuring Commercial Bank Loans*], ("A *pari passu* covenant will, however, restrict the borrower from subordinating in a formal way the debt being incurred (or restructured) pursuant to the agreement containing this clause in favor of some other external obligation."); United Nations Center for Transnational Securities, UNCTC Advisory Studies, No. 4, Series B, INTERNATIONAL DEBT RESTRUCTURING: SUBSTANTIVE ISSUES AND TECHNIQUES 29 (1989) ("A *pari passu* covenant will, however, restrict the borrower from legally subordinating in a formal way the debt being incurred or rescheduled in favour of some other external obligation."); Frank Graaf, EUROMARKET FINANCE: ISSUES OF EUROMARKET SECURITIES AND SYNDICATED EUROCURRENCY LOANS 350 (1991), ("[T]his [pari passu] clause . . . requires the borrower to ensure that the lending banks' rights under the loan agreement will, *at all times*, rank at least equally ('*pari passu*') with all of the borrower's other unsecured and unsubordinated obligations so that the banks' share of the borrower's assets in the event of its liquidation will be equal to that of all other unsecured and unsubordinated creditors . . . ."); Ravi C. Tennekoon, THE LAW AND REGULATION OF INTERNATIONAL FINANCE 89 (1991) ("The primary objective of the clause is to ensure that the borrower has not conferred priority to any other unsecured creditor at the time the syndicated loan agreement is agreed."); Lee C. Buchheit, *The pari passu clause sub specie aeternitatis*, INT'L FIN. L. REV., Dec. 1991 at 11, 12 [hereinafter *Sub Specie Aeternitatis*], ("[I]f a sovereign borrower intends as a practical matter to discriminate among its creditors in terms of payments, the *pari passu* undertaking will at least prevent the sovereign from attempting to legitimize the discrimination by enacting laws or decrees which purport to bestow a senior status on certain indebtedness or give a legal preference to certain creditors over others . . . .); Joseph J. Norton, INTERNATIONAL SYNDICATED LENDING AND ECONOMIC DEVELOPMENT IN LATIN AMERICA: THE LEGAL CONTEXT 43 (1997) [hereinafter *Norton*] ("The *pari passu* clause prevents the borrower from assuming new debts which subordinate the interests of the syndicate members."); Tony Rhodes, Keith Clark and Mark Campbell, SYNDICATED LENDING: PRACTICE AND DOCUMENTATION 285 (3d ed., 2000) [hereinafter *Syndicated Lending*] ("The [pari passu] clause in effect states that there are no legal provisions which would cause the loans to be subordinated to other indebtedness of the Company."); Lee C. Buchheit, HOW TO NEGOTIATE EUROCURRENCY LOAN AGREEMENTS 83 (2d ed., 2000) [hereinafter *Eurocurrency Loan Agreements*] ("The purpose of the *pari passu* clause is to ensure that the borrower does not have, nor will it subsequently create, a class of creditors whose claims against the borrower will rank legally senior to the indebtedness represented by the loan agreement.").

and would receive preferential treatment over subordinated creditors in a Chapter 11-type debt reorganization.[4]

Pari passu covenants[5] of this kind do not often appear in the documentation for purely domestic credit transactions.[6] The reason is that U.S. law does not permit the involuntary legal subordination of an existing creditor, so it is not necessary to ask the borrower to promise to refrain from doing something that it cannot in any event do without the lender's express consent.[7] As discussed

[4] *See*, *e.g.*, Philip R. Wood, INTERNATIONAL LOANS, BONDS AND SECURITIES REGULATION 41 (Law and Practice of International Finance 1995) [hereinafter Wood, *International Loans*] ("The clause requires the equal ranking of unsecured claims on a forced distribution of available assets to unsecured creditors, primarily on insolvency."); Edward Lee-Smith, NEGOTIATING INTERNATIONAL LOAN AGREEMENTS at 4-10 (2d ed., 2000) 4-11 ("The purpose of the *pari passu* clause is to satisfy the Banks' concern that in an insolvent liquidation of the Borrower the Banks' claims should rank equally with all other unsecured and unsubordinated claims."); Jon Yard Arnason and Ian M. Fletcher, PRACTITIONER'S GUIDE TO CROSS-BORDER INSOLVENCIES, England chapter (prepared by Hamish Anderson), at ENG – 3 (July 2001) ("The principle of *pari passu* distribution applies only in liquidation.").

[5] A reference to *pari passu* ranking can also appear as a representation and warranty confirming the equal ranking of the new debt . This serves the purpose of uncovering, before a new loan is made, the existence of senior debt, and one occasionally sees such a representation in a U.S. domestic lending instrument. *See*, *e.g.*, Sandra Schnitzer Stern, STRUCTURING AND DRAFTING COMMERCIAL LOAN AGREEMENTS Vol. I, 4.16 (2001) ("[T]he bank may also require [the *pari passu*] representation stating that its loan is not subordinated to any of the borrower's other loans."). Significantly, however, Stern's subsequent discussion of a related covenant (by which the borrower agrees "to grant it a security interest, if the borrower should grant a security interest in its property to any third party, and to agree in advance to amend the loan agreement if any debt that is not subordinated to the bank's loan is created") refers to negative pledge and debt limitation covenants rather than a conventional *pari passu* covenant of the kind used in cross-border debt instruments. On the distinction between the *pari passu* representation and warranty and the *pari passu* covenant generally, see *Eurocurrency Loan Agreements*, *supra* note 3, at 82-83.

[6] The reference materials we have consulted dealing with standard credit documentation for domestic (U.S.) lending do not refer to *pari passu* clauses. *See, e.g.*, John J. McCann, TERM LOAN HANDBOOK (Committee on Developments in Business Financing of the Section of Corporation, Banking and Business Law of the American Bar Association ed., 1983) (*cf.* discussion of negative pledge covenant at 166-167, 229) and Robert H. Behrens and James W. Evans, FUNDAMENTALS OF COMMERCIAL LOAN DOCUMENTATION (Bank Administration Institute, ed., 1989) (*cf.* discussion of negative pledge covenant at 53). The MODEL CREDIT AGREEMENT AND COMMENTARY prepared by the New York law firm of Simpson Thacher & Bartlett (3d printing, July 1996) (copy on file with authors), at E-3, discusses the *pari passu* covenant only in an Appendix captioned "Sovereign (And Other Foreign) Borrower Provisions," noting that "In sovereign loans it is customary to provide not only for a negative pledge clause but also that the obligations being created rank at least *pari passu* with all other obligations of the Borrower, so the lenders can be sure there is no other debt which has a prior claim on any assets of the Borrower. The CREDIT AGREEMENT COMMENTARY prepared by the New York law firm of Shearman & Sterling (4th ed., 1994) (copy on file with the authors) does not refer to a *pari passu* covenant in a standard domestic credit agreement.

As for domestic bonds, *pari passu* clauses are not included in the COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS published by the American Bar Foundation (1971), or the REVISED MODEL SIMPLIFIED INDENTURE published by the American Bar Association, 55 *Bus. Law.* 1115 (2000).

See also, Barry W. Taylor, *Swaps: Managing Interest Rate and Exchange Rate Risk from a Credit Perspective*, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES, 532 PLI/Corp 341 at 358, *Practising Law Institute,* 1986) ("In cross-border documents, whether they be loan agreements or swap agreements, parties often use a '*pari passu*' clause, an example of which is set forth below . . . . This kind of provision would probably be construed strictly to apply to the subordination of unsecured obligations over other unsecured obligations, which may be of little or no value except in particular jurisdictions.") (emphasis added).

[7] *See* Debra J. Schnebel, *Intercreditor and Subordination Agreements – A Practical Guide*, 118 BANKING L.J. 48, 53 (Jan. 2001) ("Generally, the claims of all unsecured creditors against a borrower are on a parity. . . . The creditors, however, may contractually alter this relationship through a subordination agreement. Debt subordination involves the agreement of one creditor (the junior creditor) to allow payment of indebtedness due to another creditor (the senior creditor) prior to the payment of indebtedness owed to it"). A subordination agreement is a type of intercreditor agreement between or among the affected creditors that describes the nature and the mechanics of an agreed

below, however, procedures exist in some other countries that can have just that effect, hence the tendency among cautious drafters of cross-border debt instruments to include an express promise on the part of the borrower to maintain the unsubordinated status of the debt.[8]

C. The Sovereign Debt Enigma

If the practical significance of maintaining a debt's *pari passu* ranking is most apparent in the event of a bankruptcy of the borrower, why is the clause also routinely included in debt instruments for sovereign borrowers -- entities that are not subject to domestic bankruptcy laws, their own or anyone else's? What were the drafters of *pari passu* clauses in sovereign debt instruments attempting to achieve?

As we discuss below, there are good historical answers to this question[9], but they cannot easily be divined from the black letter of the clause. Over the years, a few commentators (including one of the authors) have offered possible explanations for the appearance of *pari passu* covenants in sovereign credit instruments. These explanations have ranged from a suggestion that drafters may have wanted to prevent an informal "earmarking" of a sovereign's assets or revenues to service a particular debt,[10] to the more cynical explanation that this type of clause had a tendency to migrate -- through the ignorance or inattention of contract drafters -- from cross-border corporate debt instruments to sovereign debt instruments.[11] The common theme among these commentators was a degree of agnosticism about the precise denotation of the *pari passu* clause in a sovereign context.[12]

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legal subordination. *See* Schnebel, *id*., ("[I]ntercreditor relationships and the concept of subordination do not have a common meaning established by status or case law. Rather, the intercreditor relationship is defined by the parties to a particular transaction or relationship in an agreement which details the respective rights and obligations of the parties."). Such subordination agreements are enforceable under the U.S. Bankruptcy Code. 11 U.S.C. § 510(a) (2003).

[8] See Part III.C.(iii), *infra.*

[9] See Part III.C, *infra*.

[10] *See*, *e.g.,* Philip R. Wood, LAW AND PRACTICE OF INTERNATIONAL FINANCE 156 (1980) [hereinafter Wood, *International Finance*] ("In the case of a sovereign state, . . . [t]he clause is primarily intended to prevent the earmarking of revenues of the government or the allocation of its foreign currency reserves to a single creditor and generally is directed against legal measures which have the effect of preferring one set of creditors over the other or discriminating between creditors."); William Tudor John, *Sovereign Risk And Immunity Under English Law And Practice*, *in* INTERNATIONAL FINANCIAL LAW, Vol. I, 79, 96 (2d ed. R. Rendell ed., 1983) [hereinafter *Tudor John*] ("[T]he *pari passu* clause . . . is primarily intended to prevent the earmarking of revenues of the government toward a single creditor . . . ."); *Venkatachari*, *supra* note 3, at 92 ("In the case of a sovereign borrower the [pari passu] clause is intended to prevent the borrower giving preference to certain creditors by, say, giving them first bite at its foreign currency reserves or its revenues . . . . This kind of clause catches arrangements which merely give a right of priority of payment; it is not concerned with arrangements as to creation of security over the assets of the borrower (or others) – that will be provided for in the negative pledge clause."); ENCYLOPAEDIA OF BANKING LAW, F1204 (Sir Peter Cresswell *et al.* eds., 2002) ("[A] *pari passu* clause in state credit is primarily intended to prevent the legislative earmarking of revenues of the government or the legislative allocation of inadequate foreign currency reserves to a single creditor and is generally directed against legal measures which have the effect of preferring one set of creditors over the others or discriminating between creditors.").

[11] Lee C. Buchheit, *Negative Pledge Clauses: The Games People Play*, INT'L FIN. L. REV., July 1990, at 10.

[12] *See*, *e.g.,* Philip R. Wood, PROJECT FINANCE, SUBORDINATED DEBT AND STATE LOANS (Law and Practice of International Finance 1995) 165 ("In the state context, the meaning of the clause is

The commentators did agree, however, that the clause was intended to address only borrower actions having the effect of changing the legal *ranking* of the debt or perhaps the earmarking of assets or revenue streams to benefit specific creditors. None was prepared to say that a borrower not yet in bankruptcy or within the statutory period for recovering preferential payments prior to a bankruptcy filing (or, in the case of a sovereign borrower, not eligible for bankruptcy), was obligated by virtue of this clause to pay all equally-ranking debt on a strictly lockstep basis.[13] Nor did these commentators suggest that differential payments by a borrower subject to this clause would expose the borrower, as well as the recipients of the differential payments or a third party through which such a payment is processed, to legal remedies extending beyond those customarily available to unpaid creditors.[14]

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uncertain because there is no hierarchy of payment which is legally enforced under a bankruptcy regime. Probably the clause means that on a *de facto* inability to pay external debt as it falls due, one creditor will not be preferred by a method going beyond contract; and (perhaps) that there will be no discrimination against the same class in the event of insolvency."; Wood*, International Loans*, *supra* note 4, at 41 ("In government loans, the clause is probably to be construed as a general non-discrimination clause prohibiting, *e.g.*, the allocation of insufficient assets to one creditor if the state is effectively bankrupt."); *Sub Specie Aeternitatis*, *supra* note 3, at 11 ("The fact that no one seems quite sure what the clause really means, at least in the context of a loan to a sovereign borrower, has not stunted its popularity.").

[13] *See*, *e.g.,* Wood, *International Finance*, *supra* note 10, at 156 ("It should also be observed that the *pari passu* clause has nothing to do with the time of payment of unsecured indebtedness since this depends upon contractual maturity. The *pari passu* undertaking is not broken merely because one creditor is paid before another."); *Restructuring Commercial Bank Loans*, *supra* note 3, at 146 ("Such [*pari passu*] clauses do not obligate the borrower to repay all of its debt at the same time."); World Bank, *Review of IBRD's Negative Pledge Policy With Respect to Debt and Debt Service Reduction Operations* 2 (July 19, 1990) [hereinafter *World Bank Negative Pledge Policy*] (copy on file with authors) ("The *pari passu* clause, for example, does not prevent a debtor from, as a matter of practice, discriminating in favor of international financial institutions such as the [World] Bank and the IMF in making debt service payments."); *Sub Specie Aeternitatis*, *supra* note 3, at 12 ("The existence of a conventional *pari passu* undertaking in a loan agreement will have no effect on the sovereign's legal ability to pay one creditor even if it is then in default on its payment obligations to other creditors, to prepay one lender ahead of some others or to pledge assets to secure the borrower's obligations under one loan without giving equal security in respect of its other indebtedness."); *Norton, supra* note 3, 43-44 ("This [*pari passu*] clause is designed to ensure the equal ranking of unsecured claims on liquidation of assets to unsecured creditors on the borrower's insolvency. . . . The *pari passu* clause does not require concurrent or equal payment prior to that time, and does not restrict guaranteed loans or setoffs."); *Eurocurrency Loan Agreements*, *supra* note 3, at 83 ("Finally, a lender who remains unpaid at a time when other creditors are current on their loans may articulate his grievance in terms of liberty, equality or fraternity, but he should not invoke the *pari passu* covenant as the legal basis for his disappointment. This provision assures the creditor that its loan will not be subordinated to the claims of other creditors in the event of the borrower's bankruptcy, but it does not force the solvent borrower to make *pro rata* payments to all its creditors.").

[14] *See*, *e.g.*, Tudor John, *supra* note 10, at 96 ("[I]t seems certain that where a borrowing state in financial difficulties agrees to give the most pressing set of creditors preferential treatment, the mere making of priority payment will not constitute a breach of the *pari passu* clause unless accompanied by specific legal measures which disturb the right to be treated equally in the distribution of insufficient assets."); Peter Gabriel, LEGAL ASPECTS OF SYNDICATED LOANS 64 (1986) ("[P]ayment of a debt which has not matured under another contract prior to payment under the present loan contract which has matured, will not be a breach of [the *pari passu*] warranty.); Thomas A. Duvall, III, *Legal Aspects of Sovereign Lending*, in Thomas M. Klein (ed.), EXTERNAL DEBT MANAGEMENT: AN INTRODUCTION (World Bank Technical Paper Number 245, 1994), at 43-44 ("In practice, it is unlikely that a standard pari passu clause prevents a sovereign from discriminating between creditors unless it establishes a legal basis for so doing. For example, many developing countries have continued to make payments to multilateral financial institutions, such as the World Bank, even when they were unable to service commercial bank loans. The so-called 'preferred creditor status' of the World Bank rests on practical considerations rather than legal grounds and, thus, is not thought to violate such countries' pari passu undertakings. Because such discriminatory actions between creditors (whether under the same or different loans) are unlikely to be addressed by the pari passu clause, lenders may seek to include other provisions in the lending arrangement, such as mandatory prepayment clauses and, for syndicated loans, sharing clauses.").

II. THE RATABLE PAYMENT INTERPRETATION

A. Tom, Dick and Harry in Brussels

In June 2000, Elliott Associates, L.P., a New York-based hedge fund, obtained a federal court judgment against the Republic of Peru and a Peruvian public sector bank.[15] The underlying claim arose pursuant to a 1983 New York law-governed letter agreement and guarantee of Peru containing a *pari passu* clause. Elliott knew that Peru was obliged to make a payment in September 2000 to holders of the external bonds Peru had issued to restructure its old bank debt ("*Brady Bonds*"). That payment was to flow through the Chase Manhattan Bank, in its capacity as the fiscal agent for the Brady Bonds, and would eventually be credited to bondholder accounts maintained with the Euroclear System in Belgium and the Depository Trust Company ("*DTC*") in the United States.

In an effort to intercept the Brady Bond payment, Elliott served Restraining Notices on Chase Manhattan, Morgan Guaranty Trust Company (in its capacity as the operator of the Euroclear System), DTC and the Bank of New York (in its capacity as the cash correspondent for the Euroclear System).

On September 22, 2000, Elliott also filed an *ex parte* motion with the President of the Commercial Court in Brussels seeking to enjoin Morgan Guaranty Trust Company, as the operator of the Euroclear System, from processing any payments received from Peru in respect of its Brady Bonds. The Commercial Court denied the motion.[16] Elliott appealed to the Court of Appeals of Brussels, also on an *ex parte* basis.

Among Elliott's challenges to the lower court's dismissal was an argument that "the Peruvian Republic attempts to make payments in violation of a principle of equal treatment (*pari passu* clause) among foreign creditors, whereby Elliott Associates is excluded, and tries to use the Euroclear System to achieve that objective."[17]

Elliott's support for this *pari passu* argument came in the form of an affidavit it had commissioned from Professor Andreas F. Lowenfeld (a law professor with the New York University School of Law). Professor Lowenfeld admitted no shard of doubt about either the meaning of the *pari passu* clause in a sovereign debt instrument or its effect on creditor remedies. He opined in these terms:

> 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.

[15] *See Elliott Assocs., L.P. v. Banco de la Nacion*, No. 96 Civ. 7916 (RSW), 2000 WL 1449862 (S.D.N.Y. Sept. 29, 2000)

[16] *See Elliott Assocs., L.P.*, General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000) (unofficial translation on file with authors) ¶ 3 [hereinafter *Brussels Opinion*].

[17] *Id*., at 2.

> 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 (putting jurisdictional considerations aside) to Tom and Dick as well.[18]

No authority was cited in the affidavit for these opinions.

Professor Lowenfeld thus advanced an interpretation of the *pari passu* clause containing these elements:

(i) that the clause requires equal legal ranking of the debt with, in this case, Peru's other external debts;

(ii) that equally ranking debt must be paid equally, at least when the debtor promises in a *pari passu* clause to maintain the equal ranking;

(iii) that if there is not enough money to pay all equally-ranking creditors in full, each holder of equally-ranking debt must receive a ratable share;

(iv) that propositions (ii) and (iii) above are enforceable against the debtor by means of an injunction; and

(v) that propositions (ii) and (iii) above are also enforceable against the recipients of non-ratable payments by injunction.

We shall call this the "ratable payment" interpretation of the *pari passu* clause.

Proposition (i) above is the orthodox reading of the clause. Proposition (ii) contains the innovation -- that a debtor not yet in bankruptcy who has accepted a *pari passu* covenant must *pay* all its equally ranking debts equally. This is also the lynchpin. If proposition (ii) is false (as a matter of contract interpretation of the *pari passu* covenant), then propositions (iii), (iv) and (v) fall away as well.

Four days after Elliott's filing of the *ex parte* appeal, on September 26, 2000, the Belgian Court of Appeals reversed the lower court and granted Elliott's motion to block Peru's Brady Bond payment. In its decision, the Court said:

> It also appears from the basic agreement that governs the repayment of the foreign debt of Peru that the various creditors benefit from a *pari passu* clause that in effect provides that the debt must be repaid *pro rata* among all creditors. This seems to

[18] *See* Declaration of Professor Andreas F. Lowenfeld at 11-12, *Elliott Assocs., L.P. v. Banco de la Nacion, supra* note 15*; Elliott Assocs., L.P. v. Republic of Peru*, 96 Civ. 7916 (RWS), 2000 U.S. Dist. LEXIS 368 (S.D.N.Y. Jan. 18, 2000) (executed Aug. 31, 2000) (on file with authors).

lead to the conclusion that, upon an interest payment, no creditor can be deprived of its proportionate share.[19]

Shortly thereafter the case was settled, with Peru paying Elliott virtually everything Elliott had been seeking. Of course, the Belgian Court of Appeals was being asked to interpret New York law, as it applied to a boilerplate provision in an unsecured New York loan agreement, in the absence of any controlling (or, for that matter, any) New York judicial precedents on the point. Nevertheless, the Belgian Court's decision was significant: the ratable payment interpretation of the *pari passu* clause had been unleashed.

B. Implications

The ratable payment interpretation of this clause arguably has four practical implications:

(i) It may provide a legal basis for a creditor to seek specific performance of the covenant; that is, a court order directing the debtor not to pay other debts of equal rank without making a ratable payment under the debt benefiting from the clause.

(ii) It may provide a legal basis for a judicial order directed to a third-party creditor instructing that creditor not to accept a payment from the debtor unless the *pari passu*-protected lender receives a ratable payment.

(iii) It may provide a legal basis for a court order directing a third party financial intermediary such as a fiscal agent or a bond clearing system to freeze any non-ratable payment received from the debtor and to turn over to the *pari passu*-protected creditor its ratable share of the money.

(iv) It may make a third-party creditor that has knowingly received and accepted a non-ratable payment answerable to the *pari passu*-protected creditor for a ratable share of the money.[20]

C. Proliferation

Following the Belgian decision in *Elliott v. Peru*, it did not take long for other creditors to see the extraordinary implications of the ratable payment interpretation of the *pari passu* clause on creditor remedies. For example:

- On May 29, 2001, Red Mountain Finance, a judgment creditor of the Democratic Republic of the Congo, sought an order from a

[19] *See* Brussels Opinion, *supra* note 16, at 3.

[20] In other contexts, U.S. courts have sometimes been prepared to fashion remedies against a third party that knowingly colludes with a debtor in breaching a financial covenant benefiting another lender. *See generally*, Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection*, 84 CORNELL L. REV. 305, 329-30 (1999). In *First Wyoming Bank, Casper v. Mudge*, 748 F.2d 713 (Wyo. 1988), for example, a bank was held liable for tortious interference with contractual relations because it knowingly took security from a borrower in violation of an existing negative pledge undertaking. *But cf.* Schnebel, *supra* note 7, at 49 ("Subject to the provisions of Section 547 of the Federal Bankruptcy Code in respect of preference payments, a borrower may favor one lender by the payment of additional fees or loan prepayments. If this is a concern, the loan or credit agreement may restrict or prohibit such action by the borrower. If the borrower violates the agreement and makes such payment, however, the lender will have no recourse against the favored lender.")

federal District Court judge in California seeking the Congo's specific performance -- on the ratable payment theory -- of a *pari passu* clause in a 1980 credit agreement with the Congo. According to the transcript of the court hearing, the judge expressly denied the request for specific performance of that clause but nevertheless enjoined the Congo from making any payments in respect of its External Indebtedness (as defined in the 1980 credit agreement) without making a "proportionate payment" to Red Mountain.[21] The case subsequently settled.

- In April 2003, Kensington International Limited, a creditor of the Republic of the Congo ("*Congo-Brazzaville*"), sought summary judgment in London on a money claim against Congo-Brazzaville, as well as an order from the High Court in London restraining the defendant from paying its other creditors without making a *pro rata* payment to Kensington. The legal basis for the requested order was a *pari passu* clause in a loan agreement. The English trial judge apparently viewed this motion for injunctive relief as "novel and unprecedented," and he denied it.[22] On appeal, the Court of Appeals affirmed that denial.[23]

- In *Nacional Financiera, S.N.C. v. Chase Manhattan Bank, N.A.*, Judge Martin of the U.S. District Court for the Southern District of New York was called upon to interpret a *pari passu* provision in a fiscal agency agreement. It was alleged that the borrower, Tribasa, had defaulted on its payment obligations to certain noteholders (called the "*Smith Parties*"). Tribasa was alleged to have then issued new notes to another creditor, Nafin, and paid those new notes. When the Smith Parties argued that this practice violated Tribasa's *pari passu* covenant, Judge Martin ruled that the *pari passu* provision's only effect in terms of legal remedies was to ensure that, in the event of Tribasa's bankruptcy, all of Tribasa's noteholders would share equally in the distribution of the company's unencumbered accounts.[24] Nafin, before it accepted a payment by Tribasa, was under no obligation to assure itself that other noteholders were also being paid on their claims.[25]

  Citing the *Elliott v. Peru* decision in Brussels, however, Judge Martin speculated that the *pari passu* covenant "may . . . have given the Smith Parties the right to obtain an injunction to bar Tribasa from making preferential payments to some of its note holders and

[21] *See Red Mountain Fin., Inc. v. Democratic Republic of Congo and Nat'l Bank of Congo*, Case No. CV 00-0164 R (C.D. Cal. May 29, 2001).

[22] *See Kensington Int'l Ltd. v. Republic of the* Congo, 2002 No. 1088, at 6:13-16 (Commercial Ct. April 16, 2003) (judgment of Mr. Justice Tomlinson) (characterizing J. Cresswell as finding motion for injunctive relief "novel and unprecedented" and denying injunctive relief).

[23] See *Kensington Int'l Ltd. v. Republic of the Congo*, No. [2003] EWCA Civ. 709 (C.A. May 13, 2003).

[24] See *Nacional Financiera, S.N.O. v. Chase Manhattan Bank, N.A.*, No. 00 Civ. 1571 (JSM), 2003 WL 1878415, at *2 (S.D.N.Y. Apr. 14, 2003).

[25] *Id.*

that another note holder with notice of that injunction could be liable . . . if it thereafter accepted preferential payments."[26]

- On August 13, 2003, Kensington International Limited sued BNP Paribas S.A. in a state court in New York alleging, among other things, that BNP had tortiously interfered with Kensington's rights as a creditor of Congo-Brazzaville under a 1984 loan agreement (containing a *pari passu* clause) in which Kensington had purchased an assignment interest. Congo-Brazzaville defaulted on its payment obligations under the loan agreement in 1985. BNP subsequently entered into new financings with Congo-Brazzaville, and those new financings had been paid. Based on the ratable payment theory of the *pari passu* clause, Kensington alleged that BNP's acceptance of those payments at a time when the 1984 loan agreement remained in default tortiously interfered with Kensington's rights under Congo-Brazzaville's *pari passu* covenant.[27]

- In September 2003, the same trial court in Brussels that heard the *Elliott v. Peru* case in 2000 found itself confronting a very similar fact pattern. In the *Elliott* case, this court had denied Elliott's motion to freeze payments passing through the Euroclear System, only to be reversed by the Belgian Court of Appeals. Now a judgment creditor of Nicaragua, LNC, was seeking an injunction preventing Euroclear from processing payments on certain Nicaragua bonds. The legal basis for this request was a *pari passu* covenant in a 1980 loan agreement of Nicaragua. This time the Belgian trial court granted the injunction.[28] That decision has been appealed.

D. Criticisms

The most telling arguments against the ratable payment interpretation tend to highlight the implausibility of that interpretation in light of the historical behavior of market participants.[29] For example:

- <u>Domestic credit agreements</u>. If the simple device of a three-line *pari passu* clause really gives a creditor the ability to enforce ratable payments by a debtor in distress, why is it not an invariable feature of domestic credit agreements?[30] After all, most corporate borrowers faced with a cash squeeze will engage in a form of financial triage -- paying some creditors (like suppliers) while trying

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[26] *Id.*

[27] *See* Kensington Int'l Limited v. BNP Paribas SA, No. 03602569 (N.Y. Sup. Ct.) (complaint filed August 13, 2003).

[28] *See* Public Hearing of Summary Proceedings of Thursday, September 11, 2003, Republic of Nicaragua v. LNC Investments and Euroclear Bank S.A. (free translation) (copy on file with authors) [hereinafter *LNC Opinion*].

[29] There has been a limited amount of academic commentary about the ratable payment interpretation of the *pari passu* clause since the Belgian court decision in the *Elliott* case in 2000. These commentaries have criticized the ratable payment interpretation. *See* G. Mitu Gulati and Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635 (2001) and Philip R. Wood, *Pari Passu Clauses – What Do They Mean?,* BUTTERWORTH'S JOURNAL OF INTERNATIONAL BANKING (Nov. 2003), at 374.

[30] *See supra* note 6.

to sweet-talk others into showing flexibility. An unpaid lender to a U.S. corporate borrower that objects to this triage may force the debtor into bankruptcy. Once there, the lender can be assured of equal treatment of all similarly-situated creditors, and can force the clawback of preferential payments made to other creditors within 90 days of the bankruptcy filing. Under the ratable payment interpretation of the *pari passu* clause, however, such a lender could presumably arrest the financial triage without the need for an involuntary bankruptcy filing and perhaps even claw back preferential payments made much earlier than the 90-day statutory window. Indeed, only the statute of limitations might constrain the outer limits of a *pari passu*-protected lender's ability to pursue remedies against another creditor that knowingly accepted a non-ratable payment. Why then should domestic lenders have overlooked a short contractual provision that, if the ratable payment interpretation is correct, would have so significantly enhanced their available remedies outside of bankruptcy?

- Sovereign restructuring practices. Financial triage is not wholly unknown to the sovereign debtor community either. For various reasons, financially-distressed sovereigns typically pay certain types of creditors (*e.g.*, trade creditors, suppliers and international financial institutions like the World Bank) even while they restructure debts owed to banks, bondholders and bilateral creditors. Every sovereign debt restructuring in the 1980s began with a painstaking negotiation of these so-called "excluded debt" categories (excluded, that is, from the restructuring).[31] Why? If the *pari passu* clauses in all of the underlying loan agreements required ratable payments of all equally-ranking debts, why didn't some creditor somewhere obtain a court order halting this practice of allowing the debtor to continue paying *de facto* preferred creditors while restructuring the others? At the very least, why didn't the drafters of the restructuring agreements that resulted from these negotiations feel the need to include waivers or amendments of the many *pari passu* covenants in the underlying credit instruments?

- Redundant contractual provisions. Syndicated commercial bank loan agreements invariably contain a so-called "sharing clause" (sometimes running to four or five pages in length) designed to ensure that any disproportionate payment received by one member of the syndicate will be shared ratably with all the rest.[32] Why? Under the ratable payment interpretation of the *pari passu* clause, these lenders already had an effective mechanism to enforce ratable payments both within a specific syndicate of banks and more broadly with all other equally-ranking creditors. Why devote so much energy to drafting a redundant provision? Equally mysterious, why did the lawyers drafting these agreements feel the need to spill four or five pages of ink in describing the intra-syndicate sharing mechanism if the prospect of global sharing with

[31] *See Restructuring Commercial Bank Loans*, *supra* note 3, at 142.

[32] *See Eurocurrency Loan Agreements*, *supra* note 3, at 76-81.

all other equally ranking lenders could comfortably be lodged in the three lines of the *pari passu* clause, without ever using the word "share" or one of its synonyms?

- Sharing among bondholders. In 1998, official sector participants (mainly the G-10 governments and the International Monetary Fund) suggested, as part of the "new international financial architecture" debate, that emerging market sovereign bonds begin to incorporate sharing clauses modeled on those typically found in syndicated commercial bank loans.[33] Of all the proposals to change sovereign bond documentation, the investor community reserved its special wrath for the sharing clause idea. Trade associations representing bond market investors were uniform in their rejection of the proposal to add sharing clauses to sovereign bonds.[34] But why? If the ratable payment interpretation of the *pari passu* clause is correct, bonds containing *pari passu* clauses (which is most of them) already included a legally-enforceable obligation on the bondholders to share any non-ratable payments. Why then did the investor community react so fiercely to the idea of spelling out the mechanics of such sharing in a new clause?

- Wider use. We have been talking about this clause in the context of credit instruments. But if indeed the provision carries the ratable payment baggage, why does it not appear in all manner of commercial instruments and invoices? Such a clause might read: "The customer's obligations under this bar tab will rank *pari passu* in priority of payment with all of the customer's other payment obligations." By adding these few words, would the bartender acquire a legal basis (outside of bankruptcy) to keep the customer from paying her taxes before the bar tab had been settled? If served with an injunction to that effect, would the Internal Revenue Service be obliged to decline a tax payment or to turn over a ratable share of the money to the bartender?

- The butcher and the baker. The ratable payment interpretation turns upon the proposition that equally ranking debts must be paid equally. The *pari passu* clause does not itself say this of course -- indeed, it refers only to the ranking of the debt -- but this is the quiet inference that the proponents of the ratable payment theory draw from a borrower's promise to maintain equal ranking. Putting aside statutory preferences recognized in bankruptcy, contractually senior or subordinated debts and secured debts, however, most claims against an individual or a corporation will fall into the broad classification of "general unsecured" obligations. But if those

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[33] *See* G-22, REPORT OF THE WORKING GROUP ON INTERNATIONAL FINANCIAL CRISES, at 20. *See generally*, Lee C. Buchheit, *Changing Bond Documentation: The Sharing Clause*, INT'L FIN. L. REV., July 1998, at 17.

[34] *See*, *e.g.,* Edward Luce, *Pakistan a warning to bond holders*, FIN. TIMES (Feb. 18, 1999) ("Clifford Dammers, head of the International Primary Market Association -- the body representing the international bond markets -- says . . . the market opposes the sharing clause . . . ."); Emerging Market Traders Association, *Paris Club Asks Pakistan to Reschedule Eurobonds*, (undated paper, copy on file with authors) ("[I]t is EMTA's position that radical changes in bond documentation (such as including sharing clauses . . .) are undesirable . . . .").

general unsecured debts by law rank equally, must not they too be paid ratably? To continue the trend of homey examples, must not Aunt Agatha refrain -- under threat of a legal injunction -- from paying the baker while ignoring the butcher? Or does the obligation to make ratable payments derive not from the *fact* of the equal ranking of the claims, but somehow from the borrower's contractual *promise* to maintain such equal ranking? So that Aunt Agatha is free to make differential payments unless and until the baker gets her to acknowledge that he ranks *pari passu* with the butcher?

- Third-party beneficiaries. The ratable payment interpretation suggests that the phrase "this bond shall rank *pari passu* in priority of payment with all of the borrower's other debts" constitutes an enforceable promise not to pay other debts while this bond is in default. But doesn't that same sentence also confirm that the borrower's other debts rank equally with this bond? And if they do, a consistent application of the ratable payment theory leads to the conclusion that the borrower should never be paying this bond if it is then in default on any of its other debts. Remember, equally ranking debts must be paid equally -- that's the theory. By the debtor's openly announcing its agreement (in a registration statement filed with the U.S. Securities and Exchange Commission, for example) to maintain the equal ranking of this bond with those other debts, have those other creditors been given the power to enjoin a payment under this bond, regardless of whether the instruments evidencing those other debts contain their own *pari passu* covenants?

  And if there is even the remotest possibility of this outcome, why would the purchasers of such a bond agree up front to decline to accept payments under their instrument unless every other equally-ranking lender to that borrower was also being paid in full? Analyzed in this way, a *pari passu* covenant is a positively dangerous clause to include in any debt instrument.

- Plain speaking. "Following the occurrence of a [payment default] hereunder, the Borrower agrees that it will not, directly or indirectly, make any payment of any other present or future External Indebtedness of the Borrower unless, simultaneously with such payment, a ratable payment is made of amounts then due under this Agreement." If this is what the contract drafter had wanted to say, why not just say it? Is it even remotely plausible that a sophisticated drafter would have left the parties to extrapolate this conclusion from the text of a clause that speaks only about the legal ranking of debt?[35]

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[35] Even this plain-speaking text conceals a number of crucial issues that the drafter would inevitably need to spell out in the contract. For example, what does "ratable" mean in this context? Lender A has five loans outstanding to the Borrower, each in the amount of $100. Lender B has one loan to that Borrower, in the amount of $1,000, but the Borrower has stopped paying Lender B on that credit. Now the Borrower pays $50 to Lender A to be applied toward one of the five outstanding loans from Lender A. Lender B calls for a ratable payment of its $1,000 defaulted credit. But what is ratable? The obvious options are:

(i) $50 (the same dollar amount paid to Lender A), or

- <u>Tom, Dick, Harry and Sue</u>. Let's go back to Tom, Dick and Harry. Tom and Dick, at the sharp end of the injunctions obtained by Harry based upon a ratable payment theory of his *pari passu* clause, have been obliged to turn over a ratable share of their payments to Harry. But now along comes Sue, also a lender to the same borrower and also benefiting from a *pari passu* covenant. Sue seeks an injunction requiring Harry (who, unlike Tom and Dick, lives in her neighborhood) to turn over a "ratable portion" of the payment Harry had so recently extracted from Tom and Dick. What is poor Harry to do now, take another run at Tom and Dick? And if he gets a supplemental payment from them to top-up for the cash he gave to Sue, will not Sue renew her own pursuit of Harry for a ratable share of the top-up? Then Fred, also an unpaid creditor of the same borrower, hears about Sue's success and decides to come after her. And so forth and endlessly so on.

  To avoid this tangled skein of claims, counterclaims and cross-claims among creditors, the ratable payment interpretation of the *pari passu* covenant should logically require that all payments by the borrower to any equally-ranking creditor be placed into some form of global trust account, with a procedure for filing claims with the trustee and an eventual ratable distribution to all beneficiaries of *pari passu* protection. Once again, is it plausible that professional drafters of financial contracts would intend such a massive set of legal arrangements to be interpolated into the slender three lines of a conventional *pari passu* covenant?

  Or try this hypothetical: borrower defaults on a bond. One (but only one) bondholder sues and levies against an asset of the borrower to satisfy its judgment. Is the litigious creditor now holding those funds as constructive trustee for the ratable benefit of its erstwhile fellow bondholders? After all, the judgment creditor knew perfectly well that the underlying bond contained a *pari passu* covenant and that the other bondholders had not been paid.[36]

(ii) $100 (corresponding to the proportion that the $50 payment to Lender A represents of the $500 total amount due to Lender A), or

(iii) $500 (corresponding to the proportion that the $50 payment represents of the specific $100 loan that was repaid).

Of course, if one believes that a conventional *pari passu* clause has the same meaning as the plain-speaking version of the clause set out in the main text above, it raises identical interpretative issues.

[36] The judgment creditor will probably argue that it is *not* obliged to share with the other bondholders because, pursuant to the doctrine of "merger", all its claims under its original bond have been merged into the judgment. "When the plaintiff recovers a valid and final personal judgment, his original claim is extinguished and rights upon the judgment are substituted for it." RESTATEMENT (SECOND) OF JUDGMENTS § 18, cmt. a (1982). But if the doctrine of merger severs the judgment creditor from its obligation to share recoveries with its *pari passu*-ranking fellow bondholders (if such an obligation exists), why does not the doctrine of merger also sever the judgment creditor from that same *pari passu* clause when the creditor seeks -- based on the ratable payment interpretation of the clause -- to intercept payments going to other equally-ranking creditors? If the doctrine of merger detaches a judgment creditor from its obligations under that clause, surely it also separates the judgment creditor from its rights under that clause (assuming again, that such rights and obligations actually arise under the clause).

There is a single answer to all of these "whys": neither lenders nor borrowers nor their respective legal counsel nor academic commentators ever believed that a conventional *pari passu* covenant in a debt instrument carried the ratable payment interpretation. The behavior of participants in the financial markets since this clause first made its appearance in unsecured, cross-border debt instruments in the 1970s (as discussed below) demonstrates that they did not believe, or even suspect, that the clause required ratable payments (outside of bankruptcy) of all equally-ranking debts.

One is tempted to end the inquiry there: after all, contracts mean what the parties intend them to mean. In the case of boilerplate contractual provisions, the clauses carry the meaning accepted by general consensus among market participants. When in doubt, look at how the market acts, or sometimes doesn't act, in the face of a particular clause. If a question is raised about the meaning of a boilerplate clause, the established behavior (what one court has called the "deliberate and enduring course of conduct")[37] of the thousands of commercial parties to contracts containing that clause gives the best insight into their understanding of its meaning.

New York has adopted just this approach to interpreting boilerplate provisions in commercial contracts.[38] New York courts have been reluctant to risk disturbing the market's demonstrated understanding of the meaning of boilerplate clauses by, for example, allowing interpretations of those clauses to be made by juries rather than judges.[39]

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[37] *See* Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1049 (2d Cir. 1982).

[38] In *Sharon Steel*, *id*., the Second Circuit Court of Appeals affirmed the District Court's refusal to allow a boilerplate clause in a standard debenture to be submitted to a jury for interpretation. After noting that boilerplate provisions are not the consequence of the relationship of particular borrowers and lenders and do not depend upon particularized intentions of the parties, the Second Circuit said:

> Whereas participants in the capital market can adjust their affairs according to a uniform interpretation, whether it be correct or not as an initial proposition, the creation of enduring uncertainties as to the meaning of boilerplate provisions would decrease the value of all debenture issues and greatly impair the efficient working of capital markets. Such uncertainties would vastly increase the risks and, therefore, the costs of borrowing with no offsetting benefits either in the capital market or in the administration of justice.

Id. at 1048.

[39] "When standard [contract] terms exist, the role of judicial interpretation should be to promote the functions of standard terms . . ., while allowing firms to opt out of those standards and customize their own terms." Marcel Kahan and Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate"),* 83 VA. L. Rev. 713, 764-5 (1997). Professors Kahan and Klausner list among the benefits of standard clauses (i) drafting efficiency, (ii) reduced uncertainty over the meaning and validity of a term and (iii) familiarity with a term among lawyers, other professionals and the investment community. *Id.* at 719-25.

III. THE HUNT FOR PARI PASSU

There is something intellectually unsatisfying, however, about confining the inquiry to what the *pari passu* clause does *not* mean. It leaves open intriguing questions about the origin of the clause, what factors influenced its migration over the centuries into unsecured, cross-border credit instruments (including credit instruments with sovereign borrowers) and, most importantly, what protections the drafters of the provision were trying to achieve by inserting the clause into these contracts. In an effort to answer these questions, the authors embarked several years ago on a small exercise in legal paleontology: the hunt for *pari passu*.

A. Preferences and Priorities

The *pari passu* covenant is a contractual provision. Contract drafters do not usually write into their contracts what the law already provides. Drafters do not, for example, often add this sentence to their agreements: "If either party breaches this Agreement, the other party shall have the rights and remedies provided by law." The reason? The law already supplies this premise; saying it adds nothing. So when drafters feel compelled to burden their documents with express provisions, it is a pretty good sign that they are trying to address a matter that they feel needs a customized treatment. They either want to record an understanding of the parties on a matter that the law does not already cover or they seek to clarify a point on which the law is seen as murky or equivocal.

When the contract in question evidences an extension of unsecured credit to a corporate borrower, the lender will worry about four things that may affect the lender's ability to recover the debt. These are:

(i) The nature of the claims against the borrower that will, as a matter of law, enjoy a priority in a bankruptcy of the debtor. Such claims may include tax assessments, unpaid employee wages, contributions to corporate-sponsored pension programs and so forth. We shall call this category of preferred claims "*Statutory Preferences*."[40]

(ii) Claims (outside of Statutory Preferences) that rank legally senior in, and sometimes out of, bankruptcy to the debtor's general unsecured obligations. We shall call these "*Legally Senior Debts*."

(iii) Claims that benefit from a security interest over the debtor's property or revenues that can be realized in, or out of, bankruptcy. Examples include mortgages, pledges, charges, hypothecations, conditional sale arrangements and so forth. We shall call these "*Secured Debts*."

(iv) The aggregate size of other general unsecured claims against the borrower. Even if these claims will not enjoy a priority in the distribution of the debtor's unencumbered assets in bankruptcy, increasing the aggregate size of these claims will tend to dilute the recovery that any individual unsecured creditor can expect to receive from the finite pool of such unencumbered assets.

There is nothing much a creditor can do about Statutory Preferences other perhaps than to seek a clear idea of what they are in the borrower's

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[40] *See, e.g.*, Section 507 of the U.S. Bankruptcy Code which contains the list of the priorities recognized in U.S. bankruptcy practice. 11 U.S.C. § 507 (2003).

jurisdiction before lending the money. A debtor cannot, by contract, opt out of Statutory Preferences such as claims for unpaid taxes. The most that can be achieved is to include contractual commitments by the debtor to pay its taxes, pension fund contributions and so forth as they fall due, so that unsatisfied claims constituting Statutory Preferences never arise in the first place.

As noted above, drafters of U.S. domestic credit agreements do not usually include express provisions precluding the debtor's ability to incur Legally Senior Debts. The reason is that U.S. law does not permit an existing creditor to be legally subordinated without its consent. This is an example of the "don't say what you don't need to say" rule of contract drafting described in the first paragraph of this Part 3.

Secured Debts and the overall size of the pool of equally-ranking unsecured debts, however, are another matter. The law does not constrain a debtor's ability to pledge its assets or revenues, or to incur additional unsecured debts. If a creditor wants to limit this behavior by its borrower, the creditor must look to its contract as the source for that protection.

In the case of Secured Debts, this contractual protection takes the form of something called a negative pledge clause. Although there are many drafting variations, the negative pledge clause typically precludes the borrower from creating liens over its assets or revenues in favor of other lenders (often subject to specific exceptions) without equally and ratably securing the creditor benefiting from the clause.[41] The purpose is to ensure that the borrower's assets will remain unencumbered and available to satisfy the claims of all general, unsecured creditors in a bankruptcy. As one writer was later to put it, the negative pledge clause is intended to say: "If I'm unsecured, so must everybody else be."[42]

In some agreements, a protection against bloating the class of unsecured creditors takes the form of a "debt limitation" clause. It caps the ability of the borrower to incur additional, equally-ranking debt above a specified level.[43] The negative pledge clause, the debt limitation clause and, for that matter, the *pari passu* covenant, are all species under the genus "financial covenants." Their presence in a financial contract reveals the drafter's belief that these protections must be sought by contract because the ambient law governing the relationship will not otherwise provide them.

B. The Pari Passu Odyssey

Our research suggests that the *pari passu* clause evolved in three broad phases in Anglo-American credit agreements. In its original form (nineteenth and early twentieth centuries), the clause appeared in secured debt instruments and confirmed the ratable interests of the debtholders in the collateral securing that instrument (an assurance that the law -- absent express contractual language -- did not supply). By the middle of the twentieth century, a painful history had taught

[41] *See generally*, *Eurocurrency Loan Agreements*, *supra* note 3, at 86-91.

[42] T.H. Donaldson, *American Banks: Experienced Lenders or….?* EUROMONEY (Oct. 1971) [hereinafter Donaldson, *Experienced Lenders or ….?*], at 46, 47.

[43] *See* David E. Webb, DOCUMENTATION FOR HIGH YIELD DEBT (2001) at 17; John McCann, TERM LOAN HANDBOOK, *supra* note 6, at 171 ("Clearly, to the extent that the creditors of a borrower . . . are limited, the more likely it is that those creditors' claims will be satisfied by the borrower's assets in a distress/liquidation situation.").

the cross-border lenders to rely less on collateral security for emerging market bonds. Cross-border lending in this period was therefore mainly *un*secured and, in that context, the traditional *pari passu* covenant was not necessary. Instead of security and the accompanying *pari passu clause*, the drafters of mid-twentieth century unsecured debt instruments looked to the negative pledge clause to protect themselves against an erosion in credit position as a result of a borrower's pledging its assets in favor of other lenders. By the late twentieth century, however, most of the private capital flows to emerging market borrowers were coming from a new breed of lender, the international commercial banks. These institutions, apart from insisting on a negative pledge clause to safeguard their credit position as unsecured lenders, also worried that legal procedures in some countries could -- even without their knowledge or consent -- result in an involuntary subordination of the banks' claims. The banks responded to this threat with a contractual protection against such involuntary subordination: a version of the *pari passu* clause that speaks in terms of "*pari passu* in priority of payment".

(i) Nineteenth and Early Twentieth Centuries:
Pari Passu in Secured Credits

A version of the *pari passu* clause was routinely used in debentures and other debt instruments issued by both corporate and sovereign borrowers in the nineteenth and early twentieth centuries, but *only* when the instrument benefited from collateral security. A representative clause might read as follows:

> The debentures of [this] series are all to rank *pari passu* in point of charge without any preference or priority one over another . . . .[44]

Here is how Francis Beaufort Palmer, a leading nineteenth century English commentator, explained the purpose of this clause in a secured debenture (a debenture is a type of debt instrument):

> The object of the above *pari passu* provision is to place all the debentures on the same level as to security; so that, if the security is to be enforced, whatever is realized from it shall be divided amongst them ratably. But for some such provision the debentures would rank in point of security according to their dates of issue; and, accordingly, the first issued would rank as a first charge, and the next issued as a second charge, and so on . . . and this would be entirely destructive of the marketable character of the security.[45]

Indeed, Palmer was later to express his doubts about what purpose a *pari passu* clause could possibly serve in what he called a "naked or unsecured" debenture; the very presence of the clause, in Palmer's view, showed that the debenture was *not* intended to be a "naked" (unsecured) one.[46]

There was a very good reason for including a *pari passu* clause in a secured debt instrument during this period. A common practice in the nineteenth century, particularly in the case of debt securities issued by railroads, was to issue

[44] Francis B. Palmer, COMPANY LAW 197 (2d ed. 1898) [hereinafter Palmer, *Company Law*].

[45] *Id.* at 198.

[46] Palmer, *Company Precedents*, *supra* note 2, at 110.

multiple series of bonds that all benefited from a security interest in a common pool of collateral such as the railroad's real estate and rolling stock. Under prevailing English law, absent a contractual agreement to the contrary, multiple claims by the holders of the various series of bonds against a common asset pledged as collateral would have been ranked in the temporal order in which the bonds were issued.[47] Thus, a series of bonds issued in 1876 would have had a priority claim over the disposition of the common collateral in preference to a second series issued, say, in 1877.

The situation in the United States was particularly chaotic and worrisome for debtholders whose instruments did not contain an express confirmation of their *pari passu* ranking. In some situations, U.S. courts followed the English "first to be issued" priority rule in applying the proceeds of collateral among several debtholders.[48] Other courts looked to the dates on which the debt instruments were scheduled to mature as a basis for establishing the priority of claims against collateral.[49] Other states provided that all debtholders should share equally and ratably in the pledged assets.[50]

But these English and U.S. rules establishing the priority of interests in collateral among various creditors *could* be changed by contract.[51] Enter the *pari passu* clause, which confirmed the intention of the parties that all debtholders secured by the same collateral would share equally and ratably in the security, whatever the generally applicable priority rule in a particular jurisdiction. The phrase *pari passu* was thus being employed in a manner consistent with its use in the equity courts (as a way of expressing the ratable interests of multiple parties in a single asset or pool of equitable assets).

The inclusion of this provision in a debt instrument had practical consequences for the creditors. The clause served, in effect, to establish contractually the rule governing the application of the proceeds from the liquidation of collateral. If one debtholder attempted to enforce the security interest by levying against the pledged property, for example, it was forced to do so for the benefit of all its *pari passu*-ranking fellow debtholders. Any proceeds from the levy were to be held in trust for all debtholders whose claims against the borrower were secured by that collateral.

It is significant that at this stage in its life (the nineteenth and early twentieth centuries), the *pari passu* clause was used exclusively in *secured* debt instruments. The intercreditor responsibilities connoted by the presence of a *pari passu* clause in a debt instrument were strictly limited to enforcement against the collateral securing that instrument. The clause implied no broader intercreditor

[47] *See id.* at 109.

[48] *See* cases collected at 63 N.Y. JUR. 2D GUARANTY AND SURETYSHIP, 272 (2003) ("Application of Collateral Where Judgment Is Received on Several Debts").

[49] *See* cases collected at AM. JUR. 2D MORTGAGES § 315 (2003) ("Earlier-Maturity Rule"); *see also* Silvester E. Quindry, BONDS AND BONDHOLDERS: RIGHTS AND REMEDIES, Vol. 1, 388 (1934) [hereinafter Quindry] ("The earlier maturity rule, i.e. that the holders of bonds have priority in the proceeds of sale according to the priority of the maturity dates, the earlier having preference over the latter, is recognized in many jurisdictions, where the bonds mature at different dates and the trust deed is silent on the question of priorities.").

[50] *See* cases collected at AM. JUR. 2D MORTGAGES § 314 (2003) ("Pro-Rata Rule").

[51] *Quindry*, *supra* note 49, at 388. ("But, of course, the parties may contract as to priorities and preferences and the courts will enforce the agreement.").

duties. Specifically, if a creditor could -- with or without the aid of a judgment -- obtain payment of his instrument from the issuer without recourse to the pledged property, he was under no obligation to share that payment with other *pari passu*-ranking debtholders. Here is Francis Beaufort Palmer on the point:

> The presence of a *pari passu* clause does not, however, prevent a debenture holder, whose debt is due, from getting judgment and obtaining payment from the company if he can, and so, too, if, without judgment, he can obtain payment from the company, he cannot be called on to hand back what he has received for the benefit of the other debenture holders.[52]

In its original form, therefore, the *pari passu* covenant did not connote the kind of intercreditor duties that the ratable payment interpretation has recently sought to ascribe to it. Specifically, a borrower was *not* prevented by the clause from *paying* one debtholder ratably while ignoring other, equally-ranking creditors, as long as the payment was not sourced from the specifically pledged collateral to secure the issue. Nor was the creditor receiving such a payment under any obligation to account to his fellow debtholders for their ratable share of the payment.

(ii) Middle Twentieth Century:
Negative Pledge in Unsecured Credits

Cross-border lending practices changed dramatically in the middle of the twentieth century. Many of the nineteenth and early twentieth century debt instruments issued by sovereign borrowers in the international markets were secured, or at least they appeared to be.[53] The bonds would frequently be described as benefiting from some form of security or guarantee: a vaguely-worded interest in the proceeds from the sale of guano, for example, or in certain tax revenues to be collected by a sovereign borrower. These bonds often included a *pari passu* clause to confirm the bondholders' ratable interests in that collateral.

In practice, the ostensible security for these bonds was frequently of very little help in getting the bonds paid in the face of a default by the issuer, particularly a sovereign issuer. A security feature might influence the relative priority of the bond in a general diplomatic settlement of a sovereign's debts,[54] but bondholders

[52] Palmer, *Company Law*, *supra* note 44, at 198.

[53] *See* 7 SEC. AND EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 11 (May 14, 1937) [hereinafter *SEC Report*] ("[O]f the 172 [defaulted foreign bond issues listed in the annual report of the Foreign Bondholders Protective Council, Inc., for the year 1935], 109 were secured, and of these 70 were secured by pledges of revenue while but 11 were secured by mortgages of physical property only. Twenty-eight loans were secured by both the mortgaging of physical property and the pledging of revenues."). *See also* John T. Madden & Marcus Nadler, FOREIGN SECURITIES (1929) 165-66 ("Weaker countries, and especially those whose credit standing is not well established, cannot obtain foreign loans on financially satisfactory terms without pledging certain revenues as security for the payment of principal and interest on debt. . . . For a considerable period before the [first] World War, the practice of requiring specific security for government loans was becoming less common but the disorganized state of governmental finances after the war, brought about a revival of the custom.").

[54] *See* Edwin Borchard, STATE INSOLVENCY AND FOREIGN BONDHOLDERS, Vol. I, 98, 99 (1951) [hereinafter Borchard] ("[E]xperience shows that lending houses and investors, when they appeal to their governments for diplomatic interposition, have usually a better chance of obtaining governmental cooperation if there exists a specific 'pledge.' . . . During the different stages of the liquidation and readjustment of the Turkish and Egyptian public debt, as well as in other settlements, holders of secured bonds have received preferential treatment either in the form of priorities in payment and amortization, by being subjected to a smaller reduction of interest than the holders of

typically lacked the ability to enforce the security interest in the borrower's own territory absent some diplomatic or military assistance from their own governments.[55] The market's appetite for secured sovereign bonds diminished rapidly after the market crash of 1929 when these security features were shown to have little effect in promoting monetary recoveries from defaulting sovereign issuers.[56] As secured lending to sovereign borrowers declined, the *pari passu* clause (in its conventional, nineteenth century form) was no longer needed.

Negative pledge clauses, however, had become common in unsecured U.S. domestic bonds by at least the 1890s.[57] In general, they did not appear in secured debt instruments, presumably on the theory that as long as a lender is itself fully secured (and the legal validity of such security can be relied upon), it should not have any interest in how the borrower disposes of its other assets.

For the first two decades following World War II, development lending to what we would now call emerging market sovereigns came principally from bilateral (government-to-government) sources and from multilateral sources such the World Bank and other multilateral development banks. Early on, the World Bank decided as a matter of policy that it would not seek collateral security for its loans from sovereign borrowers.[58] In the absence of collateral security, there was

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unsecured bonds, by being spared any reduction in interest, or by being left entirely unaffected by the readjustment procedure."); Ernst H. Feilchenfeld, *Rights and Remedies of Foreign Bondholders*, in *Quindry*, *supra* note 49, II, at 216 [hereinafter Feilchenfeld*, Rights and Remedies*], ("[Q]uasi-secured creditors frequently try to obtain preferential treatment in the award of a higher percentage out of all available assets. . . . the expectation of such preferential treatment seems to be the major intended function of the revenue pledges and charges inserted in loan agreements . . . .").

[55] *See* Borchard, *id*., at 91 ("[A] revenue pledge can become a real security in the hands of the creditors only if the assignment of the revenues to the service of the debt is coupled with some device removing them from the debtor's unhampered control and committing them directly to the administration of the creditors. Such implementation of a pledge, however, is feasible only in exceptional cases.").

[56] *See, e.g.*, the testimony of Allen W. Dulles, then a partner in the Wall Street law firm of Sullivan & Cromwell, before a U.S. Securities and Exchange Commission committee that during the late 1930s investigated the causes of the widespread bond defaults earlier in the decade. Mr. Dulles testified:

> I have reached the conclusion the pledges of revenues are not worth the paper they are written on, on foreign loans, unless the revenues are collected and disbursed by persons other than the debtor. . . . Generally, you are forced back to the situation where the borrowing government is the collector and the disburser, and when that is the situation I don't think the security is worth anything. . . . I don't think it is worth appreciably more than the general obligation of the foreign government to pay. . . . In a debt negotiation in which I had a part I don't think where we had a first or second lien on some revenue that was not being collected would prove of any value in any situation.

The SEC report goes on to note: "This is a frank admission by a partner of a firm which drafted many of the foreign loan agreements that to him the protective covenants are empty phrases." SEC Report, *supra* note 53, at 22-23.

[57] Francis Jacob, *The Effect of Provision for Ratable Protection of Debenture Holders in Case of Subsequent Mortgage*, 52 HARV. L. REV. 77, 78 (1938).

[58] *World Bank Negative Pledge Policy, supra* note 13, at 3, fn. 3 ("In 1948, the then Treasurer of the Bank stated that in his view the Bank's real security lay in the sound economic and financial position of the borrowing country. He stated that the taking of collateral weakened the Bank's ability to induce the country to 'keep his house in order', because in taking collateral, the Bank would have less reason to 'inquire deeply' into conditions in the borrower's country."). Note that this approach to sovereign lending on the part of an international financial institution contrasts with the view of some private sector commentators who during this period continued to see benefits to secured lending, notwithstanding the admitted limitations of such pledges. See, *e.g.*, Borchard, *supra* note 54, at 81-82 ("To guard against abuses in the appropriation of funds to the various functions of government, creditors of states of weak credit standing will be well advised to insist that certain assets and

no point in adding a conventional *pari passu* clause, and in fact *pari passu* clauses did not (and still do not) appear in the standard terms and conditions for World Bank loans.[59]

For its unsecured loans to sovereign market borrowers, the World Bank opted to rely on a very strict negative pledge undertaking from the borrower.[60] This clause prevented both the sovereign and its governmental agencies from pledging collateral to secure any other external borrowings (subject to only two exceptions). Once the World Bank and the other multilateral development banks adopted this policy of using a strict negative pledge clause, of course, member countries that had signed loan agreements with the multilateral development banks were strictly limited in their ability to borrow from private sector lenders on a secured basis. The trend toward *un*secured lending to public sector borrowers in emerging market countries in the decades after 1950 was significantly boosted by these policies.

(iii) Late Twentieth Century:
<u>*Pari Passu* and Negative Pledge in Unsecured Credits</u>

In the late 1960s, another great shift occurred in private cross-border financing to emerging market borrowers. A new class of lender appeared on the scene (international commercial banks), prepared to lend money sourced from a new pool of capital (the Eurodollar market) pursuant to a new type of debt instrument (a syndicated loan agreement).[61] The general evolution of standard Eurocurrency loan agreements over the roughly 40-year history of this market is beyond the scope of this article. We shall concentrate on only two provisions in these agreements, the *pari passu* clause and the negative pledge clause.

(a) Early Euromarket Documentation

The very earliest forms of syndicated Eurodollar loan agreements (circa mid-1960s) were quite short, often only five or six pages in length.[62] A few years

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revenues – even if the assignment is unenforceable – be placed outside the reach of the government's unlimited spending power during the life of the loan and be devoted exclusively to the service of the debt.")

[59] *See, e.g.*, International Bank for Reconstruction and Development, GENERAL CONDITIONS APPLICABLE TO LOAN AND GUARANTEE AGREEMENTS FOR FIXED-SPREAD LOANS (September 1, 1999) available at http://wbln0018.worldbank.org/legal/legbdl.nsf/0/1c3f3a4937be3671852568ba0062c21a.

[60] For the current text of the clause, see *World Bank Negative Pledge Policy*, *supra* note 13, § 9.03. On the connection between the Bank's policy against taking security and its reliance on the negative pledge clause, *see*, id. at 2-3 ("The reason for requiring negative pledge clauses stems from the long standing policy of the Bank not to seek, in making loans, special security from the member concerned. . . . Where existing assets or future income streams are 'pledged' to certain external creditors in ways which effectively allocate foreign exchange to such creditors, the amount of foreign exchange available to service unsecured creditors, including the Bank, diminishes. It is this risk that the Bank's negative pledge clause seeks to reduce.").

[61] *See generally*, E. Wayne Clendenning, THE EURODOLLAR MARKET (1970).

[62] *See* David Levine, *It's time for Eurobankers to work out what they mean by market practice*, EUROMONEY (Aug. 1976), at 38 ("Not long ago borrowers (particularly sovereign borrowers) insisted, and lenders agreed, that agreements be only five or six pages long . . . . [T]oday agreements of 20-30 pages are common.") *See also* Robert P. McDonald, INTERNATIONAL SYNDICATED LOANS 36 (1982) ("The agency provision in a Eurocurrency loan contract is only one of the many evolutionary changes which contributed to the growth of the document from an average of 15 pages in 1971-72 to 60 pages or more a decade later.").

later, an editorial writer described the Eurodollar loan documentation practices in this era as "immature, inadequate and incomplete."[63]

The reason was historical. European bankers had not developed the same affinity for financial covenants in their loan documentation as had their American colleagues, in part because unsecured "term" loans (in which principal repayment is deferred for a period of, say, five or seven years) were not very common in Europe at the time. Contractual provisions that allow a lender to monitor a credit and that inhibit the borrower from taking actions during the term of the loan that could jeopardize its ability to repay at maturity were simply not necessary in short-term credits or credits repayable upon demand by the lender. When the time came in the mid-1960s to prepare the prototypes of Eurodollar syndicated loan agreements, therefore, the drafters followed documentary customs that were familiar to European borrowers and this meant few, if any, financial covenants.[64]

It did not take long for American bankers to agitate for more rigorous restrictive clauses in the Eurodollar term loan agreements in which their institutions participated. They recognized, however, that these shifts in documentation practices would take both time and persuasion. Here is a Euromarket banker writing in 1971:

> [American banks] must accept . . . that they cannot expect Euroborrowers to go straight from no restrictive clauses to all the ones used in the States. It is important therefore to keep exposing all potential borrowers and lenders in this market to various clauses, and developing a feel for those that are acceptable, and viable alternatives to those that are not.[65]

Among the aims of a "well drawn" loan agreement, this banker urged, was "[t]o ensure that the particular loan is in at least as favorable position as other loans of a comparable nature, and ideally as all other loans."[66]

(b) The Great Leap: *Pari Passu* in Unsecured Euroloans

Standard forms of Eurodollar loan agreements therefore changed very rapidly in the late 1960s and early 1970s. They got longer, much longer. Contemporary observers noted that loan agreements of only five or six pages were common at the beginning of this period; by the early 1970s, the agreements had grown to 20 or 30 pages in length.[67] They would eventually get even longer.

Among the provisions bulking up standard Eurodollar loan agreements were a version of both the *pari passu* clause and a negative pledge clause. The two would very often be combined into a single clause. Here is an example from a 1972 credit agreement with Zaire (later, the Democratic Republic of the Congo):

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[63] Editorial, *Legal Dynamite*, EUROMONEY (Sept. 1976), at 11. Today's bond investors seem to feel much the same way. *See* R. Mannix, *Investors push for rewrite of Eurobond covenants*, INT'L FIN. L. REV., Nov. 2003, at 33 ("Clauses that have remained largely unchanged since the [Eurobond] market's beginning in the early sixties [*e.g.*, the negative pledge clause] are suddenly at the center of a heated debate.").

[64] *See* Donaldson, *Experienced Lenders or …?*, *supra* note 42, at 46.

[65] *Id.*

[66] *Id.*

[67] *See* note 62 *supra*.

> The Borrower will maintain in all its force the power to contract other credits, *provided*, *however*, that the Borrower agrees that any additional external debt or any extension or refunding of presently existing external debt *will rank on a basis not more favorable than* the Advances made hereunder and that if any lien or encumbrance shall be created on any assets or revenues of the Borrower in connection with such additional external debt or extension or refunding of any presently existing external debt, then such lien or encumbrance will equally and ratably secure the payment of the principal of, and interest on, the Advances made hereunder and other amounts payable in respect of this Agreement.[68]

Here is another example from a 1980 loan agreement with an Iraqi borrower:

> The [Borrower] undertakes with the Banks that . . . the liabilities of the [Borrower] under this Agreement will rank at least equally and rateably (*pari passu*) in point of priority and security with all its other liabilities . . . .[69]

The *pari passu* clause thus apparently made a great leap in the early 1970s. For the first time, it was being used in *un*secured cross-border debt instruments. The clause had gone from confirming the equal ranking of debt instruments "in point of charge" or "in point of security" (or words to that effect) in nineteenth and early twentieth century secured bonds, to confirming the equal ranking of debt instruments "in priority of payment" or "in right of payment" (or words to that effect) in *un*secured Eurodollar loan agreements of the early-1970s. Why?

Well, for one thing, most Eurodollar loans did not call for collateral security, and certainly it was very rare in this market for a common collateral pool to secure two or more separate loans, so there was no need to include a contractual provision overriding a generally-applicable legal rule regarding the priority of claims against collateral.

The more intriguing question is why drafters of cross-border Eurodollar loan agreements began in the early 1970s to feel it necessary to revamp the *pari passu* clause, and to use it in an unsecured lending context, to address the legal ranking of their loans with all of the borrower's other unsecured indebtedness. As noted above, no similar clause then appeared (or even now appears) in standard loan agreements used in a purely domestic (U.S.) lending context.

The answer is that commercial banks had become aware that in some countries an existing creditor *could* be involuntarily subordinated to another lender, quite apart from the known risks posed by Statutory Preferences. The

[68] Quoted in Complaint ¶ 9(a), *Citibank, N.A. v. Export-Import Bank of the United States*, No. 76 Civ. 3514 (CBM) (S.D.N.Y. filed Aug. 9, 1976) [hereinafter *Citibank Complaint*] (emphasis added).

[69] U.S. $100,000,000 Letter of Credit Refinancing Agreement for the Benefit of International Contractors Group, S.A.K., Kuwait, Clause 13.1(a) (copy on file with authors).

countries most often cited in the contemporary literature were Spain and the Philippines.[70] As explained by William Tudor John:

> In Spain and certain other Spanish related jurisdictions, such as the Philippines, an unsecured creditor can, by registering the financial agreement in the prescribed manner and by paying a document tax, achieve priority over other unsecured creditors who do not formalize their agreements and, possibly, also over other unsecured creditors whose agreements are subsequently formalized. Further debt securities, such as bonds, may under local corporate laws rank for payment in a liquidation according to their date of issue.[71]

Mr. Tudor John was referring to Article 913 of the Spanish Commercial Code and paragraph 3 of Article 1924 of the Spanish Civil Code. These provisions say that "*acreedores escriturarios*" (that is, creditors holding credits contained in a public deed authorized by a Notary Public) and those that hold their credits by virtue of commercial titles or agreements intervened by a Notary Public, will rank ahead of ordinary creditors.[72] These rules were incorporated into Spanish commercial and civil laws in the nineteenth century. The rationale is that the authenticity of notarized credits has already been established and such credits should therefore be preferred over instruments that are not notarized and as to which some shadow of doubt may exist.

The Spanish procedure requires both the creditor and the debtor to appear before the notary public. The priority will take effect from the date of such notarization and will have no effect if the debtor has already entered into a bankruptcy proceeding.

Significantly, the priorities established by this procedure operate both within *and* outside of bankruptcy. For example, even before a formal bankruptcy of the debtor, if an asset has been seized by an ordinary creditor to satisfy a debt, a senior creditor whose instrument has been notarized in accordance with these rules will be entitled to bring a third-party action ("*terceria de mejor derecho*") claiming that his preferential claim must be satisfied first with the proceeds of the sale of that asset before any amounts may be paid to the ordinary creditor. This feature will become significant when we discuss the meaning of the *pari passu* clause in sovereign debt instruments (where bankruptcy is not a concern).

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[70] *See*, *e.g.*, Wood, *International Finance*, *supra* note 10, at 156 ("In Spain and certain other Spanish-related jurisdictions, such as the Philippines, an unsecured creditor can, by publicising the bonds in the prescribed manner before a public official and by paying a documentary tax, achieve priority over other unsecured creditors who do not publicise their agreement and possibly, also over other unsecured creditors whose agreements are subsequently formalised."); Wood, *International Loans*, *supra* note 4, at 41 ("In some states, especially Spain and related jurisdictions, unsecured creditors may rank ahead of other unsecured creditors if their credit document is notarized in the prescribed way (*escritura publica*)."); Slater, *supra* note 3, at 344-45 ("The first problem which banks run into [in Spain] is the question of whether they should secure their priority in the liquidation of the borrower by 'elevating' the debt by means of one of the various procedures which can be used for this purpose in Spain. Fn 23: Broadly speaking, the order of priority in the winding-up of a Spanish company can be determined by the chronological order in which the debts of its various creditors are elevated into '*escritura publica.'*).

[71] Tudor John, *supra* note 10, at 95.

[72] We are obliged to Luis de Carlos Bertrán of the firm Uria & Menendez for the information on which this description of the Spanish procedure is based.

A similar procedure existed, and still exists in the Philippines. Title XIX of the Civil Code of the Philippines ("Concurrence and Preference of Credits") sets out the priorities of creditor claims over property of a debtor. Articles 2241 and 2242 deal with priorities in specific movable and immovable property. Article 2244 then lists, in descending order of priority, preferred claims against other real or personal property of a debtor.

Subsection (14) of Article 2244 gives a priority to credits (not otherwise benefiting from a special privilege) that "appear in a public instrument … or … in a final judgment …". These credits, the law says, "shall have preference among themselves in the order of priority of the dates of the [public] instruments and of the judgments respectively."[73] The significance of Article 2244(14) is discussed at length under Part III. C ("*Pari Passu* in Unsecured Sovereign Credits") below.

Other unexpected hazards awaited the international lender that assumed its credits would rank equally with a borrower's other obligations (apart from Statutory Preferences and Secured Debts) in the event of the bankruptcy of the borrower. In 1972, for example, Argentina enacted laws that perpetuated a practice (dating back to 1862) of subordinating the claims of foreign creditors in the bankruptcy of an Argentine borrower.[74] The subordinated foreign creditor could not even file its claim until all local creditors had been paid in full.[75]

A *pari passu* covenant in a loan agreement requiring the borrower to ensure that the subject loan will always rank at least *pari passu* with all of the borrower's other unsubordinated indebtedness should either prevent the borrower from participating in the Spanish or Philippine notarization procedure described above in respect of its other debts or at least make it an event of default if the borrower did so. A representation and warranty in a loan agreement with an Argentine borrower that the loan ranks *pari passu* "in priority of payment" with all of the borrower's other indebtedness should have brought to the creditor's attention the subordination risks lurking in Argentine law.

Once cross-border lenders became aware that some legal systems permitted actions that had the effect of legally subordinating existing debt to other obligations of the borrower, in or out of bankruptcy, they needed contractual provisions that would (i) bring to light, at the time a new loan was being considered, whether such senior claims already existed in the borrower's debt stock, and (ii) prevent the borrower from subsequently subordinating the new loan. Adapting the traditional *pari passu* clause was the answer.

The phrase "ranks and will rank" in this new version of the *pari passu* clause was designed to encompass both a representation and a covenant. Replacing the old clause's "in point of security" with the qualifier "in priority of payment" or "in right of payment" showed that the drafter was concerned with the legal ranking of the debt (senior/subordinated), not with the creditor's ratable interest in collateral securing the debt. Requiring that the debt rank equally with all of the borrower's other "unsecured Indebtedness" revealed that this clause was intended to preclude the incurrence of Senior Debt, not Secured Debt (the negative pledge clause dealt with Secured Debt), and that the drafter was not focusing here

[73] Article 2244(14), Civil Code of the Philippines.

[74] *See generally* Emilio J. Cardenas, *International Lending: Subordination of Foreign Claims Under Argentine Bankruptcy Law*, in David Suratgar (ed.), DEFAULT AND RESCHEDULING 63 (1984).

[75] *Id*. at 74.

on Statutory Preferences (which generally do not constitute "Indebtedness" as that term is defined in cross-border credit agreements).

Following its introduction into cross-border syndicated loans in the 1970s to deal with the risk of involuntary subordination, this new version of the *pari passu* clause prospered. For the last thirty years, it has been a standard feature of cross-border credit agreements for both corporate and sovereign borrowers.

(c) Negative Pledge in Unsecured Euroloans

As evidenced by the 1972 Zaire clause quoted above, some early Eurodollar loan documentation tended to combine the negative pledge provision and the new "*pari passu* in priority of payment" language into a single clause even though the underlying concepts are quite distinct. The negative pledge clause is intended to safeguard the lender's resort to the borrower's general assets by restricting the borrower's ability to incur Secured Debt. The "*pari passu* in priority of payment" clause, however, curbs the borrower's ability to create Senior Debt. Additional Secured Debt would prejudice an existing creditor by diminishing the pool of unencumbered assets to which that creditor would have recourse in the event of a bankruptcy of the borrower. New Senior Debt, on the other hand, would tend to submerge the existing creditor beneath lenders whose claims will be satisfied as a matter of legal priority in any bankruptcy and may even, as discussed below, have consequences outside of bankruptcy. In other words, although the size of the borrower's pool of unencumbered assets would be unaffected, a recently-subordinated creditor would share in those assets only after the senior debtholders had been paid in full. These are two separate risks and the international debt market eventually evolved two distinct clauses to address the risks.

For the first decade of the Euromarket's history, however, creditors hoped that one or the other of the clauses would impede a certain kind of behavior that did not fit neatly into the Secured Debt/Senior Debt taxonomy. A regular feature of sovereign external borrowings, all the way back to the loans raised by the newly-independent Latin American Republics in the London market in the 1820s, had been the practice of allocating assets or revenue streams as ostensible security for the debts.[76] Commentators have referred to this practice as the "earmarking" of those assets.[77] In many cases, this earmarking did not rise to the level of a formal security interest (a pledge, charge, mortgage and so forth); it was rather an informal undertaking on the part of the debtor notionally to hive off the specified asset or revenue stream from the debtor's general property and to treat the foreign debtholders as having a preferential interest in those funds. When words such as "pledge", "mortgage" or "hypothecation" were used in the offering circulars for such bonds, the most charitable inference is that the terms were often being employed merely as figures of speech.[78]

[76] *See* text accompanying notes 53 – 56, *supra*.

[77] Ernst H. Feilchenfeld, Earle de Maury Elrick & Orrin G. Judd, *Priority Problems in Public Debt Settlements*, 1930 COLUM. L. REV. 1115, 1122 (1930) (hereinafter Feilchenfeld, *Priority Problems*) ("The chief value of such a pledge is that it constitutes an earmarking of funds, so that the creditor knows that normally there will be wherewithal to pay him."). Feilchenfeld calls these "quasi-secured debts."

[78] *See* Feilchenfeld, *Rights and Remedies*, *supra* note 54, *at* 180 ("The public bought many loans because it was thought that they were secured by the equivalent of a valuable mortgage; in reality many pledges and charges provided for in government loans amounted only to additional promises, which did not even afford a clear priority in case of bankruptcy. An unsound psychology

If all of this sounds muddled and murky, it was. These "security" features were widely advertised when the debt instruments were being marketed. Consider, for example, this assurance in the prospectus for the Honduras Railway Loan of 1867:

> The interest and sinking fund of the loan are specifically guaranteed by a first charge upon the intended railway itself and its revenue, and also by a first mortgage upon the whole of the domains and forests of the State of Honduras, which, according to official report, are of immense value.[79]

Significantly, however, the negative pledge clauses of this period typically referred to the types of security interests known to the common law: pledges, charges, mortgages, hypothecations and so forth. These were sometimes lumped together in a defined term "Liens" in the credit documentation. Informal earmarking arrangements did not worry the lender to a corporate borrower under U.S. or English law because such arrangements would not be respected in bankruptcy. They did not create Secured Debt.

But in a cross-border lending context, this legal effect -- or more precisely, lack of legal effect -- was far less certain. Certainly there had been numerous examples throughout the nineteenth and early twentieth centuries of foreign creditors attempting to "foreclose" (again, often in the metaphorical sense of the word) on earmarked assets or revenues of a sovereign borrower in order to satisfy a particular debt. Moreover, there was always the chance that a sovereign borrower would feel itself morally obliged to honor such an informal undertaking with the result that scarce foreign exchange would not be available to pay the sovereign's other obligations.[80] The practice of earmarking assets and revenues to benefit a specific sovereign credit was therefore a matter of potential concern to all other lenders to that sovereign.

The question was what sort of contractual covenant would restrict such earmarking. The traditional negative pledge clause covered only the creation of formal security interests, and these earmarking arrangements were usually not

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was cultivated because the public was taught to rely on security provisions instead of investigating the paying capacity and reliability of the debtor country. Without the name 'secured loan' the public would probably have refused to buy bonds of countries with which it was entirely unfamiliar."); *see also id*. at 1120-22.

[79] Quoted in D.C.M. Platt, *British Bondholders in Nineteenth Century Latin America – Inquiry and Remedy*, 14 INTER-AMERICAN ECONOMIC AFFAIRS 3, 18 (Winter 1960).

[80] *Cf.* Borchard, *supra* note 54, at 94 ("[T]o conclude from this inability of creditors of governments to assert their rights by the same means as private law creditors that security clauses in government loans are nothing but "boilerplate" and "not worth the paper they are written on" would mean to ignore entirely the clear manifestation in these clauses of a will on the part of the debtor government to obligate itself over and above its promises to pay interest and principal to the lender. The revenues are 'earmarked' for a specified purpose, which is the subject of a legally binding obligation. They thereby cease to be at the free disposal of its debtor-owner. That means that the debtor state is not at liberty to alter their contents or to abrogate them altogether; it has in this respect submitted to a partial control of its domestic fiscal policy by its foreign creditors."); Feilchenfeld, *Priority Problems, supra* note 77, at 1125 ("[I]t must be admitted that the quasi-secured creditor [*i.e.*, the beneficiary of earmarked assets or revenues of the sovereign debtor] has bargained for and obtained something more than the mere promise to pay given to ordinary creditors. Even though he cannot secure full satisfaction in case of general default, the fact that specific funds have been earmarked for him assures him of rapid payment, without the delay necessitated by the balancing of the budget, and of a more certain payment in case of a temporary deficit not serious enough to cause insolvency.").

formal security interests. For its part, the new "*pari passu* in priority of payment" clause spoke in terms of the "ranking" of the debt. Did the earmarking of assets really affect legal ranking of the debt?

It was probably only a matter of time before someone tried to exploit this gap in the coverage of the standard negative pledge and *pari passu* clauses used in early Euromarket credit documentation. The trick here was to devise a form of preferential arrangement over assets of the borrower that would be adequate to induce a new lender to lend. Such an arrangement, however, must stop short of creating a formal security interest in the debtor's property that might run afoul of the borrower's existing negative pledge clauses. And it must also stop short of giving the new debt a higher legal ranking "in priority of payment", because this would violate the borrower's *pari passu* covenants.

That time came in 1976. The Republic of Zaire had borrowed money from a group of commercial banks in 1972. The *pari passu*/negative pledge clause contained in Zaire's 1972 credit agreement is quoted above.[81] In 1976, Manufacturers Hanover Trust Company ("*MHT*") and the U.S. Eximbank proposed to enter into a new credit facility with Zaire. As part of this new facility, Zaire agreed to direct the proceeds from the sale of its copper exports into a "Special Deposit" account at Manufacturers Hanover where those funds would presumably have been available for debit or set off in the event the new MHT loan was not paid.[82]

Some of the lenders in the 1972 credit agreement were outraged when they learned of the proposed MHT/Eximbank transaction in July 1976.[83] "While arguably not against the letter this was flagrantly against the spirit of the negative pledge clauses in the commercial banks' loan agreements", wrote two observers of the dispute.[84] They were presumably referring to the fact that the "security" feature of the new facility did not rise to the level of a formal "lien or encumbrance" (the words used in the 1972 credit agreement's negative pledge clause) over Zaire's revenues. It thus arguably fell beyond the reach of that clause.

A month later, on August 9, 1976, Citibank, N.A. (on behalf of itself and as Agent for the other lenders in the 1972 credit agreement with Zaire) filed a complaint in the U.S. federal district court in Manhattan naming Manufacturers Hanover and Eximbank as defendants.[85] The complaint alleged that the proposed new MHT facility violated Zaire's 1972 contractual covenants. Citibank offered several theories on which the court was invited to fashion some relief, ranging from the imposition of a constructive trust over the proceeds of copper sales in favor of the 1972 lenders, to damages for tortious interference with the 1972 lenders' contract rights.[86]

The case was quickly settled and the proposed MHT/Eximbank facility scrapped. What resulted from this public bank-to-bank squabble, however, was a

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[81] *See* text accompanying note 68, *supra*.

[82] *See* T.H. Donaldson, LENDING IN INTERNATIONAL COMMERCIAL BANKING 81 (2d ed. 1988).

[83] Anthony B. Greayer & W. John N. Moore, *Zaire Promises to Do Better*, EUROMONEY (Dec. 1976), at 114.

[84] *Id*.

[85] *Citibank Complaint*, *supra* note 68.

[86] *Id*. ¶¶ 13 and 14.

change to the standard form of Euromarket negative pledge clause. No longer would the list of impermissible liens cover only formal security interests. Following the Zaire incident, drafters of Eurocurrency loan agreements increasingly added this phrase (or something like it) to the definition of "Lien" in their in their loan agreements: "or any other preferential arrangement having the practical effect of constituting a security interest."[87]

Zaire's own credit agreements are a good example of this shift in drafting practices. The 1972 version of Zaire's *pari passu*/negative pledge loans (quoted above) required that future debts not "rank on a basis…more favorable" than the 1972 advances, and not benefit from a "lien or encumbrance".[88] When Zaire next needed to refinance its external debt (in 1981), the new form of restrictive clauses read as follows:

> So long as any Credit shall remain outstanding [Zaire] will
>
> * * * *
>
> Ensure that at all times its payment obligations hereunder constitute unconditional general obligations of [Zaire] ranking at least *pari passu* in priority of payment with all other External Indebtedness of [Zaire] now or hereafter outstanding.[89]
>
> * * * *
>
> So long as any Credit shall remain outstanding [Zaire] will not:
>
> (a) Create or permit to be created and continue, nor permit the Bank of Zaire or any other Governmental Agency or Governmental Enterprise to create or permit to be created and continue,
>
> (i) any Lien for any purpose upon or with respect to (A) any International Monetary Assets or (B) any Foreign Exchange or gold owned or held by [Zaire], the Bank of Zaire or any Governmental Agency of Governmental Enterprise;
>
> (ii) any Lien upon or with respect to any Asset of [Zaire], the Bank of Zaire or any Governmental Agency or Governmental Enterprise to secure or provide for the payment of External Indebtedness of any Person; or
>
> (iii) any Lien upon or with respect to any Exportable Assets of any Person to secure or provide for the payment of External Indebtedness incurred or Guaranteed by [Zaire], the Bank of Zaire or any Governmental Agency or Governmental Enterprise . . . .[90]

For this purpose, the term "Lien" was defined as:

> "Lien" means any lien, mortgage, deed of trust, charge, pledge, security interest or other encumbrance on or with respect to, *or*

[87] *See Eurocurrency Loan Agreements*, *supra* note 3, at 88.

[88] *See* text accompanying note 68, *supra*.

[89] Refinancing Credit Agreement dated as of March 31, 1980 among Republic of Zaire as Obligor and the Agents and Banks referred to therein, § 8.01(c) (copy on file with the authors).

[90] *Id*., § 8.02(a).

> *any preferential arrangement which has the practical effect of constituting a security interest with respect to the payment of any obligation with or from the proceeds of*, any Asset.[91]

Note how dramatically these provisions had changed in the nine years between 1972 and 1981. The negative pledge was split off from *pari passu* into a separate provision. Apart from the expansion of the definition of "Liens" to cover informal preferential arrangements, the drafter of the 1981 negative pledge left no doubt about what types of government property could not be encumbered.

C. Pari Passu in Unsecured Sovereign Credits

We now come to the most intriguing question of all: what motivated modern drafters to include a *pari passu* provision (of the "*pari passu* in priority of payment" variety) in their unsecured credit instruments with sovereign borrowers. The motivation must have been something other than a desire to protect the lender against involuntary subordination in bankruptcy, for the simple reason that sovereigns are not subject to bankruptcy regimes.

Our research suggests that had they been asked at the time (the 1970s onward) to justify the presence of a *pari passu* clause in an unsecured cross-border credit instrument with a sovereign borrower, contract drafters would have given three reasons: a lingering concern about the earmarking of assets, the danger that a foreign sovereign decree altering the legal ranking of existing debts might be given effect by a court outside of the debtor country and the risk of involuntary subordination through action by another lender. The opacity of the clause is explained by the fact that in the minds of the early Euromarket drafters, it was intended to protect lenders against all three, very different, risks. They thus saw a positive virtue in the vagueness of the phrase "*pari passu* in priority of payment." As the decades moved on, one of these concerns (earmarking) was addressed through an expanded negative pledge clause in most cross-border credit instruments. A second risk (the effect of sovereign decrees) was addressed by judicial decisions. But the third (involuntary subordination through action by another lender) remains a serious concern for the cross-border lender, and the *pari passu* clause persists as the contractual mitigant for that risk.

(i) Earmarking

The traditional nineteenth century practice of a sovereign earmarking a revenue stream or asset for the benefit of one set of creditors continued to be a matter of concern for the unsecured cross-border lenders in the last quarter of the twentieth century. The commentators of the time confirm that this was so.[92] The question faced by the bankers and lawyers drafting sovereign credit agreements was how to curb this practice; a traditional negative pledge clause only restricted the creation of formal security interests. One of the original motivations for shifting the focus of a *pari passu* covenant to ranking of the debt "in right of payment" was that the drafters hoped to sweep in the kind of informal preferential arrangements that might otherwise have slipped through the negative pledge restriction.[93]

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[91] *Id*. § 1.01 (emphasis added).

[92] *See* authorities referred to in note 10, *supra*.

[93] *See* J.A. Donaldson and T.H. Donaldson, THE MEDIUM-TERM LOAN MARKET 130 (1982) ("The pari passu clause requires the debt it covers to rank pari passu with, in most cases, all other

As just described, when this gap in coverage of the two clauses became highly visible in 1976 at the time of the *Citibank v. Manufacturers Hanover* lawsuit, the market's reaction was to expand the standard form of negative pledge clause so that it would thereafter pick up "preferential arrangements that have the practical effect of constituting a security interest." The drafters did *not* attempt to resolve the problem by changing the language of the *pari passu* clause. The persistence of the clause even *after* this drafting change shows that the risk of sovereign earmarking was not the only motivation for inclusion of a *pari passu* clause in sovereign credit instruments, at least in the period after 1976.

(ii) Effect of Sovereign Decrees

A second concern justifying the inclusion of a *pari passu* clause in a sovereign credit agreement was unique to sovereign borrowers. As the lawgiving authority in its own country, what would stop a sovereign from passing a law that, for example, purported legally to subordinate all of its existing foreign lenders in favor of some new set of creditors (with the consequence that the old lenders would only be entitled to collect on their claims once the new lenders had been paid in full)?[94] More importantly, would such legislation or governmental decree be given effect by the courts in the lenders' own jurisdictions in an action to enforce payment of the old debt?

To the creditors participating in the early years of the Euromarkets, there were no certain answers to these questions, at least under the law of New York. It was not until the mid-1980s (in two highly-publicized cases, *Libra Bank Ltd. v. Banco Nacional de Costa Rica, S.A.*[95] and *Allied Bank International v. Banco Credito Agricola de Cartago*[96]), that the U.S. federal courts clarified that an American judge need *not* defer to the actions or decrees of a foreign sovereign affecting that sovereign's own debt obligations, as long as the debts in question have features (such as payments to foreign bank accounts, foreign governing law, submission to foreign court jurisdiction and so forth) that connect the debts to

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debt. It originated in countries whose law specifies an order of priority for unsecured debt unless action is taken to avoid it. . . . Otherwise, the pari passu clause has much the same effect as a negative pledge, and may even catch ways of preferring some creditors which do not qualify as a full pledge."). There is even some suggestion in the contemporary literature that Euromarket lawyers may have relied on the *pari passu* covenant as a kind of backdoor negative pledge undertaking when confronted by borrowers that balked at the traditional negative pledge. S*ee* J. Horsfall Turner, writing in 1974:

> [T]here are borrowers, particularly sovereign ones, who object to any sort of negative pledge merely because it would be seen to fetter their sovereignty. They may either not wish to do so or may be prohibited from doing so by the terms of their constitution. They may have no particular wish to create any secured borrowings. Luckily there are clauses which have the same effect and do not cause the same problems so that the borrower and the banker can both be satisfied with no loss of face.

J. Horsfall Turner, *New Trends in Eurodollar Loan Agreements*, EUROMONEY (Mar. 1974), at 29.

[94] *See* Michael Gruson, *Legal Aspects of International Lending*, in Ingo Walter (ed.), HANDBOOK OF INTERNATIONAL BUSINESS 27-13 (1983) ("[H]istory has shown that a sovereign, when in trouble, tends to change its law to alleviate its troubles.").

[95] 570 F. Supp. 870 (S.D.N.Y. 1983).

[96] 566 F. Supp. 1440 (S.D.N.Y. 1983), *rev'd*, 757 F.2d 516 (2d Cir.), *cert. dismissed*, 473 U.S. 934 (1985).

places outside the sovereign's own country.[97] But for a drafter of a Eurodollar loan agreement in 1970, these judicial decisions were fourteen years in the future. The inclusion of a contractual promise by the sovereign not to disturb the legal ranking of the debt by governmental fiat would therefore have seemed a very sensible precaution.

(iii) Involuntary Subordination

Lastly, at least some commercial bank lenders of the 1970s were acutely aware of the risk of an involuntary subordination of their credits as a result of procedures such as those existing in Spain and the Philippines. This risk was also present, in a somewhat different form, in loans to sovereign borrowers. The Spanish procedure for acquiring seniority through the notarization of a debt instrument, for example, can have practical consequences for an "ordinary" creditor even outside of bankruptcy.[98] A promise by the debtor to maintain the legal ranking of a loan at a level equal to or above all of its other unsubordinated indebtedness was the first and only contractual line of defense against this sort of mischief.

The Philippines is a particularly fascinating example of these concerns because the documentary record suggests that the subordination risks resulting from the priorities scheme contained in the Philippine Civil Code were first realized by commercial bank lenders in the late 1970s, then forgotten for about twenty years, only to reappear in 1998 as the Philippines was actively issuing bonds in the international capital markets.

In the late 1970s, the commercial bank lenders to Philippine public sector borrowers stumbled upon the possibility that, under Philippine law, subsequently-incurred debts could leapfrog their own loans in terms of legal seniority by being notarized in a public instrument. The commercial banks' response was to insist that the Central Bank of the Philippines issue a Circular (Circular 618 of July 14, 1979) to all Philippine public sector borrowers warning them -- under penalty of being denied the necessary foreign exchange approval from the Central Bank -- not to permit their credit instruments to be notarized in a public instrument.

Here is the full text of Circular 618:

> Effective immediately, no foreign loan agreements, deferred payment agreements or any other agreements which give rise to a foreign currency obligation or liability submitted to the Central Bank of the Philippines for approval and/or registration under the provisions of existing CB circulars, rules and regulations, and no promissory notes or guaranties issued in connection therewith, shall be approved and/or registered if these are notarized or are otherwise evidenced by a public instrument.[99]

When the Republic of the Philippines returned to the bond market in 1993 (after exactly ten years of debt rescheduling), the priority risks posed by

[97] *See generally* W.H. Knight, Jr. *International Debt and the Act of State Doctrine: Judicial Abstention Reconsidered,* 13 N.C. J. INT'L COM. REG. 35, 54-56 (1988).

[98] *See supra* text accompanying notes 70-72.

[99] Central Bank of the Philippines, Circular No. 618, Series of 1978 (July 14, 1978) (copy on file with authors).

Article 2244(14) of the Civil Code[100] appear to have faded from everyone's collective consciousness. The terms and conditions of the Philippines' first Eurobond in 1993 confirmed that: "The payment obligations of the Republic under the Notes and the Coupons shall, subject to [the negative pledge clause], at all times rank at least equally with its other present and future unsecured and unsubordinated External Indebtedness."[101] Identical language appeared in a subsequent issue of Republic of Philippine bonds in 1996. No mention was made of Article 2244(14).[102]

By 1998, however, the due diligence process leading up to the Republic of the Philippines 8.875% Bonds due 2008 (the first Philippine issue to be registered with the U.S. Securities and Exchange Commission) must have once again unearthed the old worry about the possible effect of Article 2244(14) of the Civil Code. This time, the description of the *pari passu* clause in the prospectus specifically called attention to the risk of involuntary subordination: "Subject to the discussion below of Article 2244(14) of the Civil Code of the Philippines, the Bonds will rank *pari passu* in priority of payment with all other unsecured and unsubordinated External Indebtedness of the Philippines."[103]

The disclosure about Article 2244(14) Prospectus deserves to be quoted in full because it reveals precisely the type of situation that cross-border lenders expected a *pari passu* clause to uncover and to address. It reads:

> Under Philippine law, in the event of insolvency or liquidation of a borrower, unsecured debt of the borrower (including guarantees of debt) which is evidenced by a public instrument as provided in Article 2244(14) of the Civil Code of the Philippines will rank ahead of unsecured debt of the borrower which is not so evidenced. Under Philippine law, debt becomes evidenced by a public instrument when it has been acknowledged before a notary or any person authorized to administer oaths in the Philippines. The Government is of the view that debt of the Republic is not subject to the preferences granted under Article 2244(14) or cannot be evidenced by a public instrument without the cooperation of the Republic. This matter has never been addressed by Philippine courts, however, and it is therefore uncertain whether a document evidencing Peso or non-Peso denominated debt (including External Indebtedness) of the Republic, notarized without the knowledge or consent of the Republic, would be considered a public instrument. If such debt were considered evidenced by a public instrument, it would then rank ahead of the Bonds in the event the Republic were unable to service its debt obligations.

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[100] *See supra* text accompanying note 73.

[101] Rule 144A Placement Memorandum, Republic of the Philippines U.S.$150,000,000 7 7/8% Notes due 1996 (Feb. 18, 1993), at 4, § 3 (copy on file with authors).

[102] Invitation by the Republic of the Philippines to Offer to Exchange (Sept. 2, 1996), at 20, § 3 (copy on file with authors).

[103] Prospectus, U.S.$500,000,000 Republic of the Philippines 8.875% Bonds due 2008 (April 2, 1998), at 71 (copy on file with authors).

> The Republic has represented that it has not in respect of any External Indebtedness prepared, executed or filed any public instrument as provided in Article 2244(14) of the Civil Code of the Philippines, or consented to or assisted in the preparation or filing of any such public instrument. The Republic has also agreed in the Bonds that it will not create any preference or priority in respect of any External Public Indebtedness pursuant to Article 2244(14) of the Civil Code of the Philippines unless amounts payable under the Bonds are granted preference or priority equally and ratably therewith.[104]

Identical disclosure language about Article 2244(14) appears in the most recent issue of Republic of the Philippines 8.25% Global Bonds due 2014 (Prospectus dated October 16, 2003).[105]

What is important for our purposes is the part of this disclosure (the last sentence of the first paragraph) warning bondholders of a remote risk that their bonds could be involuntarily subordinated through the actions of the Republic's other lenders. Although the disclosure does not spell out what the practical consequences of such a subordination might be "in the event the Republic were unable to service its debt obligations", the implication is that the consequences could be disagreeable for these bondholders. Significantly, however, these consequences, whatever they may be, will have nothing to do with a formal bankruptcy proceeding (to which the Philippine state is obviously not subject).

As the Philippine documents show, the risk that sovereign debt might be involuntarily subordinated as the result of local law procedures -- with implications outside of bankruptcy -- is still a concern for cross-border lenders. The contractual impediment to such involuntary subordination has been, and remains, a financial covenant of the "*pari passu* in priority [or right] of payment" variety. Having discovered the problem in some jurisdictions, lenders were not prepared to run the risk that similar pitfalls might await them, undiscovered, elsewhere. Bondholders and even commercial banks often perform only a perfunctory due diligence on features of the borrower's local law that might affect their investments. The clause therefore became a standard feature of most cross-border lending instruments.

IV. CONCLUSION

In summary, the *pari passu* clause has migrated from its original home in nineteenth century secured domestic debt instruments into the unsecured cross-border debt instruments of the last thirty years. Along the way, it has made several jumps, and for each jump there was a good reason: from secured to unsecured credits; from domestic to cross-border credit instruments; and from an expression of the debtholders' ratable interests in the collateral securing the instrument to a promise to maintain the unsubordinated character of the debtholders' unsecured claims.

At no time in its long journey, however, did the *pari passu* clause ever require a borrower to make ratable payments to all of its equally-ranking creditors.

[104] *Id*.

[105] Prospectus Supplement to Prospectus Dated September 24, 2003, U.S.$300,000,000 Republic of the Philippines 10.625% Global Bonds due 2025 (October 16, 2003) at 95-96 (copy on file with the authors).

Nor did it ever provide a legal basis for one unsecured creditor to enjoin or intercept non-ratable payments to another creditor, notwithstanding the equal legal ranking of their respective claims against the borrower. The ratable payment theory of the *pari passu* clause is, under the light of history, just a fallacy. If anything, the ratable payment theory episode highlights the dangers of allowing boilerplate contractual provisions to detach themselves from the market's collective memory of where they originated and what they were designed to achieve.

This leads us to the final question: how could a fallacious interpretation of a boilerplate clause -- without a basis in law, or practice or commentary -- have taken even a shallow root in the minds of some market participants? It is true that the text of the *pari passu* clause itself is remarkably unconfiding about what the drafters were seeking to achieve with the provision, but that only explains why it presented such an attractive target for creative explanations by litigants in search of an effective remedy against a sovereign debtor.

We believe that the ratable payment interpretation of the *pari passu* clause had an intuitive, almost an emotional, appeal to some people because it only seems fair that debtors not discriminate among similarly-situated creditors when faced with financial difficulties. And if a practice of differential payments just *feels* wrong, these people reasoned, then surely there must be something in the underlying instruments that forbids it? When a thorough search of the underlying instruments turned up no express prohibition against the making of differential payments, the last resort was to read such a prohibition into the Area 51, the Roswell, of cross-border credit instruments – the *pari passu* clause.

The truth is that creditors *do* sometimes worry about cash-strapped borrowers discriminating among similarly-situated creditors in terms of payments and, when they do, there are a variety of documentary techniques for dealing with the problem. For example:

- Sharing clauses are a nearly invariable feature of syndicated commercial bank loan agreements. The clauses were motivated by a concern that participating banks without an on-going business relationship with the borrower might be the first to feel a payment default, while the borrower's "house" banks continued to be paid. The sharing clause constitutes an intercreditor agreement among the banks in the syndicate to share any disproportionate payments or recoveries among themselves on a ratable basis.[106]

- In many bond issues (including all publicly-issued corporate bond issues in the United States), the securities are issued pursuant to a trust indenture (in English practice, a trust deed). The trustee is obliged to distribute all payments or recoveries among bondholders

[106] Interestingly, Schnebel, *supra* note 7, at 50, describes sharing provisions as necessary to give practical effect to the *pari passu* status of lenders in a syndicated loan:

> A multi-bank credit facility is one situation in which an agreement is used to establish and maintain parity among unsecured creditors. The credit agreement for a multi-bank credit facility will provide for the lenders to be on a *pari passu* basis. In order to implement this intercreditor relationship, the credit agreement will contain a provision requiring each lender to share any payments made to it (whether by setoff or otherwise) under the credit agreement in a greater proportion than its pro rata share of amounts payable under the credit agreement.

on a strictly ratable basis. Indeed, in U.S. trust indenture practice most, and in English practice all enforcement actions against the borrower are centralized in the trustee so that the goal of ratable sharing of recoveries is preserved.[107]

- Many project finance transactions, where several different types of lenders participate, call for an intercreditor agreement among the lenders to ensure ratable sharing of payments and losses.[108]

- Intercreditor agreements are also frequently used in corporate debt workouts where the parties wish to keep the borrower out of a formal bankruptcy proceeding. Equal treatment of similar-situated creditors is, of course, a fundamental premise of most bankruptcy systems. Creditors desiring to replicate this feature in an out-of-court debt workout can do so by means of an intercreditor agreement that provides for ratable sharing of payments or recoveries. [109]

- Subordination agreements are the instruments of choice when lenders to the same borrower want to establish legally-enforceable priorities that will take effect in, and sometimes out of, bankruptcy. These agreements come in many different varieties, but they all have one thing in common: they establish contractual payment priorities among creditors that would otherwise have equally-ranking claims against the borrower.[110]

In short, lenders are indeed sometimes concerned about borrowers making differential payments to similarly-situated creditors. To this extent, the proponents of the ratable payment theory of the *pari passu* clause have accurately analyzed a sentiment in the creditor community. But when lenders wish to address this issue, they do so explicitly (and very often elaborately) in contracts or clauses that establish their right to receive ratable payments, as well as their remedies -- against the Borrower and against each other -- if they do not. Such intercreditor duties are not inferred merely by virtue of being a lender to the same borrower (under the "it's only fair" theory of intercreditor relationships), nor are they implied by a lender's equal legal ranking with other creditors or by a contractual promise by the borrower to preserve that equal ranking.

[107] *See* Andrew Yianni, *Resolution of Sovereign Financial Crises – Evolution of the Private Sector Restructuring Process*, FIN. STABILITY REV., June 1999, at 78, 81; *see* also Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1331-32 (Fall 2002).

[108] *See generally* Jacob J. Worenklein, *Loan Documentation for Project Finance*, Practising Law Institute, Real Estate Law and Practice Course Handbook Series, PLI Order No. N4-4460, 284 PLI/Real 271, 303-4 (October 23, 1986).

[109] *See generally* Schnebel, *supra* note 7.

[110] See *generally* Kevin C. Dooley & Thomas G. Rock, *Subordination Agreements: Suggested Approaches to Key Issues*, 113 BANKING L. J. 708, 714 (July/August 1996).

V. POSTSCRIPT: A NOTE ON CONTRACT PALEONTOLOGY

Lytton Strachey, in his book *Eminent Victorians*, offered some advice to historians confronted by a subject around which a vast amount of information had accumulated. "[R]ow out over that great ocean of material," Strachey counseled, "and lower down into it, here and there, a little bucket, which will bring up to the light of day some characteristic specimen, from those far depths, to be examined with a careful curiosity."[111]

We believe that standardized commercial and financial contracts are organic things: they evolve over time in response to a complex and shifting set of influences. These include changes in the underlying legal rules, unexpected and aberrant judicial decisions whose teaching must be disowned by contract, subtle but nonetheless palpable shifts in the treatment that parties expect to receive in contract negotiations, and cross-pollination among the "model" documents produced by different participants such as banks and law firms.

A contract can only be understood in the context of the legal rules at the time it was prepared, and these rules sometimes change. When they do, a perceptive contract drafter adjusts her provisions accordingly; some get dropped, some added and others modified. The very notion of what constitutes a standard document is itself highly subjective. It can be very hard sometimes to disentangle the descriptive from the aspirational in the word "standard". The proponents of the first drafts of commercial contracts have always cherished the word "standard." Once uttered on the battlefield of a contract negotiation, it is thought to be irresistible, unanswerable (except by the proffering of equally standard clauses) and intentionally demoralizing to the opposition.

Proponents of contracts also like to pretend that their documentation practices are eternal -- not just long-lived like Rome or the solar system or Dick Clark -- but eternal. Even better, they like to leave the impression that at some point in the document's history, its drafting was influenced by divine revelation. But of course this is silly. Documentary practices, even in the context of stultifyingly standard commercial and financial documents, do change. And in this lies this challenge for the historian attempting to dip Strachey's little bucket into a vast reservoir composed of thousands of allegedly standard commercial or financial agreements prepared over many decades.

When dipped, the little bucket will bring up from this reservoir individual examples of contracts or specific clauses in contracts. The historian will then note the drafting changes, dramatic or incremental, that have taken place over time. What the black letter of the documents will not confide, however, is the motivation for any single change. Did some feature of the underlying legal regime shift, rendering prior text obsolete or requiring the addition of new language? Was there a scandal in the market or an unexpected judicial decision? Did the text come from the hand of a drafter who knew more, or who knew less, than his contemporaries about the subject matter? Was the change just a matter of a different "house style" by the law firm or financial institution preparing that particular example, with no difference in substantive content intended? Or was it, after all, just a mistake attributable to an untutored or sleep-deprived drafter?

[111] Lytton Strachey, EMINENT VICTORIANS (1920), Preface at v.

The historian will need to look beyond the text of the clause to answer these questions. The sources for this information may include descriptions of the relevant law at the time the contract was drafted, or the history of contemporary disturbances to the market, or that most rare source -- a practicing lawyer of the day taking the time to record for posterity why documentation patterns were changing.

The exercise is therefore a kind of paleontology. A scientist examines the fossil record and seeks to explain why a prehistoric species may have evolved in the way the fragmentary fossil evidence suggests it did. Contract paleontology starts with a similar effort to locate examples of contracts or clauses from an often equally fragmentary record. Commercial contracts are not thought to be documents of literary or historical significance. When the business relationship is over, or the debt repaid, the legal agreements often fall victim to the remorseless dictates of someone's "document retention" policy, a euphemism in most organizations for <u>not</u> retaining documents.

Even when examples can be found of a particular type of agreement or clause, it is hazardous to assume that all signs of evolution in the historical drafting of the document were deliberate or even conscious. Practicing lawyers whose experience qualifies them to draft contracts in a competent way often enjoy the seniority that permits them to delegate those tasks to junior lawyers lacking both experience and competence in the job at hand. The contractual fossil record, even more than the natural fossil record, is therefore apt to be populated with specimens that have no rational explanation.

What makes a paleontological study of standard form contracts and boilerplate clauses possible is the standard nature of the documents. Forms, models and precedents tend to reproduce themselves in deal after deal, sometimes with only limited customizing of the operative provisions to fit a specific transaction, and usually with no changes to the boilerplate clauses. The text of such a document therefore contains its drafting DNA; even slight alterations to the genetic code will be visible in subsequent iterations of the document. The historian's job is to track these changes over time and, when confronted by what appears to be intentional drafting change, to discover the motivation for the shift.

To read a standard form of commercial agreement or a boilerplate contractual provision with a knowledge of its historical evolution is to appreciate the inherent drama of the instrument. To read it without that knowledge is to mistake it for an inanimate thing, without progenitors and without posterity.