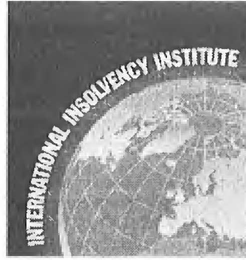

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Sovereign Piracy

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International Insolvency Institute
PMB 112
10332 Main Street
Fairfax, Virginia 22030-2410
USA
Email: *info@iiiglobal.org*

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Sovereign Piracy

*By G. Mitu Gulati and Kenneth N. Klee**

INTRODUCTION

In October 1995, Peru announced its Brady Plan debt restructuring of guaranteed Banco de la Nacion and Banco Popular del Peru bank loans.[1] Approximately four months later, Elliott Associates, LP (Elliott), a well-known vulture fund, purchased nearly $20.7 million face amount of loans from two international banks for about $11.4 million.[2] The restructuring went forward with Elliott holding out. Instead, Elliott filed suit in New York against one bank and Peru demanding full payment on the bank loans and guaranty. In June 2000, Elliott obtained a judgment against Peru for $55.7 million.[3]

The problem for Elliott, however, was the standard problem that arises when a creditor sues a sovereign. Often, especially if the state is the debtor, there is little in the way of assets that can be attached.[4] Elliott's lawyers, however, came up with a creative solution. They intercepted and attached the payments that were about to be made to the other creditors, i.e., the ones who had agreed to the Brady Plan debt restructuring.

* Mr. Gulati is an Acting Professor of Law at UCLA School of Law. Mr. Klee is an Acting Professor of Law at UCLA School of Law and Partner at Klee, Tuchin, Bogdanoff & Stern LLP. The views in this Article do not necessarily represent those of Professor Klee's law firm or any client.

1. Elliott Assocs., L.P. v. Banco de la Nacion, 194 F.3d 363, 366 (2d Cir. 1999).

2. *See id.* at 366-67; *see also* Joshua Chaffin, *Investor "Vultures" Come Under Scrutiny*, FIN. TIMES, Oct. 25, 2000, at 19.

3. *See* Elliott Assocs., L.P. v. Banco de la Nacion, 2000 U.S. Dist. Lexis 14169, at *2 (S.D.N.Y. Sept. 29, 2000). For descriptions of these recent events involving Elliott and Peru, see ERIC LINDENBAUM & ALICIA DURAN, MERRILL LYNCH & CO., DEBT RESTRUCTURINGS: LEGAL CONSIDERATIONS (Oct. 30, 2000). *See also* GABRIELLE LIPWORTH & JENS NYSTEDT, INTERNATIONAL MONETARY FUND, CRISIS RESOLUTION AND PRIVATE SECTOR ADAPTATION (paper presented at the First Annual IMF Research Conference, Nov. 9-10, 2000).

4. The reason for this is that generally only property used for the commercial activity in question inside the jurisdiction where the suit is brought may be attached. *See, e.g.*, 28 U.S.C. § 1610 (1994 & Supp. IV 1998). Given that most of the sovereign's assets relating to the borrowing are likely located within the sovereign's own boundaries, this leaves few assets for the creditors to reach. *See* MOODY'S INVESTOR SERV., SPECIAL COMMENT, HOW TO SUE A SOVEREIGN: THE CASE OF PERU (Nov. 2000); *see also* MOODY'S INVESTOR SERV., SPECIAL COMMENT, SOVEREIGN DEBT: WHAT HAPPENS IF A SOVEREIGN DEFAULTS (July 2000).

Elliott did two things to put this strategy into effect. First, it obtained a restraining order against The Chase Manhattan Bank in New York (Chase), the New York fiscal agent for the Brady bonds, after successfully arguing that the funds were still the property of Peru (Chase being the agent for the debtor).[5] This tactic was thwarted temporarily because Peru got word of the order just in time to stop the transfer of funds to Chase. Elliott next sought *ex parte*, but did not get, an order from a Brussels Commercial court restraining Euroclear from either accepting money from Peru or paying it to the other creditors. Elliott quickly appealed *ex parte* to the Court of Appeals of Brussels, which issued the restraining order the next day.[6] By this time, Peru was getting close to defaulting on its Brady payments—the thirty-day grace period was close to ending—and it chose to settle by paying Elliott $56.3 million.[7]

Central to Elliott's victory in Brussels was its success in arguing that Peru was contractually barred from paying one group of creditors (here, the creditors who had agreed to the restructuring) before paying it (the holdout). The basis for the argument was a device called the *pari passu* clause[8]—a standard clause found in almost all sovereign bond indentures.[9] The clause typically states (as it did in this case) that the debtor represents and warrants that "[t]he obligations of the Guarantor hereunder do rank and will rank at least *pari passu* in priority of payment with all other External Indebtedness of the Guarantor, and interest thereon."[10] Professor Andreas Lowenfeld of New York University explained Elliott's argument in a declaration to the court.[11] Elliott argued that the meaning of the *pari passu* clause was clear.[12] What the clause says, according to Lowenfeld's opinion, is that if the debtor does not have enough money to pay its creditors in full,[13] they all have to be paid their pro rata

5. *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 *The Business Lawyer*, University of Maryland School of Law) [hereinafter Brussels Opinion].

6. *Id.*

7. The settlement includes post-judgment interest. *See* LINDENBAUM & DURAN, *supra* note 3, at 2.

8. "[T]he term '*pari passu*' is adopted from the Latin for 'with equal step,' or 'side by side.'" Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection*, 84 CORNELL L. REV. 305, 309 n.6 (1999).

9. *See* Brussels Opinion, *supra* note 5.

10. *See* Declaration of Professor Andreas Lowenfeld at 8, Elliott Assocs., L.P. v. Banco de la Nacion, 2000 U.S. Dist. LEXIS 14169 (S.D.N.Y. Sept. 29, 2000); Elliott Assocs., L.P. v. Republic of Peru, 2000 U.S. Dist. LEXIS 368 (S.D.N.Y. Jan. 18, 2000) (executed Aug. 31, 2000) (on file with *The Business Lawyer*, University of Maryland School of Law).

11. *Id.*

12. As noted in footnote 10, we have a copy of Professor Lowenfeld's opinion that was submitted in the New York cases. We are advised that the same memorandum was submitted in the Brussels case.

13. Professor Lowenfeld limits his opinion to the context where there is "not enough money to go around," or the debtor is insolvent in the equity sense of inability to pay debts

shares.[14] The debtor is not allowed to pay one creditor in full and leave the others unpaid. In vivid, Tom-Dick-Harry terms, Lowenfeld explains:

> 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:
>
> 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.[15]

At a first cut, the Lowenfeld position may make sense to some. After all, the *pari passu* clause explicitly states that creditors are to rank equally in priority of payments. Ranking equally must mean that, if there is not enough money, all the *pari passu* creditors get paid pro rata out of whatever funds are available. Our contention, however, is that one does not have to dig deep into the context of sovereign borrowing and the guaranty documents to realize that the above articulation is not quite so clear. For one, whatever else the *pari passu* clause may mean, "it does not force the solvent borrower to make pro rata payments to all its creditors."[16] Moreover, we do not think it clear at all that the clause means that a sovereign that has inadequate funds to pay all its creditors is required to pay all of its creditors ratably.

Prior to the issuance of the Brussels Opinion, the problem of holdouts was considered to be one of the primary barriers to orderly sovereign debt

as they become due. In the current case it is unclear whether Peru had enough money to go around. After all, ultimately it paid Elliott in full. Moreover, it is not clear based on its plain meaning that the *pari passu* clause is restricted to instances where the borrower is insolvent. For example, in theory, the clause could apply to a solvent debtor that was flush with cash but chose not to pay a particular debt. Alternatively, the clause could apply to require ratable payment of all outstanding debts even if a particular debt was not yet due. The authors believe that the basic *pari passu* clause applies whether or not the borrower is insolvent, but only to guarantee ratable priority, not ratable payment.

14. *See* Lowenfeld Declaration, *supra* note 10, at 12.

15. *Id.* at 11-12.

16. *See, e.g.,* LEE C. BUCHHEIT, HOW TO NEGOTIATE EUROCURRENCY LOAN AGREEMENTS 83 (2d ed. 2000); PHILIP WOOD, LAW AND PRACTICE OF INTERNATIONAL FINANCE 156 (1980) ("The *pari passu* undertaking is not broken merely because one creditor is paid before another.").

restructurings and, hence, one of the sources of global financial instability causing the need for bailouts and the sort.[17] What the Brussels Opinion does is to put a large hammer in the hands of holdout creditors,[18] thereby enabling them to cause even more disruption in restructurings. Those inclined to be holdouts have a stronger position, and it encourages others to hold out. For the sovereigns and, we argue, for the majority of creditors, this is a nightmarish situation. The result is likely to be that the *threat* of Elliott and its brethren being able to attach payment streams to creditors will force sovereigns in distress to turn to more extreme forms of renegotiation. This might include exit consent offers that would amend the terms of bonds held by the holdouts to prevent such disruptions.[19]

The Brussels court made its interpretation on the basis of an *ex parte* motion by Elliott.[20] Had Peru had an opportunity to respond, we think that the court would not have leapt quite so easily to its conclusion. The court did not reference the market understanding of the standard *pari passu* clause. And as a result, we argue, it concluded that the clause meant something different than the market understanding. The danger now is that some later court will look to the Brussels court's interpretation and hold that as the standard interpretation. Our purpose is to argue that the Brussels court's interpretation was wrong and should be disregarded. Elliott managed to extract one windfall, but things should stop there.

This Article proceeds in four parts. First, this Article explains why, from an *ex ante* bargaining perspective, sovereign debtors would be loathe to agree to *pari passu* clauses with the interpretation given by the Brussels court. Next, the Article looks to the literature and case law construing sovereign and corporate debt and demonstrates why the Brussels inter-

17. *See, e.g.,* BARRY EICHENGREEN & ASHOKA MODY, INTERNATIONAL MONETARY FUND, BAIL-INS, BAILOUTS, AND BORROWING COSTS 5-6 (paper presented at the First Annual IMF Research Conference, Nov. 9-10, 2000) [hereinafter EICHENGREEN & MODY]; Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges,* 48 UCLA L. REV. 59, 62 (2000); Barry Eichengreen, *Bailing in the Private Sector: Burden Sharing in International Financial Crisis Management,* 23 FLETCHER F. WORLD AFF. 57 (1999); Samuel E. Goldman, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring,* 5 UCLA J. INT'L L. & FOREIGN AFF. 159, 164-65 (2000); Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach,* 85 CORNELL L. REV. 956 (2000). Elliott's strategy against Peru is not an isolated occurrence. In fact, in 1996, Elliott successfully obtained a $57 million judgment and attachment order against Panama. *See* Elliott Assocs., LP v. Banco de la Nacion, 194 F.3d 363, 366 (2d Cir. 1999).

18. Remember, these *pari passu* clauses are standard.

19. Ecuador's recent Exit Consent offer had in place a couple of provisions that might have worked to thwart the attachment strategy. For one, the restructured bonds had payments coming in through a Trustee (who was technically the agent of the creditors) and not through a Fiscal Agent (who is typically the agent of the debtor). And second, the bonds provided for the time and place of the payments to be altered if the circumstances called for it (i.e., so that the vultures would not know where the payments were coming in). On the Ecuador offer, see REPUBLIC OF ECUADOR: OFFER TO EXCHANGE (June 27, 2000).

20. *See* Brussels Opinion, *supra* note 5.

pretation is wrong, results in a windfall to holdout creditors, and harms the majority of other creditors. The Article then discusses New York bond interpretation law and the need for the Brussels interpretation to be challenged. Finally, we provide a brief conclusion forecasting the impact of the Brussels interpretation on sovereign debt and corporate debt transactions.

NEGOTIATING THE PARI PASSU *CLAUSE*

The thrust of Lowenfeld's argument on the meaning of the *pari passu* clause is twofold. First, Lowenfeld argues that the clause is clear and unambiguous.[21] Second, he argues that the clear meaning is that all payments on all the debts that are ranked *pari passu* must be made pro rata.[22] There is some superficial appeal to his interpretation. After all, for a creditor, what else does "ranked equally" mean other than being paid on a pro rata basis? In other words, what would be the point of being "ranked" equally if that did not mean that one was going to be "paid" pro rata along with everyone else at the same rank? It turns out, however, that the above interpretation of this *standard* term is not so obvious. Indeed, the above interpretation is precisely what the clause does *not* mean. Debtors, and especially sovereign debtors, would be crazy to agree to such a term with all of their creditors. To the extent that sovereigns do agree to give creditors the *pari passu* payment rights—rights that the Brussels court held that they already have under the *pari passu* clause[23]—this is likely to result in a lower interest coupon for the creditors who receive it, to be granted only after hard negotiations, and to be given to only a few creditors.

The first question is that if the *pari passu* clause does not mean what Lowenfeld says it means, what does it mean? After all, the thrust of Lowenfeld's argument seems to be that it *must* mean pro rata payment. The purpose of this clause,[24] however, is to ensure that the borrower does not have, nor will it subsequently create, a class of creditors whose claims will rank senior in priority to the lending claims of the current creditors.[25] In the corporate debt context, this means that no other lender will enjoy a priority in a liquidation distribution of the borrower's assets.[26]

21. *See* Lowenfeld Declaration, *supra* note 10, at 11-12.

22. *Id.*

23. *See* Brussels Opinion, *supra* note 5.

24. The phrase, "ranks, and will rank, *pari passu.*"

25. These current creditors are protected by the standard *pari passu* clause.

26. In this sense, the *pari passu* clause is the flip side of a subordination agreement. It is an agreement not to subordinate debt that is the beneficiary of the clause to other debts of the borrower. There are two basic kinds of subordination agreements: complete and inchoate. An inchoate subordination agreement becomes operative only when an insolvent debtor makes a distribution of its assets. A complete subordination agreement operates immediately to preclude the borrower from paying principal or interest on the subordinated debt so long as the senior debt remains unpaid. *See* Dee Martin Calligar, *Subordination Agreements*, 70 YALE L.J. 376, 377-78 (1961). Just as "subordination" has two meanings, so too does *pari passu.* If

In the sovereign debt context, where there is no liquidation, the *pari passu* clause works as a covenant by the borrower that it will not bestow a legally senior priority status on certain lenders.[27] This protects against the temptation for the sovereign to enact laws affecting the legal ranking of creditors.[28] "Ranking" *pari passu*, therefore, is about insolvency payouts (in the corporate context) or about the alteration of payment priorities by law (in the sovereign context).[29] It is an equal ranking, but it applies to specific contexts.[30] The point here is that there is a well-established, alternate "clear" interpretation of the clause.

the *pari passu* clause is complete, it requires all payments by the borrower to be ratable. On the other hand, if it is inchoate, it only precludes the borrower from creating a new class of senior debt or subordinating the existing debt.

27. As a general matter, a debtor cannot legally subordinate a lender unless it obtains her consent. *See* Buchheit, *supra* note 16, at 83. The concern with a sovereign, however, is that the sovereign will simply alter the law to subordinate the disfavored lender.

28. *See* Buchheit, *supra* note 16, at 84 ("[S]overeign borrowers, because they have it within their power to enact laws affecting the legal ranking of creditors, are thought to be appropriate objects of a *pari passu* covenant."); *see also* Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships*, 1988 U. ILL. L. REV. 493, 497 ("[T]he borrower violates [the *pari passu*] undertaking only by attempting to create a class of senior indebtedness in preference to that outstanding under the loan agreement in which the clause appears."). On this point, the Lowenfeld opinion itself quotes William Tudor John to say of the clause:

> [I]t is primarily intended to prevent the earmarking of revenues of the government towards a single creditor, the allocation of foreign currency reserves, and generally against legal measures which have the effect of preferring one set of creditors against the others or which discriminate between creditors.

Lowenfeld Declaration, *supra* note 10, at 10 (quoting William Tudor John, *Sovereign Risk and Immunity Under English Law and Practice*, in 1 INTERNATIONAL FINANCIAL LAW 71, 96 (Robert S. Rendell ed. 2d ed. 1983)). The clause also protects against a law subordinating existing debt to new debt issues.

29. Indeed, it would be interesting to look at the historical evolution of the clause in sovereign lending agreements. Consistent with Lowenfeld's quote from Tudor John, the original goal of the clause may have been to keep sovereigns from earmarking particular revenue streams for favored creditors. At the time (most likely in the early part of the 20th century), there were no sovereign security interests and, hence, no negative pledge clauses. The *pari passu* clause, therefore, probably served as something of a substitute because the primary risk to guard against was not collateralization but subordination.

30. Whether the context is corporate or sovereign debt, however, the function of the clause is to assure equality of rank. Inevitably there are recognized senior claims to which the debt will be subordinated. Examples include secured claims, claims of favored creditors such as depositors, and the like. A commentator, writing about the giving of *pari passu* opinions by counsel, explains: "In many cases, it is suggested that the opinion recipient recognize that preferred claims may exist and that a general exception should be read into the *pari passu* opinion." Michael Gruson & Stephan Hutter, *International Bar Association Project on Legal Opinions in International Business Transactions*, 10 U. PA. J. INT'L BUS. L. 71, 85 (1988). As discussed *infra* notes 39-56 and accompanying text, when the parties' intent is for the equal ranking to be broader than priority status and to have the meaning attributed to the clause by the Brussels court, the debt instrument either contains additional language that is used to supplement the standard clause or includes other clauses.

Providing an alternate and milder interpretation for the clause does not by itself mean that this interpretation trumps the one given by the Brussels court. Why would all lenders not also want to be paid pro rata and, therefore, negotiate for that additional right? The answer lies in the interests of the sovereign debtor.

Consider the case of a sovereign debtor, Fredonia. Fredonia is a small developing country that faces a realistic possibility of having occasions where it will not have enough funds to pay all its debts. In such a situation, Fredonia is unlikely to pay all its unsecured creditors, with their standard *pari passu* clauses, pro rata.[31] Fredonia will want to be able to pay its most important unsecured creditors first. Those are the international financial institutions like the International Money Fund (IMF), the Asian Development Bank (ADB), and the World Bank,[32] workers and police or military personnel who protect public health and safety, and trade creditors who provide much needed supplies. Indeed, the Brussels Opinion is likely to have sent a shock to the IMF and World Bank who are accustomed to assuming that countries can and will pay them first.[33] A sovereign that is short of cash will not wish to make payments pro rata, thereby defaulting on all its debts and bringing upon itself the ire of every creditor. Instead, a sovereign will want to be able to pay the important creditors first so that they continue to provide support. Given the sovereign's strong interest in being able to make payments to some creditors over the others, and given that there are at least two plausible interpretations of the *pari passu* clause, it makes sense to interpret the clause to reflect more likely the parties' bargain *ex ante*.[34]

In addition, there is the holdout problem that the broad interpretation of the *pari passu* clause exacerbates. For a sovereign like Fredonia that is

31. As the Lowenfeld opinion explains: "A clause such as Section 11(c) [the basic *pari passu* clause] is a standard clause included in virtually all loan or debt restructuring agreements." Lowenfeld Declaration, *supra* note 10, at 9. Implicit in that statement is the assertion that the rights granted by that clause are ones that the sovereign debtor has agreed to give *all* of its creditors.

32. The IMF and World Bank are a crucial source of continuing credit for a sovereign in trouble.

33. On the effectively preferred creditor status of the international financial institutions such as the World Bank, the IMF, and the ADB, see Lee C. Buchheit, *Of Creditors, Preferred and Otherwise*, INT'L FIN. REV., June 1991, at 12-13.

34. In his classic bond contract interpretation opinion in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, Judge Winter explains:

> Where contractual language seems designed to protect the interests of both parties and where conflicting interpretations are argued, the contract should be construed to sacrifice the principal interests of each party as little as possible. An interpretation which sacrifices a major interest of one of the parties while furthering only a marginal interest of the other should be rejected in favor of an interpretation which sacrifices marginal interests of both parties in order to protect their major concerns.

691 F.2d 1039, 1051 (2d Cir. 1982).

negotiating its debt clauses, there is always the possibility that the day will come when the debt has to be restructured and the creditors have to be asked to extend the maturity or take less. Creditors will not likely renegotiate if they know that someone like Elliott can grab onto payments that are supposed to go to their restructured debt. Unlike corporate debtors, sovereigns cannot declare bankruptcy and rely on the law to force a restructuring on recalcitrant creditors.[35] Holdout problems, therefore, are a major issue for sovereigns. This is illustrated by the recent discussions over whether the standard unanimity provisions in sovereign debt contracts governed by New York law can and should be replaced by super-majority action clauses.[36] The last thing that a sovereign, already worried about holdouts, desires is to give potential holdouts even more leverage. The Brussels Opinion, however, does just that. This leverage is not a power that the sovereigns are likely to have bargained, *ex ante*, to give away.

Indeed, giving the holdouts such power is something that the majority of creditors are unlikely to want themselves. To the extent renegotiation of distressed sovereign debt serves to further the interests of both the debtors and creditors, a holdout imposes costs on both sides.[37] In other words, the pie becomes smaller if the holdout is able to extract a premium for itself. To the extent that some creditor is given the power that Elliott claimed the basic *pari passu* clause gave it, it is likely that the debtor will

35. With respect to new debt issues, however, the sovereign can select English law rather than New York law. *See infra* note 57.

36. *See, e.g.,* BARRY EICHENGREEN & ASHOKA MODY, WOULD COLLECTIVE ACTION CLAUSES RAISE BORROWING COSTS? AN UPDATE AND ADDITIONAL RESULTS (May 2000), *available at* <http://elsa.berkeley.edu/users/eichengr/research.htm>; EICHENGREEN & MODY, *supra* note 17, at 5-6; Liz Dixon & David Wall, *Collective Action Problems and Collective Action Clauses*, FIN. STABILITY REV., June 2000, at 142.

37. A recent Moody's Investor Service Special Comment makes the same point with respect to a different issue in the Elliott versus Peru proceedings. What Elliott succeeded in doing was attaining: "post-judgment attachment of all assets of the sovereign's agent, Banco de La Nacion, in the United States." SPECIAL COMMENT, HOW TO SUE A SOVEREIGN, *supra* note 4, at 1. The Special Comment further explains:

> That an entity closely related to the sovereign can conceivably be held financially liable and that all of its assets in the jurisdiction where the suit is brought may be attached to make good on defaulted debt opens a door that had hitherto not been considered available . . . . [And it turns the investor's] suit from an academic and avenging "I told you so" exercise to a more lethal weapon lending this disconsolate investor's bark a bit more bite.
>
> This case has also raised concerns that proliferation of such suits by aggressive investors could realign incentives of sovereign and other creditors. After all, when a sovereign settles out of court for a substantial sum with one litigious creditor it will adversely impact, however marginally, the claims of its other creditors. It is possible, and indeed probable, that to protect their interests these creditors will attempt to somehow hinder their uncooperative brethren.

Id.