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US holders of pre-1949 China bonds sue rating agencies

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A group of Florida bondholders is launching a class action suit against the three biggest credit rating agencies, alleging that they have failed to recognise that the People's Republic of China has defaulted on bonds issued between 1912 and 1942 by the country's Nationalist government.

The bondholders claim that Standard & Poor's, Moody's and Fitch have knowingly ignored these defaults and misled investors by failing to change China's rating from A2/A-/A to Ba or Ca/SD/DDD or 'RD proposed'.

The security in question for this lawsuit is the £25m Chinese Government Five Percent Reorganisation Gold Loan, issued in 1913 and linked to the prevailing market value of gold, meaning it is worth far more today.

Kevin O'Brien, president of Sovereign Advisers, an Arizona-based financial advisory firm that is advising the bondholders, believes China's total defaulted obligations to US bondholders are now worth $175bn.

O'Brien also said investors in PRC bonds issued after 1949 should pay attention to this lawsuit. "For investors in sovereign PRC bonds, the credit rating does not disclose the risk of litigation and the seizure of interest payments," he said.

He added that another group of US bondholders intended to sue Euroclear, the paying agent for recent PRC sovereign bonds, for making discriminatory payments to one class of investors and not another.

The bondholders bringing the class action are about 25 individuals in the state of Florida, led by an unnamed charitable foundation.

Once a federal judge in New York's southern district court has certified the class action, O'Brien said the bondholders would invite investors in Nationalist-era bonds from other countries to join the action as co-plaintiffs.

O'Brien said the rating agencies should take this matter seriously: "They... realise that the Chinese government has rejected the successor government doctrine of settled international law."

In the past, Sovereign Advisers has argued that China's Communist government has a responsibility to honour debts raised by Chiang Kai-Shek's Kuomintang government.

It points out that the Soviet Union settled the claims of British holders of defaulted pre-1917 bonds in 1986 and that the PRC also settled pre-1949 claims with British bondholders in 1987.

Sovereign told EuroWeek last year that the PRC was negotiating the claims of French bondholders of pre-1949 paper.

The Nationalist government that issued these debts took refuge in Taiwan when the Communists gained control of mainland China in 1949. But it could be difficult for the PRC to claim that the bonds are Taiwan's responsibility since it regards the island as a rogue province of China rather than a sovereign nation that could have sovereign obligations.

O'Brien said the Florida bondholders had several objectives in bringing this action. "They are looking to stop the publication of China's phoney credit rating, to recover payment of defaulted debt and to damages from the egregious acts of the ratings agencies."

He said the class action would allege the ratings agencies were guilty of: "foreknowledge of falsity," "a reckless standard of care," "aiding and abetting circumvention of payment" and "aiding and abetting the discriminatory payment of other creditors", among other charges.

Because the agencies had been previously notified and given the opportunity to change their ratings for China, O'Brien added, they risked prosecution under the Racketeer Influenced Corrupt Organizations Act, a US federal law which provides for extended penalties for criminal acts performed as part of an ongoing criminal organisation.

The suit is still being prepared, but it is understood that it will be filed in October. "While we cannot comment specifically on a complaint we have not seen," said David Wargin, a spokesman for Standard & Poor's in New York, "we are aware of the claims and believe them to be totally without factual or legal merit."

Spokespeople for Moody's and Fitch did not comment.