

**SPECIALISED TECHNICAL PAPER**

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**“Dealing with uncooperative creditors in sovereign debt workouts”**

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## SUMMARY

Uncooperative creditors in sovereign debt workouts are creditors who adopt opportunistic behaviours with the sole objective to take financial advantage of large gaps in the international governance of sovereign debt resolution. The most common type of uncooperative creditors are ‘vulture funds’. Such funds are increasingly perceived to pose a threat to debtor economies as well as the wider financial system, by imposing high costs on sovereign debt workout mechanisms.<sup>1</sup> This is particularly but not solely, objectionable in regard to the sovereign debt of Heavily Indebted Poor Countries (HIPCs). Overall, vulture funds have averaged recovery rates of around 3 to 20 times their original investment, equivalent to returns of 300 to 2,000 per cent.<sup>2</sup> The amounts obtained through litigations have amounted to up to 13% of a debtor state's GDP and have involved the seizure of development aid by private creditors.<sup>3</sup>

This paper sets out the core features of vulture funds, their history and legal and institutional options to limit their disruptive impact on developmental objectives. In line with ongoing discussions about how to reach sustainable development goals (SDGs), a number of questions are raised, regarding (1) the legal foundations of claims against vulture funds, (2) the identification of 'vulture'-like practices by commercial creditors and (3) ways of neutralizing such practices, at national and international levels. The paper highlights the ultimate need for multilateral action to create conditions conducive to orderly, predictable and efficient sovereign debt workouts at international level.

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<sup>1</sup> The Human Rights Council of the United Nations adopted a resolution in 2014 (A/HRC/27/L.26) condemning the activities of Vulture Funds

<sup>2</sup> African Development Bank "Vulture funds in sovereign debt context". Available from: <http://www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-legal-support-facility/vulture-funds-in-the-sovereign-debt-context/>

<sup>3</sup> Kensington International Ltd -v- Republic of Congo; CA 7-Nov-2007

## DEALING WITH UNCOOPERATIVE CREDITORS IN SOVEREIGN DEBT WORKOUTS

### A. WHAT IS A 'VULTURE FUND'?

Uncooperative creditors in sovereign debt workouts most commonly are financial institutions or funds trading developing country sovereign debt in secondary markets. Not all uncooperative creditors are financial institutions or funds, but those funds that have specialized in this activity are known as 'vulture funds' in the context of academic, legal as well as journalistic debate and publications. Vulture funds are usually hedge funds – that is, a limited liability fund pooling investor capital in securities and other financial instruments with no or little regulation for caps on leverage and specialized in highly liquid assets – but the reverse does not hold: Not all hedge funds are, of course, vulture funds.

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*".<sup>4</sup> Similarly, former independent expert on Sovereign debt and Human Rights, Cephias 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 judgements, with the aim of achieving a high return*".<sup>5</sup> 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 litigation through litigation, if necessary*".<sup>6</sup>

These basic definitions raise three core points that characterize a vulture fund:

- 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 to obtain payment at full face value of sovereign debt instruments, including interest payments, and a financial returns strategy based on the often very large difference between the discounted purchase value of a sovereign debt instrument and its face value.

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

*(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?

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<sup>4</sup> "Legislation to ensure effective debt relief for poor countries", HM Treasury Press Release 69/09, 21 July 2009, para 1.2

<sup>5</sup> 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, Cephias Lumina.

<sup>6</sup> AfDB "Vulture funds in the Sovereign Debt Context", supra n.4, §3

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) cheap 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."<sup>7</sup> 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 with the sole intention to block these*. This 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 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?

(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 legal, economic and ethical issues, the most important of which can be summarised 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<sup>8</sup>) – agree with the well-known *Financial Times* columnist Martin Wolf: "*Servicing debt is indeed important. But it is not more important than everything else.*"<sup>9</sup> In this latter view, legal frameworks are the servants of economic growth, as well as of social and political stability, not their master. Their core role is to eradicate abuse and to ensure social, economic and political prosperity and stability. This argument has gained much moral and ethical ground in particular in relation to heavily indebted poor countries (HIPC)

<sup>7</sup> AfdB "Vulture funds in the Sovereign Debt Context", supra n.4, §3

<sup>8</sup> [http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=987&Sitemap\\_x0020\\_Taxonomy=UNCTAD%20Home;#4;#Globalization%20and%20Development;#1705;#Debt%20and%20Development%20Finance](http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=987&Sitemap_x0020_Taxonomy=UNCTAD%20Home;#4;#Globalization%20and%20Development;#1705;#Debt%20and%20Development%20Finance)

<sup>9</sup> Martin Wolf " Holdouts give vultures a bad name", *Financial Times*, September 2014

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and the additional burden on their general plight imposed by the activities of vulture funds, but is not limited to such cases. 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*, tend to disregard not only the cost payed by entire countries and their citizens, but also that to other (restructured) creditors, thus deepening the already high fragmentation of mechanisms to address sovereign debt resolution.

## B. VULTURE FUNDS IN ACTION

Vulture funds began their operations in 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, essentially by allowing for the exchange of bank loans for bonds of either equal face amount but with a fixed and below-market rate of interest or a lesser amount of face value in bonds.

In 1992, Kenneth Dart, founder of Dart Management Limited (DML), bought \$1.4 billion of Brazilian sovereign debt at a discounted price of \$375 million. This made him the owner of 4% of the country's external debt and the nation's largest private creditor. Subsequently, DML refused to participate in debt restructuring negotiations of Brazilian debt worth \$49 billion, delaying the process by 6 months. Despite the conclusion of an agreement with other creditors, Dart forced pursued litigation until 1994, obtaining a rate of return on its initial investments in Brazilian debt of 161%. Around the same time, Elliott Management won cases against Peru and Panama, in New York courts, earning it returns of more than 50 million USD, respectively.

It is clear that the activities of vulture funds, while these can be traced back to as early as the 1970s, have expanded rapidly since the mid-1990s: out of all litigation cases against sovereign debtors since the 1970s, 42.5% have been carried out in the 1990s and 45.8% in the 2000s<sup>10</sup>. 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<sup>11</sup> in a US court which awarded a sum of about \$8 million to be paid to the company.

Prominent creditors have often filed lawsuits through one of their lesser-known subsidiaries, adding to the rather typical opaqueness of such operation. As Theo Phanos, founding partner of Trafalgar

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<sup>10</sup> Schumacher, Julian and Trebesch, Christoph and Enderlein, Henrik, Sovereign Defaults in Court (May 6, 2014).

<http://ssrn.com/abstract=2189997> or <http://dx.doi.org/10.2139/ssrn.2189997>

<sup>11</sup> Continental Grain, et al v. Republic of Liberia, et al  
<https://www.unitedstatescourts.org/federal/nysd/121318/>

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Asset Managers, a London-based hedge fund buying distressed European debt, told the *Financial Times*: “We thrive on people being misinformed”<sup>12</sup>. In some cases such opacity has resulted in the transaction being judged illegal. This has, for example, been the case of debt of the Democratic Republic of the Congo that was sold to FG Hemisphere. This was, in fact, 30 year old debt from Yugoslavia to Zaire. The UK Privy Council ruled in 2012 that the transaction was illegal and blocked FG Hemisphere<sup>13</sup> from collecting \$108.3m on its investment into this particular debt.

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 foreign sovereigns from the interference of courts. Creditors have become increasingly creative in trying to recover their money. 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 litigation cases filed by vulture funds have involved at least one attempted asset seizure, against 21% for cases filed by other creditors<sup>14</sup>. 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<sup>15</sup> 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 US. Other vulture funds went after other creditors, such as Kensington International Ltd who sued BNP Paribas<sup>16</sup>. The same fund also sued the DRC in 2007<sup>17</sup> and seized funds earmarked for development. In an attempt to obtain an application of the recent judgment against the Republic of Argentina, some creditors laid claim on the country's Central Bank's foreign reserves which had been earmarked to repay debt owed to the IMF<sup>18</sup>. To protect their assets, countries like Spain, France, Slovenia and China have adopted specific legislation to protect the assets of their central banks<sup>19</sup>.

Vulture funds have also targeted payment flows and pushed debtor states to technical default in Peru and Argentina. In Peru, Elliott Management tried to stop the country from paying its bondholders and to seize the payments to be made through the Euroclear System. In Argentina's case, holdout creditors have tried to seize the bonds of cooperative bondholder on the grounds that these will belong to the government of Argentina in the event of a successful restructuring. 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

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<sup>12</sup> 'Best Bargains found in the Abyss' *Financial Times*, October 2007, 2008

<sup>13</sup> *La Générale des Carrières et des Mines ('Gécamines') v F.G. Hemisphere LLC ('Hemisphere')* [2012] UKPC 27

<sup>14</sup> Schumacher, Julian and Trebesch, Christoph and Enderlein, Henrik, *Sovereign Defaults in Court* (May 6, 2014).

<sup>15</sup> *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)

Wautelet, Patrick R., *Vulture Funds, Creditors and Sovereign Debtors: How to Find a Balance?* (March 28, 2011).

*Insolvabilité des Etats et Dettes Souveraines*, M. Audit, ed., LGDJ, November 2011

<sup>16</sup> *Kensington International, Ltd. v. BNP Paribas S.A.*, Case No. 03602569 (*Sup. Ct. N.Y. Co. 2003, unpublished opinion*)

<sup>17</sup> *Kensington International Ltd v Republic of Congo & Ors* [2007] EWCA Civ 1128 (07 November 2007)

<sup>18</sup> *EM Ltd. v. Republic of Argentina*, 473 F.3d 463 (2d Cir. 2007) (*cert. denied*, 128 S. Ct. 109 (2007))

<sup>19</sup> See Patrick Wautelet, 'Vulture Funds, Creditors and Sovereign Debtors: How to Find a Balance?', *Insolvabilité des Etats et Dettes Souveraines* (LGDJ Lextenso editions, 2011) 39.

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detained an Argentine naval vessel at the Ghanaian coast. NML Capital was behind the freezing, in May 2015, of Argentina's government accounts in Belgium. Such attempts to seize ‘attached’ assets have exerted a tremendous amount of pressure on debtor states and their economies , not least through related costly lawsuits.

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 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<sup>20</sup>..

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<sup>20</sup> Schumacher, Julian and Trebesch, Christoph and Enderlein, Henrik, Sovereign Defaults in Court (May 6, 2014). (this number does not include out of court settlements that are not in favor of the creditor)

**Table 1: Vulture Funds in Action**

This table contains a selected number of cases based on their general significance.

Date of Judgement or Decision of Settlement	Country	Fund	Debt Purchased at (USD)	Jurisdiction	Payment Awarded
1994	Brazil	Vulture Funds around Kenneth B. Dart	375 million dollars, worth 1.4 billion	"out-of-court settlement" (negotiation with 750 banks and Cardoso's Government)	980 million USD
1996	Panama	Elliott Associates	17.5 million	NY District Court	57 million USD
1999	Peru	Elliott Associates	11 million	NY Federal Court of Appeal	58 million USD
1999	Nicaragua	Leucadia National Corporation (LNC Investments)	1.4 million	NY Federal Court (South District)	87 million USD
2006	Nicaragua	GP hemisphere LNC investments (subsidiary of Elliott Associates) Van Eck Emerging Markets Opportunities Fund	2.7 million	NY Federal Court (South District)	276 million USD
2004	Congo Brazzaville	FG Hemisphere	2.6 million	Court of Appeal of Jersey  Ruling overturned in 2012 by the Privy Council of England	108.3 million USD
2007	Congo Brazzaville	Kensington International Ltd. (subsidiary of Elliott Associates)	1.5 million	UK Court	300 million USD
2007	Zambia	Donegal International Ltd.	1.8 million	UK Supreme Court	31 million USD
2009	Liberia	Hamsah Investments and Wall Capital	6.5 million	London and New York	20 million USD
2012	Argentina	NML Capital Aurelius Capital	49 million	NY Court	1.33 billion USD
2012	Greece	Dart Management Ltd	Unknown	Brussels (no litigation, decision by bureaucrats)	90% of 436 <sup>21</sup> million euros

<sup>21</sup> This payment called for two other payments of 790 million and 540 million euros to creditors



## C. GOING FORWARD

Options to limit the harm done by uncooperative creditors and by vulture funds in particular range from domestic to international regulations, and from market-based to multilateral interventions.

### (i) Promoting national legislation and jurisprudential efforts

National legislation can act on different levers to deter creditors from adopting 'vulture'-like strategies. The most direct way is to act on access to litigation by such creditors. Following the restriction of the sovereign immunity doctrine<sup>22</sup>, defendants would invoke the Champerty defense. This refers to an English common law doctrine that prohibits, as abuse of process, the purchase of debt with the intent, and for the purpose, of bringing a lawsuit.<sup>23</sup> This doctrine was applicable (though not used) in the US until 2004 when it was eliminated by statute.<sup>24</sup> Following the famous case of *Elliott Associates L.P. v. Republic of Peru*, lost by Peru, other courts began to apply a similarly narrow reading of the Champerty doctrine<sup>25</sup>, which in turn encouraged vulture funds to lobby the US government to amend the doctrine by statute.

Closely related to the access to litigation is the consideration of balancing foreign policy concerns with creditors' interest. *Comity* is a doctrine defined by the US supreme court in 1985 as the "recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens, or of other persons under the protection of its laws."<sup>26</sup> *Comity* has been invoked in sovereign debt cases submitted to a New York court to justify stays on litigation related to the settlement of sovereign debts.<sup>27</sup> Staying litigation is less drastic than barring access to litigation altogether. It also has the benefit of preventing holdout creditors from blocking restructuring processes, but does not necessarily prevent creditors from holding out. While potentially of some use, this doctrine has not been implemented in recent cases involving vulture funds, thus calling into question the relevance of foreign policy considerations in this context. A higher regard for *Comity* in the US and UK – where much of sovereign debt is issued now – might have the potential of creating

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<sup>22</sup> The doctrine is discussed below

<sup>23</sup> See generally Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or new business opportunity?* 30 AM. BUS. L.J. 485-89 (1992)

<sup>24</sup> N.Y. Judiciary Law 489 eliminates the champerty defense for debt purchases or assignments having a value of more than USD 500,000.

<sup>25</sup> See for instance *Turkmani v. Republic of Bolivia*, 193 F.Supp.2d 165, 167 (D.D.C. 2002), or *Camdex International Ltd. v Bank of Zambia* (1996) 3 All ER 431.

<sup>26</sup> *Hilton v. Guyot*, 159 U.S. 113, 164 (1895)

<sup>27</sup> In *Pravin Bankers Associates, Ltd. v. Banco Popular del Peru*, Pravin I, 165 B.R. 379 (SDNY 1994), the court granted a 6 month stay to allow for orderly completion of the Banks' restructuring process. In *Pravin IV*, 109 F.3d 850, 855(2d Cir.1997), however the District court decided against the granting of an indefinite stay of litigation, explaining that it would make the process equivalent to a "judicially enforced bankruptcy proceeding" instead of the voluntary negotiated process that the US policy envisages.

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the conditions for the application of domestic bankruptcy laws to sovereign insolvency cases tried in these jurisdictions<sup>28</sup>

The act of state doctrine constitutes another potential source of protection for debtor states from external scrutiny of their internal affairs. However, a famous US decision (in the Sabbatino case) made this doctrine irrelevant for cases in which the law of the foreign (debtor) state is inconsistent with the law and policy of the relevant jurisdiction.<sup>29</sup>

Lending institutions could also enact changes in the regulation of secondary debt markets in the very limited circumstances of countries qualifying for the HIPC initiative, or any future similar initiative. These changes could include a prohibition of the assignment of contractors or debts to third parties without prior consent of the state and/or a prohibition of the securitizing of loans and debts. If the sale or the securitization is approved by the state, a capping of the debt at the selling price, plus interest for late payment only, could be introduced. As mentioned such regulatory changes in secondary markets for sovereign debt can trigger higher costs of borrowing for sovereigns. Even though these costs could be perceived as an insurance policy for sovereign borrowers, this is, in fact, rarely the case.

Rather than acting directly on the right to litigation, disruptive activity by uncooperative creditors can also be discouraged by limiting creditors’ means to recover assets. This strategy consists in avoiding potentially highly controversial judicial precedents (such as contravening the right to litigate for breach of contract or the enforcement of property rights) because this touch upon fundamental pillars of private law. In the past, states have used the doctrine of state immunity to this effect. International sovereign debt contracts nowadays frequently include a waiver of state immunity, entitling creditors to initiate litigation in foreign jurisdictions.. In addition, most states have established by statute that sovereign states engaging in commercial activity are automatically considered as economic agents who cannot be protected by the state immunity doctrine.<sup>30</sup> The US Supreme Court’s decision in the case of *The Republic of Argentina v. Weltover* established the issuance of sovereign debt as a commercial activity thereby opening the door for creditors to sue sovereign debtors in US courts.<sup>31</sup> While the doctrine of sovereign immunity now has little impact on rulings in the global economy’s core financial centres, it still is relevant for execution purposes. Even though the doctrine only protects assets linked to the execution of matters of state, creditors formally do not have many options to attach foreign commercial assets to their cases in foreign jurisdictions. Vulture funds, however, have been quite creative in devising strategies to obtain the execution of courts’ judgements<sup>32</sup>. In the recent case of *NML Capital Ltd v. The Republic of Argentina*, the US Supreme Court decision (2014) to grant access to bank information to facilitate attachment of sovereign assets was heavily criticized by the international community for encouraging vulture

**Comment [NN1]:** There is also a claim on waiver of execution in bond contracts which is more relevant for execution purposes than sovereign immunity.

<sup>28</sup> Christopher Wheeler and Amir Attaran, ‘Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation’ (2003) 39 *Stanford Journal of International Law* 256, 273.

<sup>29</sup> Sabbatino, 376 U.S. - see Christopher Wheeler and Amir Attaran, ‘Declawing the Vulture Funds’ supra note 26, 274

<sup>30</sup> Starting with the US (FSIA 1976) and the UK (SIA 1978), similar laws have been adopted in Canada, Australia, South Africa, Argentina, Israel, Japan and Singapore. A number of civil law countries have come to similar conclusions in jurisprudence and decrees.

<sup>31</sup> *Republic of Argentina v. Weltover* 504 U.S. 607 (1992)

<sup>32</sup> See Part B, p 4.

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creditors' actions.<sup>33</sup> In an attempt to prevent execution by these creditors, several countries reacted by issuing legislations banning creditors from seizing certain state assets, including funds earmarked for development or essential public expenditures.<sup>34</sup>

Anti-vulture fund laws have been enacted by several developed countries. In 2008 Belgium passed a bill to prevent the seizure or transfer of public funds for international cooperation, in particular related to the methods of vulture funds.<sup>35</sup> In June 2015, the Belgium parliament also overwhelmingly passed a law to ‘combat vulture funds’.<sup>36</sup> A significant merit of this legislation is that it actually defines essential characteristics of vulture funds and the contexts in which their actions are not acceptable. Spain is committed to not selling or securitizing debt owed by Heavily Indebted Poor Countries (HIPCs). France supports the World Bank’s Debt Reduction Facility and Italy is committed to prevent aggressive litigation against HIPCs at the Paris Club and through the World Bank. In 2007, the French National Assembly proposed a bill excluding the possibility to issue judicial decisions against debtor states attacked by vulture funds.<sup>37</sup> In 2011, the UK made the Debt Relief (Developing Countries) Act 2010 permanent. This legislation limits the amount of money that commercial creditors can recover from developing countries participating in the HIPC Initiative, removing the incentive to file cases against such countries in UK courts.

National law initiatives against uncooperative creditor conduct are important and should be supported. . However, it is doubtful that such punctual and far-in-between initiatives, laudable as these may be, are sufficient to address systemic gaps in the current international governance of sovereign debt restructurings that have facilitated the rise of vulture funds, in the first place.

(ii) Market-based options to limit holdout litigation: The role of contractual improvements.

Another possible way to deal with problems arising from the activities of vulture creditors at the source is to prevent creditors from opting out of voluntarily negotiated agreements that engage a majority (or supermajority) of creditors. Recent efforts of the creditor community (led by the International Credit Market Association (ICMA)) to address collective action problems resulted in the improvement of Collective Action Clauses ('CACs'). While CACs currently only apply to bonds, when applicable in this context, their success in creating the conditions for a swift debt exchange has been demonstrated for some cases<sup>38</sup>, but has also led to further complications in other sovereign debt restructurings. While this contractual avenue could potentially be effective in dealing with some aspects of sovereign debt restructuring processes, a core drawback of this approach is that

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<sup>33</sup> See for instance UNCTAD (2014), Argentina's 'vulture fund' crisis threatens profound consequences for international financial system available at <http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=783>

<sup>34</sup> European Directive 98/26/CE on settlement finality in payment and securities settlement systems (preventing holdouts from using the euroclear system as a means to block payments to creditors having accepted a restructuring offer with a view to obtain a payment in full by a sovereign debtor)

<sup>35</sup> Art 36, Loi relative à la Coopération belge au Développement du 19 mars 2013

<sup>36</sup> Chambre des représentants de Belgique, avril 2015, "proposition de loi relative à la lutte contre les activités des fonds vautours", doc 54/1057/001

<sup>37</sup> Assemblée Nationales, août 2007, "proposition de loi visant à lutter contre l'action des fonds financiers dits "fonds vautours", No 131

<sup>38</sup> Udaibir S Das, Michael G Papaioannou and Christoph Trebesch, 'Restructuring Sovereign Debt, 1950–2010: From Process to Outcomes' <<http://www.voxeu.org/article/restructuring-sovereign-debt-1950-2010-process-outcomes>> accessed 17 April 2013.

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contractual changes are usually dominated by the interests of lenders, equipped with high bargaining power vis-à-vis the borrower. More importantly, such contractual improvements do not address the requirements of debt crises prevention or provide the tools necessary for their solutions.

(iii) Towards consensual international options

Domestic legislation complemented by contractual efforts can be useful in dealing with uncooperative creditor activities, but the risk of incoherence that pervades a fragmented legal and institutional framework remains. Global governance issues, such as sovereign debt restructurings, which have an immense impact on the social and economic development of debtor states as well as, to an extent, on states hosting major commercial lenders require international cooperation to promote burden sharing between borrowing states, lenders and the states in which creditors reside.

The moment states become willing to negotiate consensual norms at the international level, various options implying varying degrees of institutionalization are available. A major challenge consists in achieving the active engagement of states hosting current financial centers.

A multilateral framework entailing the legal agreement of all states represents the most inclusive, coherent and legitimate approach to dealing with global governance issues. Bilateral or regional agreements may also be used although they may reproduce fragmentation to a certain extent. The power of such multilateral legal instrument would vary in accordance with the reach of its contents but also with the type of institutional oversight organized by the concluding parties.<sup>39</sup> While a fully-fledged bankruptcy code<sup>40</sup> at the international level might be desirable, states' international commitments do not have to be this far-reaching to be efficient. Combined with contractual improvements such as those mentioned above, states could agree on a limited number of principles that would open the way to an overall improvement of practices for dealing with sovereign debt restructuring.

First, states could agree to recognize a creditor's duty to negotiation in good faith internationally.<sup>41</sup> Good faith would be documented throughout the sovereign debt restructuring process and, should holdouts remain following a vote by all creditors (without CACs), domestic courts would have the responsibility to assess good faith conduct by both parties. Creditors refusing to participate in negotiations would be presumed to be in bad faith and would not obtain what they claim.<sup>42</sup> With the help of CACs, this would effectively put an end to holdout litigations unless the negotiations are conducted in bad faith by the debtor, for instance, in the absence of debtor state consultation with creditors. Such agreements would be all the more efficient if they were accompanied by a provision stating that **all bonds are considered to include CACs with aggregation features.** Second, states could

**Comment [NN2]:** You mean including even the old bonds issued without CACs

<sup>39</sup> Institutional options may range from a permanent international tribunal dedicated to resolving debt issues to a more flexible scenario involving ad hoc arrangements, through the involvement of facilitators, mediators and/or arbitration panels resulting in binding agreements recognized by all domestic courts.

<sup>40</sup> A few treaty proposals from the University of Nanterre and from the ILC are currently in preparation.

<sup>41</sup> See the Sovereign Debt Workout Principle of Good faith contained in the Roadmap and Guide for Sovereign Debt Workouts released by UNCTAD in April 2015 (available at: [http://unctad.org/en/PublicationsLibrary/gdsddf2015misc1\\_en.pdf](http://unctad.org/en/PublicationsLibrary/gdsddf2015misc1_en.pdf))

<sup>42</sup> To ensure a legitimate process, a creditor who lent abusively should obtain less through a restructuring process than a good faith lender - see Bohoslavsky (n 35) 401. Of course, defining abusive lending is not an easy task and proving it is even more difficult.

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agree to enforce an automatic stay of litigation during debt workouts conducted in good faith. This would effectively put a halt to vulture strategies and to some extent, also reduce procrastination to enter debt workouts when needed. Here again, creditor litigations may still happen post restructuring, in which case, national courts would be responsible for determining whether negotiations were conducted in good faith during the process.

By adopting international principles that can later be interpreted at the national level, the risk of legal incoherence stemming from different sources of jurisdiction remains unless it is guided or overseen by a judicial body or mechanism at international level. Hence, internationally agreed guiding principles beyond the example of good faith and, for example, suggested in the UNCTAD Roadmap and Guide to Sovereign Debt Workouts (see fn 8 above), would ultimately need to be based on a multilateral treaty to enshrine those principles in international law and institutions that bind nation states. To provide an institutional place for such a multilateral or statutory approach to sovereign debt workouts could typically be the role of the International Court of Justice (ICJ), which could issue legal opinions at the request of states and/or international organizations. Being the highest judicial body of the UN, the ICJ is by its membership, mandate and procedures, the most legitimate body in capacity of giving advice on matters involving public interests. If the debtor state and its creditors agree to resolve disputes related to sovereign debt outside national jurisdictions, the Permanent Court of Arbitration (PCA) could also have a role in settling disputes in a way similar to what is already covered by this Court in regard to investment disputes relative to bilateral and multilateral investment treaties.<sup>43</sup> This is provided that a set of rules applicable to sovereign debt disputes is agreed on at the international level.<sup>44</sup> The mentioned UNCTAD general sovereign debt workout principles (SDWPs) could be used by international court and arbitration tribunals in their legal reasoning when tackling debt disputes. Being purposefully general, these principles, which rely on public law concepts, would be well suited for the work of interpretation undertaken by judges. Other substantive normative sources could derive from domestic bankruptcy laws (private and public).<sup>45</sup>

## D. CONCLUSIONS

Sovereign debt is an area of global governance that, so far, remains within the purview of national jurisdictions and legal frameworks, as well as a number of ad hoc international arrangements, despite its glaringly international significance through cross border contracting between sovereign borrower states and both official as well as private lenders. The absence of a shared legal framework at the international level means that national states are expected to self-regulate so as to protect the interest of debtor states facing disruptive creditor behaviour. However, one may well wonder to

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<sup>43</sup> While similar in terms of institutional structure, the Permanent Court of Arbitration relies on well-established jurisprudence and is less subject to criticism than ICSID led dispute resolutions, which have a commercial mindset often disregarding the public role performed by a sovereign state.

<sup>44</sup> See Arbitration And Sovereign Debt (2012) A Paper Prepared By The Steering Committee Of The Netherlands Government And The Permanent Court Of Arbitration

<sup>45</sup> Well known examples are chap 9 and 11 of the US bankruptcy codes

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what extent individual jurisdictions can possibly adopt coherent language that will avoid further fragmentation in the legal landscape that governs sovereign debt restructurings at present.

Stopping vulture funds in their tracks is clearly very relevant to improving an internationally coordinated approach to sovereign debt restructuring. The options laid out in this paper detail different steps that can be taken in this direction. Importantly, the role and impact of uncooperative creditors needs to be considered in a wider global context: It is worthwhile to keep in mind that the rise of this kind of litigation is only one manifestation of a much broader trend: that of a fast growing exposure of developing country external debt to high market, exchange rate and refinancing risks. The composition of developing country external debt has changed in the last decade from predominantly syndicated bank lending to bond financing. Similarly, a growing number of developing countries are shifting from foreign to local currency denominated debt, with very high participation of 'footloose' non-resident investors. Together with the rapid rise of private external debt, these developments have considerably increased the risk of financial instability in times of crises. Other factors, such as the expected normalization of US interest rates and increasingly volatile commodity markets, further add to the challenges that developing countries will face to the future sustainability of their debts. In this context of growing vulnerabilities and challenges, efficient and fair mechanisms for sovereign debt resolution are more important than ever. At present, countries face a fragmented and opaque set of arrangements for sovereign that has enormously facilitated the rise of costly and aggressive litigation by uncooperative creditors. The wider task at hand is, therefore, to find multilateral solutions that foster greater financial stability by reducing excessive risk taking, while ensuring a fairer and more efficient resolution of debt crises when these happen. Both borrowers and the vast majority of creditors alike will benefit from timely, fair, transparent, and predictable international debt settlements.