INSOLVENCY & RESTRUCTURING - USA

Second Circuit determines that Argentine central bank is not alter ego of Argentina

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Introduction

In *EM Ltd v Banco Cent De La Republica Argentina* (800 F 3d 78 (2d Cir 2015)(1),), the US Court of Appeals for the Second Circuit refused to allow individual bondholder plaintiffs that had opted out of a class action to enforce judgments for $2.4 billion against Argentina by collecting against funds held by Argentina's central bank, Banco Central de la República Argentina (BCRA), in New York. Argentina had agreed to waive its sovereign immunity when it issued the bonds in order to secure the investments.(2) However, the Second Circuit found that Argentina's express waiver of sovereign immunity did not extend to the country's central bank because BCRA, as an instrumentality of a sovereign state, was immune from suit under the Foreign Sovereign Immunities Act(3) and the 'alter ego' and 'commercial activity' exceptions to the Foreign Sovereign Immunities Act did not apply. *Banco Centrale* makes clear that the Second Circuit will strictly interpret and apply any waivers of sovereign immunity. The Second Circuit established a high bar for creditors seeking to prove that state-owned instrumentalities are the alter egos of their states, and sets clear limits on the types of activity that will permit application of the commercial activity exception.

Facts

The plaintiffs EM Ltd and NML Capital, Ltd held bonds issued by Argentina under a fiscal agency agreement (FAA) that included an express waiver of sovereign immunity.(4) The waiver was included in the FAA at the insistence of investors because of Argentina's history of defaulting on sovereign obligations.(5) Argentina began issuing bonds under the FAA in 1994.(6)

A severe financial crisis beset Argentina in 2001 and Argentina suspended payment on the FAA bonds.(7) Although the majority of the bonds were restructured through "global exchange offers" (offers to trade the bonds for new securities with substantially reduced value), the plaintiffs' FAA bonds were not.(8)

In 2003 the plaintiffs initiated an action in the US District Court for the Southern District of New York seeking to recover their unpaid principal and interest.(9) The plaintiffs went on to obtain numerous judgments against Argentina, currently totalling around $2.4 billion.(10)

The plaintiffs made their first attempt to enforce their judgments against Argentina by attaching funds held by BCRA in 2005. The plaintiffs moved the district court for an *ex parte* order to restrain BCRA funds held in the Federal Reserve Bank of New York,(11) claiming that Argentina had transferred ownership of certain BCRA funds from BCRA to Argentina by enacting various decrees. The district court ultimately rejected this attempt to reach the BCRA funds held by the Federal Reserve and the Second Circuit affirmed.(12) However, the Second Circuit noted that if the plaintiffs were able to establish that BCRA was "'so extensively controlled by [Argentina] that a relationship of principal and agent is created,' or that recognizing BCRA's separate juridical status would 'work fraud

or injustice'",(13) it would "subject all of BCRA's assets to potential attachment by Argentina's judgment creditors".(14)

The plaintiffs sought a declaratory judgment that BCRA was the alter ego of Argentina, and thus liable for any and all of Argentina's debts.(15) The plaintiffs' stated intent was to use the declaratory judgment to attach BCRA funds in foreign jurisdictions.(16)

In November 2012 Argentina and BCRA moved to dismiss this action for lack of subject-matter jurisdiction on sovereign immunity grounds.(17) In response, the plaintiffs contended that Argentina's waiver of sovereign immunity in the FAA should be imputed to BCRA, and that BCRA had also waived sovereign immunity by engaging in "commercial activity" in New York through its Federal Reserve account.(18)

The district court denied BCRA's motion to dismiss on September 25 2013,(19) concluding that BCRA had waived its sovereign immunity under the Foreign Sovereign Immunities Act. Specifically, the district court found that the FAA's express waiver of sovereign immunity also waived BCRA's immunity because BCRA is Argentina's alter ego, and thus 28 USC § 1605(a)(1) – which provides an exception to the Foreign Sovereign Immunities Act for express waiver – applied.(20) Second, the court held that BCRA's use of its account with the Federal Reserve constituted 'commercial activity' in the United States that waived BCRA's sovereign immunity under 28 USC § 1605(a)(2).(21) BCRA appealed and the Second Circuit reversed. This decision is discussed below.

In February 2016 Argentina made an offer to resolve the bondholders' claims.(22) Recently, EM, Ltd and NML Capital, Ltd reached an agreement with Argentina, subject to the approval of the Congress of Argentina and the lifting of a law blocking the settlements.(23) The class action was resolved on February 16 2016.(24)

Decision

Alter ego exception

To determine whether this exception applied, the Second Circuit closely analysed and applied *First National City Bank v Banco Para El Comercio Exterior de Cuba (Bancec)* (462 US 611 (1983)), the leading case regarding when an instrumentality of a sovereign state becomes the alter ego of that state.(25) In *Bancec* the Supreme Court established that the presumption that an instrumentality will be accorded separate legal status can be overcome if:

- there is such extensive control of the instrumentality by its owner that a relationship of principal and agent is created; or
- recognising an instrumentality's separate legal status would cause a fraud or injustice.(26)

Although determining the level of control that a foreign sovereign exerts over an instrumentality is fact intensive, the courts have developed several factors to guide the analysis.(27) The relevant criteria include:

> "*whether the sovereign nation: (1) uses the instrumentality's property as its own; (2) ignores the instrumentality's separate status or ordinary corporate formalities; (3) deprives the instrumentality of the independence from close political control that is generally enjoyed by government agencies; (4) requires the instrumentality to obtain approvals for ordinary business decisions from a political actor; and (5) issues policies or directives that cause the instrumentality to act directly on behalf of the sovereign state.*"(28)

These considerations inform "the touchstone inquiry for 'extensive control': namely, whether the sovereign state exercises significant and repeated control over the instrumentality's day-to-day operations".(29)

Applying these factors, the Second Circuit found that "on paper" BCRA appeared to be a regular government instrumentality, and thus one able to assert sovereign immunity.(30) The court considered the three categories of fact that the plaintiffs put forth as proof that that this formal independence was at odds with Argentina's actual control over the bank's operations.

The first set of facts was whether Argentina had "systematically" eviscerated BCRA's legal independence by controlling the appointment and removal of the bank's officers and directors.(31) Other courts have held that the appointment or removal of an instrumentality's officers or directors, standing alone, does not overcome the presumption of legal separateness.(32) The Second Circuit asserted that a government does not exert extensive control by comprising a board of directors for an instrumentality that will comport with the sovereign's goals and policies.(33) To demonstrate extensive control, the plaintiffs would have to establish that Argentina used its influence over the bank's officers and directors in order to interfere with the bank's ordinary business decisions.(34)

Next, the court considered whether Argentina's enactment of laws that enabled the government to borrow from the bank and the government's subsequent borrowing of billions of dollars to pay other creditors demonstrated extensive control. The Second Circuit noted that it is common for central banks to perform payment functions for governments.(35) Further, Argentina's request to borrow funds from BCRA was reviewed and approved by the bank's legal advisers and board of directors.(36) The Second Circuit concluded that the Argentinean government's decision to borrow funds from BCRA to repay certain creditors did not demonstrate extensive control sufficient to defeat the presumption of legal separateness.(37)

Finally, the court addressed the plaintiffs' contention that Argentina and BCRA worked together to devise an "inflationary" monetary policy.(38) The Second Circuit stated that it is common for central banks to coordinate monetary policy with their governments, and subjective determinations regarding the resulting polices have no bearing on the central inquiry: whether Argentina exercised day-to-day control over BCRA.(39) In sum, the court concluded that "[a]lthough these allegations certainly establish[ed] that the Republic sought the assistance of BCRA in responding to an extremely severe debt crisis, and that Argentina took steps to ensure that BCRA shared its policies and goals during this time", they did not establish extensive control over the day-to-day operations of BCRA so as to transform BCRA into the republic's alter ego.(40) Indeed, the majority of the actions taken by the BCRA were "governmental functions performed by most central banks—i.e., paying a nation's creditors, controlling currency flows, and keeping foreign exchange deposits".(41) The court stressed that BCRA was not a party to the FAA and was not involved in Argentina's decision to cease making principal and interest payments on FAA bonds.(42)

The Second Circuit also held that the recognition of BCRA as a separate entity would not effect a "fraud or injustice", the second route to deeming an instrumentality an alter ego of a sovereign state. In *Bancec* the Supreme Court held that the bank, Cuba's instrumentality, was not a separate juridical entity because Cuba dissolved the bank and took complete control of its assets.(43) Other courts have found fraud or injustice when a foreign instrumentality is run as a sham or the state is abusing the corporate form, such as when a country dissolved an oil company that had breached an agreement, substituted it with an under-capitalised state-owned oil company, and enacted immunity protection for that entity.(44) However, the Second Circuit found that the plaintiffs did not demonstrate a case of "flagrant" fraud and injustice, pointing out that the plaintiffs did not claim that Argentina used BCRA's immune status to frustrate the plaintiffs' collection attempts, or that Argentina used BCRA to shield funds. The Second Circuit concluded that BCRA did not constitute Argentina's "alter ego" and thus that Argentina's waiver of its own sovereign immunity in the FAA could not be extended to BCRA.(45)

Commercial activity exception

The commercial activity exception to the Foreign Sovereign Immunities Act requires a sufficient "degree of closeness" between the gravamen of the complaint and the commercial activity.(46) Because the crux of the plaintiffs' complaint was that BCRA must be held liable for Argentina's failure to pay its FAA bonds and BCRA was not involved in the FAA or Argentina's default, the Second Circuit explained that the relevant actions were those BCRA took after the 2001 default.(47) The plaintiffs contended that BCRA engaged in commercial activity by using its Federal Reserve account to purchase dollars and using those dollars to make loans to Argentina.(48) But the Second Circuit deemed this activity "entirely incidental to plaintiffs' claim",(49) finding no nexus between this activity and the gravamen of the complaint, the alter-ego claim based on loans made by BCRA to Argentina in Argentina.(50) The fact that BCRA used an account in the United States had no bearing on the adverse consequences plaintiffs allegedly suffered as a result of BCRA's loans to Argentina; the result would have been the same had the bank used any other account anywhere in the world.(51) The court held that the commercial activity exception to sovereign immunity did not apply.(52)

Part of the rationale for the Second Circuit's decision was the court's view that the plaintiffs' asserted basis for applying the commercial activity exception threatened to "dramatically expand" the exception's scope, rendering it applicable anytime the plaintiffs could show that dollars that were allegedly misused were acquired in a transaction made in the United States.(53) As New York is a financial centre, any country that used bank accounts in New York would be at risk of waiving its sovereign immunity.(54) The court quoted extensively from an amicus brief written by the United States in an earlier proceeding in the case, cautioning that the "weakening [of] the immunity from suit or attachment traditionally enjoyed by the instrumentalities of foreign states" could result in foreign central banks deciding to "withdraw their reserves from the United States and place them in other countries", which "could have an immediate and adverse impact on the U.S. economy and the global financial system".(55) The Second Circuit concluded that such a "capacious" view of the commercial activity exception was entirely at odds with the Foreign Sovereign Immunities Act's presumption that foreign states and instrumentalities are entitled to sovereign immunity.(56)

The Second Circuit reversed the district court and remanded with instructions to dismiss the plaintiffs' complaint.

Comment

The *Banco Centrale* decision illustrates that the Second Circuit will restrictively interpret any waiver of sovereign immunity, and foreign instrumentalities will be presumed to be separate from their sovereigns unless the entity seeking to reach the instrumentality meets an extremely high bar. The practical implication of the case is that an investor that obtains a waiver of sovereign immunity from a foreign sovereign to secure an investment in that foreign sovereign should expect that the waiver will be interpreted restrictively, and will not be extended to the sovereign's foreign instrumentalities. If the investor seeks a waiver because of concerns regarding the foreign sovereign's financial performance, the best practice would be also to obtain a waiver of sovereign immunity from all other foreign instrumentalities that the investor may need to reach.

The Second Circuit's decision also establishes that although, as a practical reality, state-owned instrumentalities are closely tied to their sovereigns, it must be demonstrated that there is much more than the ordinary, expected connections and influence between the two in order for the instrumentality to be deemed the alter ego of the sovereign. The sovereign must so dominate the instrumentality that it takes over its day-to-day operations, or it must be abusing the corporate form. The case also emphasises that commercial activity done in the United States by a foreign instrumentality will not trigger a waiver of immunity unless the claim is directly linked to that activity, and that the routine use of bank accounts in the United States or the making of transactions in US dollars will not occasion a waiver. The Second Circuit made clear that this decision was motivated, at least in part, by a desire to protect New York as a global financial centre, stressing that lessening the sovereign immunity instrumentalities that foreign states typically hold could result in central bank reserves being withdrawn from the United States.

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Endnotes

(1) Petition for writ of certorari, *EM Ltd* v *Banco Cent De La Republica Argentina*, No 15-872, (US Sup Ct Jan 8 2016)

(2) *Banco Centrale*, 800 F 3d at 82.

(3) 28 USC §§ 1330, 1602 and following.

(4) *Banco Centrale*, 800 F.3d at 83.

(5) *Id*. See also *id* (recording Argentina's "many contributions to the law of foreign insolvency through its numerous defaults on its sovereign obligations, as well as through... a diplomacy of

default"); *id* at n 5, citing *EM Ltd v Republic of Argentina*, 473 F 3d 463, 466 n 2 (2d Cir 2007).

(6) *Id* at 83.

(7) *Id*.

(8) *Id*.

(9) *Id*.

(10) *Id*.

(11) *Banco Centrale*, 800 F 3d at 84.

(12) *Id*.

(13) *Id* at 85 (citing *First Nat'l City Bank v Banco Para El Comercio Exterior de Cuba*, 462 US 611, 629, 103 S Ct 2591, 77 L Ed 2d 46 (1983)).

(14) *Id*.

(15) *Id*.

(16) *Id* at 86.

(17) *Id*.

(18) *Id*.

(19) *Banco Centrale*, 800 F 3d at 86.

(20) *Id*.

(21) *Id*.

(22) Nate Raymond, *Argentina Reaches Settlement in US Debt Class Action: Mediator*, Reuters (Feb 16 2016, 6:21 PM), www.reuters.com/article/us-argentina-debt-idUSKCN0VP2QE.

(23) Katia Porzecanski and Ben Bartenstein, *Argentina Reaches Partial Deal on Debt, But Holdouts Remain*, Bloomberg (Feb 8 2016, 12:33 AM), www.bloomberg.com/news/articles/2016-02-05/argentina-offering-holdout-creditors-about-75-of-debt-claims; Special Master Announces Settlement of 15-Year Battle, Mercopress (March 1 2016) en.mercopress.com/2016/3/01/special-master-announces-settlement-of-15-year-battle-between-argentina-and-holdout-hedge-funds.

(24) Nate Raymond, *Argentina Reaches Settlement in US Debt Class Action: Mediator*, Reuters (Feb 16 2016, 6:21 PM), www.reuters.com/article/us-argentina-debt-idUSKCN0VP2QE.

(25) *Id* at 89.

(26) *Id* at 90.

(27) *Id* at 91.

(28) *Id*.

(29) *Id*.

(30) *Id* at 92.

(31) *Id*.

(32) *Id*.

(33) *Id*.

(34) *Id*.

(35) *Id* at 93-94.

(36) *Id*. See also *id* (noting that "one BCRA Governor testified before Argentina's Congress that it made policy sense to permit the government to borrow funds from BCRA while its reserves earned relatively low interest").

(37) *Id*.

(38) *Id* at 93.

(39) *Id*.

(40) *Id*.

(41) *Id* at 94.

(42) *Id* at 94-95.

(43) *Id* at 95.

(44) *Id*, discussing *Bridas SAPIC v Gov't of Turkmenistan*, 447 F 3d 411 (5th Cir 2006) (the Fifth Circuit found "fraud or injustice" where Turkmenistan dissolved a state-owned oil company that had breached an agreement with plaintiff, replacing it with an under-capitalised state entity and enacting immunity protection for that entity); *Kensington Int'l Ltd v Republic of Congo*, No 03 Civ 4578 (LAP), 2007 WL 1032269 (SDNY Mar 30 2007) (finding fraud when the Republic of Congo designed the corporate structure of its allegedly independent oil company to allow Congo to engage in "unnecessarily complex transactions and charades for the purpose of confounding its creditors", passed all oil sales' proceeds to the government, and did not permit the company to exercise its right to collect a percentage on transactions, and commingled state and company assets).

(45) *Id* at 96.

(46) *Id* at 97.

(47) *Id*.

(48) *Id*.

(49) *Id* at 97-98. The court found the plaintiffs' claims analogous to those at issue in *Kensington Int'l Ltd v Itoua*, 505 F 3d 147 (2d Cir 2007). That case involved a creditor of the Republic of Congo, which claimed that an oil company owned by the state had entered into deals executed in France exchanging oil rights for prepayment, resulting in the Congo's oil revenues being diverted from payment to the creditor. The creditor argued that the Foreign Sovereign Immunities Act's commercial activity exception applied because the oil was ultimately sent to the United States, and the premium payments were made in the United States. The Second Circuit found that the requisite nexus did not exist between this commercial activity and the gravamen of the complaint, the prepayment agreements that were executed in France, and declined to apply the commercial activity exception to waive sovereign immunity.

(50) *Id* at 98.

(51) *Id*.

(52) *Id.*

(53) *Id.*

(54) *Id.*

(55) *Id.*

(56) *Id.*

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