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Sovereign Debt Restructurings:

Lessons learned from legislative steps taken by certain countries and other appropriate action to reduce the vulnerability of sovereigns to holdout creditors

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BACKGROUND NOTE[1]:

VULTURE FUNDS IN ACTION: ECONOMIC AND SOCIAL IMPACT

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This background note is divided in five sections. The first briefly describes the strategies of investors seeking financial returns on distressed debt. The second section shows why the activity of distressed debt and vulture funds can undermine orderly sovereign debt restructuring. The third section retraces core litigation by vulture funds against sovereign debtors in distress since the Brady Plan. The fourth section makes reference to the economic and social costs of holdout litigation. Finally, the fifth section discusses a number of proposals for reform and regulation to protect countries and cooperative bondholders from predatory financial actors.

A. DISTRESSED DEBT INVESTORS IN CORPORATE AND SOVEREIGN DEBT MARKETS

Distressed debt investors —also widely known as 'vultures' or 'vulture funds' in academic, legal as well as journalistic debate and publications — originally operated in domestic markets for corporate restructuring before extending their operations to cross-border corporate restructurings and sovereign debt markets. With the explosive growth of hedge funds in the 1980s, investment in distressed securities has become well-established as a source of financial opportunities for professional investors and specialised investment funds. The removal of restrictions on international capital flows further facilitated the activities of many such investors, who begun to target cross-border corporate distressed securities and instruments of sovereign debt.

In the context of corporate restructurings, vulture funds have pursued two main strategies. The so-called 'active investment strategy', typically conducted through a private equity fund, consists in the acquisition of strongly discounted distressed corporate debt in secondary markets. The objective is to become a major creditor and to influence the recovery or the reorganisation process of the firm with a view to subsequently selling the company at a profit.[2] By contrast, with a 'passive investment strategy' – sometimes also referred to as an 'opportunistic' or 'pure' vulture fund strategy[3], the investor is uninterested in equity positions, instead simply aiming to benefit from trading in relatively closed markets. Distressed securities provide opportunities for some investors – mainly hedge funds – precisely because large institutional investors may face restrictions on

[2] Also known as '*distressed-to-control*' or '*loan-to-own*' strategies.

[3] See e.g. Anson, M.J.P., F.J. Fabozzi and F.J. Jones (2011). *Handbook of Traditional and Alternative Investment Vehicles: Investment Characteristics and Strategies*. John Wiley & Sons, Hoboken, New Jersey, p. 439.

holding substantial amounts of distressed debt or below-investment grade securities, arising from their investment policy or from regulations.[4] Such investors will convert their claims into cash rather than take part in a possibly long drawn out reorganisation process, creating opportunities for bargain hunters poised to benefit from the pressure to sell large institutional investors will exert, thereby depressing bond prices.[5]

The Investment strategies of vulture funds are therefore determined not only by their assessment of a company's future prospects, but also by national legislation and regulation. Apart from national bankruptcy legislation, this also includes wider regulations for securities trading, such as those that ban public trading of distressed corporate debt and entail provisions to exclude certain types of investors (e.g. pension funds) from investments in 'bad' debt.

When operating within such given legal frameworks, the role of vulture funds is often associated with two main benefits: they provide liquidity to the corporate debt market, easing financial constraints on perhaps only temporarily distressed companies, and they bring often extensive expertise in successful company restructurings. As active investors in domestic corporate restructurings, vulture funds also take a real business risk, over and above the risks associated with trading out of distressed debt position: a selected company may turn out not to be viable after all.

In the context of sovereign debt restructurings (and, to an extent, that of cross-border corporate restructurings), many of the features that ensure active vulture funds are potentially efficient players in domestic markets for distressed corporate debt, do not apply. Most obviously, there is no international equivalent to national bankruptcy legislations and, more widely, no international equivalent to national regulations of distressed debt markets. In September 2015, the UN General Assembly adopted a Resolution on Basic Principles on Sovereign Debt Restructuring[6], according to which sovereign debt restructuring processes

[4] Hedge funds are limited liability funds pooling investor capital in securities and other financial instruments with no or little regulation for caps on leverage.

[5] Hedge funds also seek gains through 'distressed debt arbitrage'. The arbitrage involves purchasing the traded bonds of bankrupt companies and short-selling the common equity. If the company's prospects worsen, the value of the company's debt and equity should decline, but the hedge fund manager hopes that the equity (a residual claim) will decline to a greater degree. If the prospects improve, the bond price would likely be increase faster than the equity shares; in particular if the firm's debt rating is upgraded.

[6] A/RES/69/319, available at: http://research.un.org/en/docs/ga/quick/regular/69

should be guided by customary law and by basic international principles of law, such as sovereignty, good faith, transparency, legitimacy, equitable treatment and sustainability. It does not, however, establish a binding multilateral legal framework for sovereign debt restructurings. A similar regulatory 'vacuum' in regard to bankruptcy procedures typically complicates cross-border corporate restructurings.

Furthermore, in the case of sovereign debt restructurings, there is no equivalent for active vulture fund investment strategies in the context of domestic markets for corporate restructurings. Vulture funds cannot take 'control' of a sovereign state or country, as they can of a domestic company, nor can they convert distressed debt positions into 'equity' positions. Moreover, unlike a defaulting corporate borrower, a sovereign cannot be liquidated.

In the context of sovereign debt restructurings, their role is therefore essentially that of 'pure vultures' with a passive investment strategy: The investment objective is short-term speculative financial gain - in this case not by exploiting possibilities arising from segmented and inefficient nationally regulated markets in corporate distressed debt, but through nationally based litigation against sovereigns in the absence of a multilateral legal framework for sovereign bankruptcy procedures and related regulations of secondary markets for sovereign debt instruments.

If vulture funds pursuing active investment strategies in corporate restructurings are sometimes also referred to as patient bondholders[7] because they adopt long-term investment horizons, this same characterization takes on a different meaning in the context of sovereign debt restructurings. Here, vulture funds are 'patient bondholders'[8] only in the sense that their financial and legal holding power allows them to oppose sovereign debt restructurings and any haircuts these may entail. By refusing to participate in voluntary restructurings, 'patient' holdouts make debt-restructuring processes slower, more difficult, and uncertain, leading to economic and social costs for debtor countries in need of debt relief. Such funds prey on the indebted countries, but, in the process, they can also harm other creditors by refusing some form of burden-sharing among bondholders.[9].

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[7] Anson et al, *op cit*, p. 432

[8] See e.g. Gallagher, K.P. (2014). "The new vultures culture". In: *The clash of globalizations: Essays in the Political Economy of Trade and Development Policy*. Anthem Press, p. 50

[9] An example are the adverse impacts of distressed debt funds operating during the recent European financial crisis, and particularly in Ireland. In this case vulture funds, operating mostly from overseas,

B. 'VULTURE FUNDS' AND SOVEREIGN DEBT WORKOUTS

According to the UK Treasury, *"vulture funds [...] buy up defaulted debts at very low prices when a country is in economic distress and aggressively litigate to recoup the debt's full value*".[10] Similarly, former independent expert on Sovereign debt and Human Rights, Cephas Lumina, states that "*the term vulture funds is used to describe private commercial entities that acquire, either by purchase, assignment or some other forms of transaction, defaulted or distressed debts, and sometimes actual court judgments, with the aim of achieving a high return*".[11] The African Development Bank further notes that vulture funds "[...] *purchase distressed debt at a steep discount, refuse to participate in restructuring, and pursue full value of the debt often at face value plus interest, arrears and penalties through litigation, if necessary*".[12]

These basic definitions raise three core points that characterize the role of vulture funds in sovereign debt restructurings:

- The type of debt purchased in secondary markets, i.e. distressed sovereign debt.
- A clear intention not to participate in debt restructurings.
- The use of litigation as part of a financial strategy based on exploiting the often very large difference between the discounted purchase value of a sovereign debt instrument and its face value plus arrears and litigation costs.

Taking these characteristics one by one, the following legal as well as economic issues arise:

benefited from the abundance of cheap assets during the financial collapse and bought up distressed loan books linked to the property market. Irish tax legislation that exempts certain types of foreign-owned companies from tax on their Irish operations also applied to many of these vulture funds. In addition, many Irish banks that sold their loan books at a heavy discount later received state support (bailouts). Thus, taxpayers indirectly financed vulture fund gains. See, e.g. The Independent (2016) "We needed vulture funds, but the legal exploitation of the system is leaving the country out of pocket on taxes" (31/07). Available at: http://www.independent.ie/business/irish/we-needed-vulture-funds-but-the-legal-exploitation-of-the-system-is-leaving-the-country-out-of-pocket-on-taxes-34925135.html

[10] "Legislation to ensure effective debt relief for poor countries", HM Treasury Press Release 69/09, 21 July 2009, para 1.2.

[11] Human Rights Council, April 2010 "Promotion of all human rights, civil, political economic, social and cultural rights, including the right to development" A/HR/14/21, 7 § 8 Report of the independent expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights, Cephas Lumina.

[12] AfdB "Vulture funds in the Sovereign Debt Context", supra n.4, §3.

(i) *Vulture funds buy distressed debt at a steep discount in secondary markets for sovereign debt instruments*. This raises two questions about the regulation of secondary markets for sovereign debt instruments. First, from which point onwards does a commercial creditor, buying discounted sovereign debt instruments with a view to recover its full face value, become a 'vulture' investor? Put differently, is there an 'acceptable' discount threshold or not? What, in law, makes a creditor who obtains a 90% discount different from a creditor who has purchased a sovereign debt instrument at a 10% discount? The legitimacy and effectiveness of future regulation of secondary markets for sovereign debt instruments may need to take into consideration that such thresholds have to be defined. Second, sellers of sovereign debt instruments may wish to keep secondary markets open to obtain (initially) cheaper access to borrowing. Thus, the African Development Bank maintains that "*when creditors can freely sell the debt they want on secondary markets, there is less risk involved in lending to sovereigns and creditors are therefore more likely to provide the capital sovereigns need*."[13] The legal as well as ethical question that arises here is therefore that of determining whether the act of attempting to recover the full face value of bad debt' should be opposed on the basis that this undermines the (sovereign) borrower interest – i.e. potentially a country's prospects of economic growth and political stability – if and when that borrower has 'freely' chosen to engage with secondary markets.

(ii) *Vulture funds set out to use the context of debt restructurings without any intention to participate in any form of debt relief (haircut or re-profiling).* Plaintiffs typically do not accept exchange offers to restructure debts. They deliberately adopt a non-cooperative stance during the restructuring process by bringing enforcement actions or seeking out-of-court settlements on their claims.[14]

Vulture funds, therefore, are not true lenders but entities purchasing distressed debt in the secondary markets with the sole purpose to litigate. Such opportunistic behaviour calls into question a widely accepted legal principle across different contexts and jurisdictions, namely the principle of good faith. It also raises the issue of the impact any outright lack of good faith may have on a sovereign debtor, that is, on a whole people. The social, economic and political costs arising from sovereign debt

[13] AfdB "Vulture funds in the Sovereign Debt Context", supra n.4, §3

[14] *Republic of Argentina v. NML Capital Ltd et al.* Brief for the Republic of France as amicus curiae in support of the Republic of Argentina's petition for a writ of certiorari. No. 13-990. p/ 16.

restructurings are not limited to final settlements, but include costs arising from delayed process, often for years, and that generally are not accounted for. Should therefore the material costs of lack of good faith from the start be included in debt restructuring processes involving vulture funds and should vulture funds be held responsible for these costs because of lack of good faith?

Some scholars argue that vulture funds play an important role in the stabilization of distressed sovereign debt markets as they provide a safety net to other investors who would normally face large losses when a government defaults. Institutional investors do not like to sue sovereigns and will, instead, search for ways to avoid damaging future relationships with sovereign debtors by selling the defaulted debt to vulture funds. Furthermore, these scholars typically argue that raising legal limitations on secondary market trading or on the possibility to litigate in order to enforce a contract may severely affect borrowing costs for sovereigns.[15] However, in the event of a sovereign debt crisis, sovereign bonds held by vulture funds generally constitute a small fraction of the outstanding debt. The disruptive effects of holdout litigation are very likely to largely outweigh any benefits in terms of increased market liquidity arising from vulture funds bond purchases. Indeed, the chances to succeed in recovering the full face value of sovereign bonds are inversely related to the relative weight of rogue holdouts among all creditors: Should the majority of creditors decide to oppose debt restructuring and ask for full repayment at face value in the courts, they would stand no realistic chance of succeeding.

From this perspective, minority creditors, rather than helping the case of involuntary holders of distressed debt, challenge restructurings designed principally for the benefit of the majority. They make large gains to the detriment of other less aggressive creditors: Any preferential payment to vulture funds reduces the size of payments that can be made to other creditors under restructuring plans. Finally, by holding out on restructuring plans, including plans that are acceptable to the vast majority of creditors, holdout litigation increases the costs of restructuration.

(iii) *Vulture funds engage in aggressive litigation to obtain potentially spectacular financial returns on discounted sovereign debt instruments*. This last and most prevalent feature of vulture funds raises a whole array of

[15] Fisch J and C. Gentile (2004). "Vultures or Vanguards? The Role of Litigation in Sovereign Debt Restructuring" *Emory Law Journal* 1047. According to the authors, "*[j]udicial enforcement of sovereign debt obligations enhances the operation of the sovereign debt market by lowering the cost of financing to sovereign debtors and increasing the value of the obligations to creditors*".

legal, economic and ethical issues, the most important of which can be summarized as follows.

First and at the most basic level of discussions, the question is one of opposing core principles; those defending the activities of vulture funds refer to the sanctity of contracts. Unless contracts, entered into voluntarily in a formal sense, are respected in full, the whole of legal edifices is called into doubt. In this view, this is a potentially (too) high price to pay to take on board the economic, social and political distress caused to large communities by the even then admittedly - borderline activities of vulture funds.

Those regarding the activities of vulture funds as an aberration from core values underlying the productive workings of decentralized market economies and their legal frameworks – such as good faith, legitimacy, impartiality, transparency and sustainability (see e.g. UNCTAD Roadmap and Guide to Sovereign Debt Workouts[16]) – agree with the well-known Financial Times columnist Martin Wolf: "*Servicing debt is indeed important. But it is not more important than everything else*."[17] In this latter view, legal frameworks are the servants of economic prosperity, as well as of social and political stability, not their master. Their core role is to eradicate abuse and to ensure economic and political prosperity and stability. This argument has gained much moral and ethical ground in particular in relation to *Heavily Indebted Poor Countries* (HIPCs) and the additional burden on their general plight imposed by the activities of vulture funds, but is not limited to such cases. The more general case is that pay-outs to vulture funds outside restructuring deals weigh heavily on government expenditures and on their populations, entailing restrictions on basic social provisions such as health and education affecting human dignity.[18]

Second, in the absence of a multilateral system to address sovereign debt restructurings in an orderly fashion, the weight of domestic courts, judges and jurisdiction in allowing and ruling upon litigations brought by vulture funds is very strong. Ad hoc domestic rulings, such as the recent ruling of a New York circuit judge on *NML Capital Ltd vs the Republic of Argentina*,

[16] http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=987&Sitemap_x0020_Taxonomy=UNCTAD%20Home;#4;#Globalization%20and%20Development;#1705;#Debt%20and%20Development%20Finance

[17] Martin Wolf " Holdouts give vultures a bad name", Financial Times, September 2014

[18] United Nations General Assembly, Human Rights Council. A/HRC/33/54. See also Stiglitz J. and M. Guzman http://www.socialeurope.eu/2015/06/a-rule-of-law- for-sovereign-debt/

tend to disregard not only the cost paid by entire countries and their citizens, but also that to other (restructured) creditors, thus deepening the already high fragmentation of deepening the already high fragmentation of mechanisms to address sovereign debt resolution. In addition, vulture funds target sovereign states with distressed economies and frequently with a weak capacity for legal defense[19].

In sum, the mentioned characteristics of the vulture funds business and the potential damage of their activities are a source of concern and require international policy coordination. A particular concern is that prominent holdout have often filed lawsuits through one of their lesser-known subsidiaries, or funds created ad hoc, usually based in offshore tax havens, adding opaqueness to their operations. Often, affiliated entities are set up by these larger hedge funds for the sole purpose of pursuing a single borrower. Some vulture funds tend to be quite secretive and there is limited or no information on who owns them, raising questions about the implementation of Anti-Money-Laundering (AML) and Centre for Financial Training (CFT) principles. As Theo Phanos, founding partner of Trafalgar Asset Managers, a London-based hedge fund buying distressed European debt, told the Financial Times: "*We thrive on people being misinformed*"[20].

C. VULTURE FUNDS IN ACTION IN SOVEREIGN BOND MARKETS

Vulture funds began to operate more systematically in sovereign debt markets since the early 1990s, following the Brady Plan in response to the Latin American debt crisis of the 1980s. This plan put into place a process of 'financial dis-intermediation' between sovereigns and lenders, through the conversion of bank loans into tradable securities. The rise of debt-offerings distributed through the capital markets in the 1990s and the attendant opportunities for arbitrage in the secondary markets eventually boosted the vulture funds industry.

The terms of international bonds issued by developing countries have included legal 'sweeteners' to make the securities more appealing to investors. These include covenants regarding jurisdiction, applicable law or even sovereign immunity waivers. New York state law and English law are the prime systems of governing law with regard to sovereign debt

[19] A/HRC/33/54

agreements[21]. In both cases, the law has a restrictive approach to state immunity. The United States *Foreign Sovereign Immunities Act* (FSIA) of 1976 and in the United Kingdom *State Immunity Act* of 1978, provide that sovereign immunity does not automatically apply with regard to 'commercial activities' —including borrowing— of foreign states. The limits to the scope of sovereign immunity that, at least until the mid-twentieth century, had protected sovereigns from the interference of foreign courts' judgments, has significantly improved the leverage of creditors in restructuring processes[22].

While the activities of vulture funds in sovereign debt can be traced back to as early as the 1970s, the first major successes for professional plaintiffs in sovereign debt litigation for professional go back to restructurings launched under the Brady initiative.

In 1992, the *CIBC Bank and Trust Company* —a Cayman Islands company owned by the Dart family, one of whose members, Kenneth Dart, went on to found the vulture fund *Dart Management Limited*— bought $1.4 billion of Brazilian sovereign debt at a discounted price of $375 million. This purchase made the Dart family the owners of 4% of the country's external debt and the nation's largest private creditors. Subsequently, the Darts refused to accept the terms of the debt restructuring negotiations of Brazilian debt worth $49 billion and litigated in New York Courts, obtaining a favourable judgment in 1994. Two years later, in an out-of-court settlement, Brazil agreed to pay accumulated due interest, and the vulture fund was able to sell its entire stake in Brazilian debt at a substantial profit (estimated at 161%) [23] Around the same time, the hedge fund *Elliott Associates L.P.* —managed by *Elliott Management Corporation*— won cases against Peru and Panama, also in New York courts. In the case of Peru, Elliott had bought $20 million worth of debt for approximately $11millon, receiving $58 million when Peru eventually settled..

Vulture fund litigation proliferated with the rise of international capital markets and large bond issuances in emerging and frontier market economies. Out of all litigation cases against

[21] Sovereign bonds governed by the laws of New York and England are estimated to represent approximately 48 per cent and 40 per cent of the notional amount of the outstanding stock of international sovereign bonds, respectively. International Monetary Fund (2014). "Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring", October, Washington D.C.

[22] See M.C. Weidemaier (2014). "Sovereign Immunity and Sovereign Debt". U. Ill. L. Rev. 67, 68

[23] New York Times (1996). "Brazil settles a suit with Dart family". Available at: http://www.nytimes.com/1996/03/20/business/brazil-settles-a-suit-with-dart-family.html?_r=0

sovereign debtors since the 1970s, 42.5% have been carried out in the 1990s and 45.8% in the 2000s[24]. More than 50% of all lawsuits since the 1970s have been filed by hedge funds, and 25% have been filed by commercial banks. Hedge funds have increasingly become the predominant plaintiff in lawsuits against sovereign debtors and represent 75% of all litigation cases since the year 2000. Commercial banks have also sued debtor states, holding back debt for a profit. Thus, in 2005, Grenada was sued by *Ex-Im bank*. Similarly, other commercial creditors have filed litigation against sovereigns. In 2009, Liberia lost a lawsuit filed in 1994 by the *Continental Grain Company*[25] in a United States court which awarded a sum of about $8 million to be paid to the company.

In the wake of the Brady plan and financial deregulation across many core jurisdictions and financial activities, major financial centers started to adopt legislation to limit the scope of sovereign immunity that, until then, had protected sovereigns from the interference of foreign courts' judgments. Creditors have become increasingly creative in trying to recover their investments and have benefited from the erosion of the unenforceability of the collection of state assets. A series of judicial decisions under New York legislation over the past thirty years has undermined or eliminated key state defences. Sovereign borrowing came to be considered a 'commercial activity' in 1992—thus lacking immunity under the Foreign Sovereign Immunities Act (FSIA)—with the Supreme Court decision in *Republic of Argentina v. Weltover*[26]. Moreover, the Judiciary Law 489 passed in 2004 eliminated the Champerty defence for debt above $500,000 under New York law. The Champerty doctrine, that originated in English common law and was later adopted by state legislatures in the United States, forbids as an abuse of process the purchase of debt with the intent, and for the purpose of, bringing a lawsuit[27].

The proportion of lawsuits in which creditors have attempted to seize sovereign assets has increased from around 20% in the 1990s to more than 50% in the past decades. 56% of

[24] Schumacher, J., C. Trebesch and H. Enderlein (2014). "Sovereign Defaults in Court". http://ssrn.com/abstract=2189997 or http://dx.doi.org/10.2139/ssrn.2189997

[25] *Continental Grain, et al v. Republic of Liberia, et al*. https://www.unitedstatescourts.org/federal/nysd/121318/

[26] The United States Supreme Court had to decide whether Argentina's default on certain bonds issued as part of a plan to stabilize its currency was an act taken "in connection with a commercial activity".

[27] Blackman, J.I. and R. Muckhi (2010). "The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna", *Law and Contemporary Problems* 73(4), September.

litigation cases filed by vulture funds have involved at least one attempted asset seizure, against 21% for cases filed by other creditors[28]. In recent cases, creditors have tried to attach assets to their cases that did not directly belong to debtor states but had the potential to be 'state commercial assets'. Hence, in the case of the Democratic Republic of Congo (DRC), some creditors attempted to seize assets owed to the state: *FG Hemisphere* and *Af-Cap*[29] tried to seize royalties and tax obligations owed by state-owned oil companies. Courts determined that those royalties and tax revenues constituted 'commercial activities' as they had previously been used to repay commercial debt located in the United States. Other vulture funds went after other creditors, such as *Kensington International Ltd* who sued *BNP Paribas*[30]. The same fund also sued the DRC in 2007[31] and seized funds earmarked for development. In an attempt to obtain an application of a judgment against the Republic of Argentina, holdout creditors laid claim on the country's Central Bank's foreign reserves held in a *Federal Reserve Bank of New York* account, arguing that the institution was not independent and was the 'alter ego' of the government[32]. The US Court of Appeals ruled in favour of Argentina's Central Bank, on the basis that the FSIA explicitly protects central bank assets from judicial interference, independently of the status of the central bank regarding its independence or links with the government. In some countries where no statutory protection existed for assets held by foreign central banks, like Spain, France, Slovenia and China, legislators have adopted specific legislation to protect foreign-exchange reserves[33].

NML Capital filed a lawsuit against Argentina in California in 2014 to block Argentina from launching satellites into space. Vulture funds have also attempted to seize the presidential plane, and have detained an Argentine military naval vessel at the Ghanaian coast. *NML Capital* was behind the freezing, in May 2015, of Argentina's government accounts in Belgium and France, including banking accounts used by Argentine embassies and various other

[28] Schumacher, *et al. op.cit*.

[29] *Af-Cap, Inc. v. Republic of Congo*, 383 F.3d 361 (5th Cir. 2004, *FG Hemisphere Associates v. République du Congo*, 455 F.3d 575 (5th Cir. 2006).

[30] *Kensington International, Ltd. v. BNP Paribas S.A*., Case No. 03602569 (Sup. Ct. N.Y. Co. 2003, unpublished opinion)

[31] *Kensington International Ltd v Republic of Congo & Ors* [2007] EWCA Civ 1128 (07 November 2007)

[32] EM Ltd. v. Republic of Argentina, 473 F.3d 463 (2d Cir. 2007) (cert. denied, 128 S. Ct. 109 (2007). The case originates in Argentina's default on more than $80 billion of debt in 2001, with 91% of creditors agreeing the terms of the restructuration, but with active holdout creditors engaging in various attempts to recover the full value owed.

[33] See Wautelet, P R (2011). "Vulture Funds, Creditors and Sovereign Debtors: How to Find a Balance?". *Insolvabilité des Etats et Dettes Souveraines*, *M. Audit, ed*., LGDJ.

Argentine public bodies or missions to international institutions such as UNESCO. Such attempts to attach sovereign assets outside national borders have rarely been successful, but have exerted a tremendous amount of pressure on debtor states and their economies, not least through related costly lawsuits.

Holdouts have also succeeded in suing states for breaches of the *pari passu* clause, a standard provision in unsecured debt obligations that prevents the borrower from changing the ranking of their obligations, and thus from subordinating a creditor. They also benefited from powerful injunctions placed on the *pari passu* clause..

In the case of *Elliott Associates L.P. v. Banco de la Nacion* (a stated-owned bank in Peru), the litigants obtained a favourable judgment in New York and an order to attach all property used for commercial activity in the United States. Peru circumvented New York in order to fulfil its payment obligations under the Brady Bonds and start processing payments in Europe. In 2000, *Elliott Associates L.P* initiated legal proceedings in Belgium based on the enforceable judgements in place from New York courts. Regarding the *pari passu* clause, Elliott argued that the debtor was in breach of this clause because, by paying one creditor, it should also be paying its other creditors *pro rata* so as to not subordinate any creditors. The request was eventually granted by the Belgium courts, which accepted Elliott's argument and attached deposited payments to Brady bondholders being channeled through the *Euroclear* system. This potent injunction forced Peru to choose between defaulting on the exchanged bonds or paying holdouts. In order to avoid a default on its Brady Bonds, Peru finally settled and paid *Elliott Associates* in full.

A similar enforcement device based on the *pari passu* clause was presented in *NML Capital, Ltd. v. Argentina* (*NML Capital* is a Cayman Islands affiliate of the aforementioned *Elliott Management Corporation*). The New York District Court held that Argentina was in breach of the *pari passu* clause contained in its unrestructured bonds and ordered Argentina not to make any payments on restructured bonds unless it also made a ratable payment to the holders of the old bonds[34]. The New York

[34] From a market-participant perspective, it was far from clear that the *pari passu* clause meant in practice that any payments by the debtor to a bondholder would confer on it the status of preferred creditor, as understood by the Court. The *International Capital Market Association* (ICMA), the largest trading association representing bondholders, underwriters, issuers and financial intermediaries felt compelled, after the NML v. Argentina decision, to promulgate model *pari passu* clauses for use in sovereign bonds that expressly disavow the court's ratable payment interpretation of the provision. The International Monetary Fund

Appeals Court upheld the ruling, and the Supreme Court declined Argentina's request to review the case. The judge also issued an injunction preventing anyone (including settlement houses and paying agents) from helping Argentina avoid the order. For almost two years, Argentina refused to pay the vulture funds while continuing to deposit funds to investors who had agreed to debt exchanges in 2005 and 2010[35]. However, due to the blockade, the funds could not be successfully channeled to the bondholders, so that the country fell into 'technical' default despite having initiated usual service payments[36]. In early 2016, Argentina offered a settlement in cash to the vulture funds, recognizing past due interests, compensatory rates and litigation costs. Leading litigants received $4.65 billion in cash, and some vulture funds, a return of 800% on their original investment[37].

Greece also fell victim to *Elliot Associates* and *Dart Management* in the context of €200bn of debt restructuring in 2012. Holdouts kept around €6.4bn in old Greek bonds, overwhelmingly concentrated in bond issuances governed by international law. Local law bonds were retroactively fitted with collective action clauses (CACs), which facilitated a haircut agreed with the majority of creditors. Greece has so far elected to repay all holdouts in full.

More recently, the vulture fund *Gramercy*, filed a $1.6 billion claim for arbitration against Peru under the country's free trade agreement with the United States. In 2006, the hedge fund bought defaulted bonds issued in 1969. The 2013 Constitutional Court recognized the debt, governed under Peruvian law, but left *Gramercy* with as little as $12 million. *Gramercy* has filed a claim against Peru arguing that the "indirect expropriation" violated several articles of the agreement.

Not all vulture funds have been successful. The case of *LNC Investments* against Nicaragua was settled in 2008 under the country's Debt Relief Initiative. It is assumed that *LNC* received payment on the same terms as other creditors participating in the donor-funded buyback (45 cents to the dollar), therefore obtaining only a

(IMF) also noted "*While a handful of commentators have supported the interpretation offered by NML, the majority have supported the view that the typical pari passu clause does not require ratable payments, noting that this is consistent with the market understanding of the clause*". IMF (*op.cit*, p.41).

[35] The injunction was also applied for the restructured bonds governed by Argentine Law or English Law.

[36] The Argentine government also (unsuccessfully) tried to circumvent the injunction replacing the payment agent and inviting bondholders to swap their bonds to new ones governed by Argentine or French law.

[37] "This fund made an 800% return on Argentina debt". CNN Money (2/3/2016). Available at: http://money.cnn.com/2016/03/02/news/economy/hedge-funds-argentina-debt/

return of 7% on their initial investment after 20 years of litigation. *Hamsah Investments* and *Wall Capital* bought Liberia's debt from other creditors and continued their lawsuit, but the case was settled in December 2010 through a buyback at 3% of the face value following 8 years of litigation. Of 55 cases of litigation brought against sovereign debtors in the 2000s, 5.45% failed.[38] In some cases the opaqueness of vulture funds actions has resulted in the transaction being judged illegal. This has, for example, been the case of the Democratic Republic of the Congo's debt, a 30-year-old debt from Yugoslavia to Zaire that was sold to *FG Hemisphere*. The UK Privy Council ruled in 2012 that the transaction was illegal and blocked *FG Hemisphere*[39] from collecting $108.3 million on its investment into this particular debt.

D. THE ECONOMIC AND SOCIAL CONSEQUENCES OF VULTURE FUND LITIGATION

Predatory practices of vulture funds have been called into question from different angles, based on:

i. the adverse effect of debt repayments under predatory conditions and of legal fees on the state's public finances and economic growth (direct impact).
ii. the adverse consequences of litigation on borrowing costs for states and on their access to external finance (indirect impact).
iii. the adverse impact of litigation on international financial and trade flows as well as on the functioning and the integrity of financial markets.

More broadly, vulture funds activities have been argued to be inherently exploitative and illegitimate. Thus, the Advisory Committee of the UN Human Rights Council on vulture fund activities maintains that "*seeking the repayment in full of a sovereign debt from a State that has defaulted, or is close to default, is an illegitimate outcome*" and condemns the activities of culture funds "*for the direct negative effect that the debt repayment to those funds, under predatory conditions, has on the capacity of governments to fulfil their human rights obligations, particularly economic, social and cultural rights*."[40]

[38] Schumacher, J et al, *op.cit*. . This number does not include out of court settlements that are not in favor of the creditor.

[39] La *Générale des Carrières et des Mines* ('Gécamines') v *F.G. Hemisphere LLC* ('Hemisphere') [2012] UKPC 27.

[40] A/HRC/33/54.

i. Immediate consequences of holdout litigation on public finances and development

Restructurings are a legitimate and sometimes essential exit mechanism out of debt crises allowing countries to ensure the provision of basic public services and instigate economic recovery. Preferential settlements of claims outside of a consensual workout process thus have the potential to deprive nations of much-needed resources to support welfare-enhancing policies. Even where governments may have to shoulder some blame for financial mismanagement, holdout litigation penalizes citizens by claiming or blocking funds otherwise available for furthering the social good.

Evaluating the impact of holdout settlements on fiscal budgets is not straightforward. A rigorous evaluation will require counterfactual assumptions, such as estimating what would have happened if all creditors had cooperated in the restructuration process. It furthermore requires considering the form of the settlement, cash or new debt, and taking into account all legal fees associated with the litigation (that can drag on for years), with the corresponding discount rates and so on. Table 1 displays the most rudimentary indicator for selected countries having faced an adverse court ruling. This simply compares the face value of settlements to GDP and to budget expenditures, measured in the corresponding year. The impact of vulture fund or holdout creditors can represent up to 7% of GDP or up to 25% of public expenditures[41]. This basic measure does not include legal fees incurred by states throughout often long drawn-out litigation. In some cases, the ratio of legal costs to debt service obligations can reach up to 200%. In response to this problem, the African Development bank launched its *African legal support facility* in 2009 to provide support to countries facing litigation from creditors.

[41] In the case of HIPCs, the IMF has reported that in some cases the claims by commercial creditors constitute as much as 12 to 13 per cent of a country's GDP. However, this measure corresponds to the whole universe of litigants, including vulture funds but also commercial banks involved in trade credit (that are actually "true" lenders).

Table 1. Value of settlements

Country	Case	Year	Amount		
			US$ (millions)	% GDP	% Public Expenditures
Argentina	*NML, Aurelius Capital Management, Dart Management, Blue Angel Capital, etc. v. Argentina*	2016	7600	1.6	3.7
Panama	*Elliott v. Panama*	1996	26.3	0.3	1.3
Peru	*Elliott v. Peru*	2000	58.0	0.5	2.2
Zambia	*Donegan v. Zambia*	2005	15.5	0.2	0.9
Republic of Congo	*Kensington v. Congo* *FG Hemisphere v. Congo*	2002	207.9	6.8	24.5

Sources: World Bank, World Development Indicators, press articles, Standard and Poor's.

The main concern is that large repayments tend to hurt a country's ability to ever emerge from a debt crisis. This is worrisome for developing countries, in particular for the group of vulnerable countries, including ex-HIPCs. Vulture fund activities may represent a considerable social cost of lost revenue for poverty reduction and limit debt relief: the resources saved from the global movement to cancel debt eventually fall into the hands of vulture funds and are diverted away from social expenditures, undermining the development of the most vulnerable.[42]

ii. Borrowing costs and access to market financing

Beyond immediate costs, such as settlement payments and legal fees, holdout litigation is also associated with a loss of access to international capital markets or higher borrowing costs, reducing governments' borrowing options[43]. This happens through various channels:

First, delays in crisis resolution tend to have an adverse impact on sovereign debt country ratings. During restructuring processes, ratings are lower and spreads are higher, making costs of funding more expensive. For example, in Argentina, legal threats seen to potentially impair the country's ability to service future debt has been repeatedly mentioned as a factor affecting creditworthiness assessments by leading credit rating agencies.[44]

Second, the perceived risk of lending to a country involved in litigation may increase, if investors include in their expectations the threat of creditor attachment, implying a virtual blockade on capital flows to the country. This risk may have significantly increased after the *pari passu* injunctions issued by courts in the aforementioned cases of Peru and Argentina—prohibiting a country from paying existing holders of restructured

[42] This behaviour has incurred much public opprobrium: it often represents a cynical attempt to exploit the willingness of other creditors to grant debt relief to a sovereign borrower. See also Buchheit Lee C. and G. Mitu Gulati (2010). "Responsible Sovereign Lending and Borrowing", 73 LAW & CONTEMP. PROBS. 63, 64, 69–70.

[43] Pitchford R. and M. L. J. Wright (2012). "Holdouts in Sovereign Debt Restructuring: A Theory of Negotiation in a Weak Contractual Environment," *Review of Economic Studies*, Oxford University Press, vol. 79(2) ; and and Schumacher (2014) et. al, op. cit. provide empirical evidence that links litigation to loss of market access.

[44] Following the announcement by Argentine authorities to enter into negotiations with vulture funds, Standard and Poor's noted: "[W]e will reassess the sovereign's general credit standing, most likely raising the foreign currency rating to the 'CCC' or low 'B' categories, depending to a large extent on our assessment of the government's ability to implement its economic reforms and on any possible lingering legal threats that could impair its ability to service future debt.". Standard and Poor's (2016). *Research Update: "Argentina Local Currency Ratings Raised To 'B-/B'; Outlook Stable; Foreign Currency Ratings Remain 'SD/SD'* " 3/2/2016.

debt or new debt unless holdout investors are paid as well— and therefore increasing the risk of a future technical default.

Third, litigation may result in market exclusion, which is a channel traditionally emphasized in the reputation literature. [45] Although the default history of a country may weigh more on reputation than other factors, vulture funds lobby energetically to force policy outcomes that make their bets pay off. In the case of Argentina, vulture funds financed the *American Task Force Argentina* (ATFA), a lobbying group behind media campaigns hostile to the Kirchner Fernandez government pushing to block the country's access to multilateral credit and capital markets, and trying to link the country to terrorist activities and other atrocities. The executive director of ATFA once told the press that "*[m]embers have come in and out over the years, and I expect will continue to do so as long as Argentina fights so hard to avoid its commitments* (…) *That's the sole reason we've come together; that's the sole interest of the task force—to draw attention to Argentina's misbehaviour*." One of its members, also representing a U.S. farmer association, called Argentina's debt default "*a manipulative practice to drive down the value of their currency and create an unfair export incentive for their country's agricultural products*." [46]

iii. Other spill-over effects

Finally, holdout litigation can induce inefficiencies in trade and financial markets. Thus, trade financing could be cut off and countries may need to trade in roundabout ways to avoid seizures. Litigious creditors may also impair trade, as in the case of Republic of Congo where holdouts blocked the country's oil exports for years. In the 1990s, litigating creditors also successfully attached trade revenues in Ecuador and Zambia from oil and copper exports, respectively.[47]

By seeking full debt repayment, holdouts do not get involved in the loss-bearing and loss-sharing process inherent to a debt crisis resolution. Their refusal to cooperate lengthens the restructuring process resulting in higher costs for all market participants. If, in the event of a sovereign debt crisis, creditors understand that the legal enforcement

[45] Sturzenegger, F, and J. Zettelmeyer (2007). "Creditors' Losses versus Debt Relief: Results from a Decade of Sovereign Debt Crisis." *Journal of the European Economic Association*, 5(2–3): 343–51 The authors suggest that litigation can have adverse implications for market access and investments, partly due to the reputational damage that legal disputes can entail.

[46] Wall Street Journal (15/10/2012) "Argentine Lobby Mystifies 'Members'." http://www.wsj.com/articles/SB10000872396390444657804578050923796499176

[47] Schumacher (2014) *et al.* Op.cit.

advantages conferred on rogue holdouts are large, they may be discouraged from accepting any haircut and wait to obtain 'me too' treatment, an outcome that is clearly to the detriment of the majority of bondholders. In addition, the incapacity to organize successful debt restructurings is likely to deepen debt crises and therefore increase the risk of contagion, either to the financial markets or to other countries.

Enforcement instruments or devices based on the *pari passu* injunction may also have adverse consequences for the normal functioning of the international financial system. Argentina's experience shows that the New York courts, by imposing a ruling on financial institutions operating in different countries, exerted *de facto* universal jurisdiction, thereby impinging on other countries' sovereignty and rule of law. By meeting its obligations under the *pari passu* injunction —*i.e*. not to process payments to bondholders— Citibank was forced to violate Argentine law and to stood to lose its banking license, which would have been a "catastrophic and irreversible harm" to the bank.[48] Citibank finally choose to close its Argentine branch and execute a plan to exit the custody business for Argentine bonds, including for those governed by Argentine law. Other institutions involved in processing payments for bonds issued under English and Japanese law faced conflicting orders. In February 2015, an English Judge ordered *BoNY Mellon* to transfer payments to clearing houses (*Euroclear* and *Clearstream*) of Argentine restructured bonds governed by English Law, an order that, if complied with, would have defied the New York order. *BoNY Mellon*, incorporated under New York law and with its registered office in New York, decided not to be cited for contempt in its own jurisdiction.[49] A Belgian court also ordered *BoNY Mellon* to transfer payments to holders of bonds in euros, but to no effect.

Last, but not least, the business model of vulture funds could impair financial market integrity. According to the World Bank, "*[f]inancial market integrity matters for development. Countries' financial systems must be transparent, inclusive, and function with integrity to ensure economic development and promote good governance*". As mentioned,, prominent holdouts have often filed lawsuits through subsidiaries, sometimes

[48] *Further Citibank letter to Judge Griesa regarding stay application* 13/3/2015. Case 1:08-cv-06978-TPG, Document 764. Filed 03/13/15

[49] Bloomberg (13/02/2015), "Argentina's Bond Mess Gets Slightly More Complicated". Available at: https://www.bloomberg.com/view/articles/2015-02-13/argentina-s-bond-mess-gets-slightly-more-complicated

based in non-cooperative jurisdictions, that tend to be secretive with limited or no information regarding ultimate ownership. Such activities may then leave the financial sector unprotected from abuse and reputational risks that undermine its core functions.

E. OPTIONS FOR IMPROVEMENT

Concerns about holdout litigation have acquired urgency as a result of the proliferation and success of vulture funds and the growing recognition that vulture practices undermine countries' development efforts. Fears that developing countries, in particular those for which revenues rely on commodity exports, may in the future face difficulties in serving debts, have accentuated the need neutralize the threat posed by vulture investors. A growing consensus has emerged on the need to tackle the activities of vulture funds and actions have been taken in different fronts, to insulate countries from the opportunistic behaviour of non-cooperative creditors.

i. Domestic regulation to mitigate vulture fund activities

Protection of sovereign states from vulture investors can be strengthened at the domestic level through legislative action. The enactment of national legislation is particularly needed in jurisdictions that govern international bonds or where payments are processed. Some countries have already carried out reforms by passing new laws.

In July 2015, in Belgium, home to a major global clearinghouse, the parliament adopted a bill "to combat vulture fund activities". The new law introduces a ceiling for the amount the vulture funds can reclaim from government bonds bought at highly discounted prices from economies close to default. The law allows Belgian judges to stop vulture funds from claiming repayment above the discounted market price it paid for government bonds, for example at original face value. This follows earlier legislation, adopted in March 2013, to prevent creditors' seizure of funds earmarked for development and taking "illegitimate advantage". The *United Kingdom Debt relief Act* of 2010 prevents vulture funds from gaining massive profits from debt restructuring in developing economies. The legislation is less stringent and comprehensive than the new Belgian legislation and it is limited specifically to the HIPCs[50]. More generally, this avenue of working through national legislation could be particularly effective if principles included in UNCTAD's roadmap and guide for sovereign debt workouts were adopted in jurisdictions that govern international bonds.[51]

From the perspective of developing countries, governments issuing international debt should avoid waiving their sovereign immunity to foreign jurisdictions, and if they deem this strictly necessary, they should only resort to jurisdictions where the law protects bond issuers from vulture funds, as in Belgium.[52]

ii. Market-based solutions: refinements to debt contracts

In order to achieve a more predictable sovereign debt restructuring process, and to discourage non-cooperative holdout strategies in sovereign debt restructurings, many relevant market participants and international institutions, including the IMF, have encouraged the adoption of Collective Action Clauses (CACs) in international bond contracts.

CACs allow a supermajority of bondholders to agree to changes in bond payment terms that are legally binding on all bondholders and which then apply to all bondholders. However, CACs may fail to stop holdouts, if they manage to block the building up of a majority group in any particular bond issue. Market-based institutions, including the *Institute of International Finance* and the *International Capital Market Association* (ICMA) have proposed the formulation of a model of aggregated CACs for sovereign bonds that addresses this possibility[53]. Those institutions recommend a threshold of at least 66% of creditor participation for aggregated bonds, as well as a threshold of more than 50% participation for each individual bond series.

The ICMA also issued a new model *pari passu* clause that excludes any right to ratable payment by creditors preventing ruling, such as those in the aforementioned cases of Peru and Argentina.

[50] UNCTAD *Trade and Development Report 2015*, p.144.

[51] It is worth noting the multilateral progress in tackling vulture funds, including from the Paris Club that committed not to sell claims on HIPCs to creditors who do not intend to provide debt relief. See *Press Release of the Paris Club on the threats posed by some litigating creditors in Heavily Indebted Poor Countries,* Paris Club (May 22, 2007).

[52] Experts have suggested a number of initiatives that include prohibiting commercial or public entities based to invest in vulture funds, regulate the sovereign debt secondary markets limiting the access of buyers having been identified as vulture fund.

[53] https://www.iif.com/news/iif-participated-discussions-icma-model-aggregated-cacs-sovereign-bonds

Prominent analysts have also suggested actively using exit amendments in sovereign bond exchanges to address holdout creditors[54]. For example, the terms of a debt restructruing could stipulate, as a condition to participate in the exchange, that bondholders agree to vote in favour of a resolution that amends the terms of the existing bonds, so as to remove most of the protective covenants (such as cross-acceleration clauses or the listing requirement) and to negatively affect their value, or even destroy it completely. One example is the inclusion of a provision in non-restructured bonds allowing the debtor to redeem the bonds at a near zero value. This would discourage prospective holdouts. This solution does not require the use of CACs under New York law. Clauses preclude any changes to the payment terms of the bonds without the consent of each affected bondholder. However, any other provision of the bond can be amended with the consent of the issuer and a minimum threshold, which has often been set as low as 50 per cent.

While the legality of the most coercive exit consents have frequently been questioned, making it a controversial issue, the IMF has expressed support for to the use of the amended *pari passu* clause and the introduction of more robust CACs in bonds governed by foreign law.

Nevertheless, as recognized by the IMF[55], contractual refinements to sovereign bonds do not solve potential problems with debt restructurings in the future. Even if all new contractual provisions were included in new international sovereign issuances, these would not apply to the current stock of international sovereign bonds, estimated at more than $900 billion. In addition, New York law governs more than half of international bonds in a context in which at least past decisions by New York judges have been broadly favourable to holdouts.

iii. Principles-based approaches and beyond[56]

Many have argued that approaches to improve sovereign debt restructurings that rely solely on strengthening the legal underpinnings of bond markets, introducing strong collective action clauses in contracts and clarifying the *pari passu* (equal treatment of bondholders) provision, as well as promoting the use of GDP-indexed or contingent-convertible bonds, are

[54] Buchleit Lee C. and Gulati, G. Mitu (2000). "Exit consents in sovereign bond exchanges". *UCLA Law Review 59*.

[55] IMF(2014), *op. cit*.

[56] For more detailed discussion, see Special Edition on Sovereign Debt. *The Yale Journal of International Law Online*. Vol. 41 (2). Fall 2016. Free online access at: http://campuspress.yale.edu/yjil/volume-41-special-edition/

insufficient. In this view, this approach is voluntary and consensual but misses large chunks of the debt market and does little to support recovery and a return to sustainable growth.

A second option focuses on building a consensus around soft-law principles to guide restructuring efforts. These would apply to all debt instruments and could provide greater coordination than the market-based approach. As mentioned, in September 2015 the UN General Assembly adopted resolution A/RES/69/319 on "Basic Principles for Sovereign Debt Restructuring Processes" that,, establishes a set of of nine legal principles to guide sovereign debt restructurings, including sovereignty, good faith, transparency, legitimacy, equitable treatment and sustainability. Debates about how best to implement these Principles are ongoing (see footnote 64). Generally speaking, while these have the advantage of familiarity, they are non-binding, with no guarantee of the willingness of a critical mass of parties to adhere to them.

This problem can ultimately be resolved only through a set of rules and norms agreed in advance as part of an international debt workout mechanism, the third option. The contrast between strong national bankruptcy laws and their absence at the international level provides the rationale for this approach. Such a mechanism aims not just to facilitate an equitable restructuring of debt that can no longer be serviced according to the original contract, but to prevent financial meltdown in countries facing difficulties servicing their external obligations. Meeting these goals implies using accepted principles to guide and implement some simple steps: a temporary standstill on all due payments, private or public; an automatic stay on creditor litigation; temporary exchange-rate and capital controls; interim financing for vital current account transactions; and, eventually, debt restructuring and relief.

While the importance of adopting a multilaterally agreed sovereign workout mechanism goes far beyond the problem of holdout litigation, it would definitely close gaps in the current *ad hoc* system that are being exploited by vulture funds and allow them to obtain preferential settlements outside of a consensual workout process.