

# Tackling the Vultures:

## A briefing on legislative action to address vulture funds

by Tiago Stichelmans

Argentina has been the latest country to fall victim to the harmful and immoral actions of vulture funds. This year, the US Supreme Court threw out the country's appeal against the actions of vulture fund Elliott Management Corporation. These events have put in jeopardy all future debt workouts of countries in financial distress. This briefing gives an insight into vulture fund behaviour, the consequences for developing countries, and lays out proposals for vulture fund legislation in the European Union.

### Summary

Vulture funds are speculative investment funds that buy up the debt of distressed countries at a very low price and then pursue full reimbursement of the original debt through lawsuits. Vulture funds target crisis countries that are already struggling to finance public services and infrastructures and wait until a debt restructuring takes place so that they can sue for high returns.

The lack of a comprehensive international framework to deal with debt restructuring means that vulture funds can get away with this, and the latest case of Argentina has only strengthened their position. Besides their effect on individual nations of slowing down or preventing economic recovery, the actions of vulture funds are jeopardising debt restructuring the world over.

Although they tend to target poor countries, vulture funds are a threat to any country facing debt distress, including members of the European Union.

### An efficient EU legislative initiative against the vulture funds must be reached and should include the following points:

- Improve the transparency of vulture funds. Some are located in tax heavens and their owners are usually unknown. This affects the capacity of targeted countries to deal with their actions. The creation of public registries of vulture funds would be a good solution to this problem.
- Prevent vulture funds from making exorbitant profits from their actions. Using the model of the UK Debt Relief (Developing Countries) Act, legislation should ensure that any existing national debt restructuring agreements also apply to such funds.
- Make development cooperation funds non-assignable and elusive, as well as funds that European enterprises must transfer to foreign states and assets of states and enterprises that are on European territory.
- Prohibit commercial or public entities based in the EU to invest in vulture funds.
- Prevent any juridical action from vulture funds in European courts.

### What are vulture funds?

Vulture funds are speculative investment funds. They are called 'vultures' because of their practice of buying the debt of distressed countries that are in default - or likely to default soon - at a very low price and then forcing the countries, through lawsuits, to repay the original debt with interest, penalties and legal fees. When the courts rule in their favour, vulture funds use measures to recover the debt, such as political pressure and the seizure of overseas assets. Many of these companies are based in tax havens, operate within a culture of secrecy, and refuse to share information on their real - or beneficial - ownership.

Vulture funds usually wait for a process of debt restructuring before starting their actions, taking advantage of the improving financial state of the country or the company

following the restructure to claim the full value of their bond in addition to interests and possibly delay penalties. They do not work like normal financial market actors, which make profits or losses according to the evolution of the value of their holdings, but rather try to make a profit through judiciary routes. This *modus operandi* prevents economic recovery of - usually - poor countries, damaging their development and affecting the living conditions of their population. In addition, they often jeopardise debt restructuring processes, such as in the recent case of Argentina.

When vulture funds jeopardise restructuring processes, this also affects public debt relief initiatives - such as the Heavily Indebted Poor Countries (HIPC) initiative - and therefore public money, including development aid. The HIPC initiative was launched to allow the financing of development of poor countries, but the funds made available by this initiative were targeted by vulture funds. This practice was heavily condemned by the donor countries<sup>1</sup> and multilateral institutions. The 2008 Doha Declaration on Financing for Development reflects this when it welcomes: "steps taken to prevent aggressive litigation against HIPC-eligible countries [...] and call on the creditors not to sell claims on HIPC to creditors that do not participate adequately in the debt relief efforts"<sup>2</sup>.

### The case of Argentina

After its debt crisis and resulting default in 2001, Argentina made two exchange offers to its creditors in 2005 and 2010, leading to a USD 81 billion haircut, which was accepted by bondholders representing 93% of outstanding debt<sup>3</sup>. Since then, Argentina has serviced the restructured debt without interruption, showing a successful restructuring process. However, creditors representing around 7% of Argentina's defaulted debt refused the swap and started a litigation strategy. They are known as holdouts. In 2012, the New York Second Circuit Court ruled in favour of 19 of those holdouts, led by Elliott Management Corporation, which had acquired in 2008

USD 222 million worth of debt for \$48 million, and demanded that Argentina pay full value plus interest on the outstanding bonds, for a total of \$1.33 billion. According to the ruling of US Judge Thomas Griesa, payment on restructured debt without honouring the debt of the holdouts would be illegal. This is the consequence of an unusual interpretation of the *pari passu* clause<sup>4</sup>. This ruling implies that all the other “holdouts” now have a strong case against Argentina, and may claim up to USD 15 billion<sup>5</sup>. The situation was worsened by the Right Upon Future Offers (RUFO) clause that Argentina included during the swap with bondholders who accepted the restructuring deal, in order to make sure that the cooperative creditors are not worse off than vulture funds. The RUFO clause entitles them to receive a similar deal if Argentina “voluntarily” makes a better offer to the creditors before 31 December 2014. This may cost up to USD 100 billion for Argentina<sup>6</sup>, an unpayable sum for the country. Argentina appealed the decision to the US Supreme Court, but on 16th June 2014 the court announced that they would not hear the case. Because of the interpretation of the *pari passu* clause, Argentina legally cannot pay only the restructured debt, and failed by 30th July to pay the bondholders that had accepted the restructuring as these funds were blocked by a New York Bank. This situation jeopardises the whole restructuring process.

## Debt restructuring under threat in Europe

The fact that vulture funds seem to win their cases against sovereign debtors will incentivise creditors to refuse to take part in debt restructuring initiatives in future, as holdouts usually make more profits than the creditors that accept a financial haircut. In the absence of a comprehensive framework for debt restructuring negotiations that would bind all creditors, each one of them has an incentive to refuse to participate, hoping to receive a higher pay-out. This problem has recently been highlighted by the International Monetary Fund (IMF)<sup>7</sup>.

With the incentive for creditors to holdout, debt restructuring will be more complex and take more time, provoking longer debt crises, leading to more economic hardship and long-term harm. This could also increasingly affect Europe, after it was reported that the vulture fund Elliott Management Corporation recently acquired a EUR 300 million portfolio of non-performing loans from the bank Santander for EUR 12 million<sup>8</sup>. Greece was also the victim of vulture fund strategies. In 2012, its government paid EUR 436 million to settle a case with several holdouts of its debt restructuring. Dart Management was among them, and received 90% of that amount. Considering that holdouts still possess EUR 6 billion in Greek bonds, vulture funds might

cause further costs in the future<sup>9</sup>, which will ultimately be borne by the Greek state, diverting scarce tax income and/or Troika loans from financing the economic recovery.

## Promoting reckless lending

The inability of a sovereign state to restructure its debt because of vulture funds lawsuits could also impact on the behaviour of creditors. The failure to organise orderly restructurings will give an incentive for creditors to lend recklessly to sovereigns without consideration for the financial situation of the debtor, as they now have a very high probability of never losing their money. This will create unsustainable debt levels in many countries, potentially triggering new debt crises.

At the same time, responsible lenders that cooperate in times of debt crisis are being punished. Their willingness to write off a share of their claims in order to restore the debtor's solvency and repayment capacity is also exploited by the vultures.

## A threat to the stability of the international financial system

The actions of the vulture funds, and the new interpretation of the *pari passu* clause, are a threat to the stability of the international financial system. Firstly, the incapacity for a government to organise successful debt restructuring will extend the length of debt crises and therefore increase the risk of contagion (either to private debt or to other countries). Secondly, the shift of the balance of power in favour of the creditors will make it more difficult for countries to regain debt sustainability and economic growth. Thirdly, the impact of this new paradigm on lenders' behaviour may provoke new debt crisis.

## The social impact on the poor

The actions of vulture funds have huge social costs. They undermine the capacity for a country to finance its development and should therefore be considered immoral and unjust. The UN Human Rights Council *Guiding Principles on External Debt and Human Rights* reaffirm that human rights, including in particular economic, social, and cultural rights, take precedence over any commercial agreement or debt contract<sup>10</sup>. The actions of vulture funds also violate the UNCTAD “Principles on Promoting Responsible Sovereign Lending and Borrowing”. On debt restructurings, those Principles state that “a creditor that acquires a debt instrument of a sovereign in financial distress with the intent of forcing a preferential settlement of the claim outside of a consensual workout process is acting abusively”<sup>11</sup>. It should be noted, that vulture funds target crisis countries that already struggle to finance public services and

infrastructures, undermining their capacity to fight poverty and reach their Development Goals.

## How to resolve this? - Recommendations to legislators and decision-makers

### Towards a new international framework to deal with sovereign debt restructurings

In the absence of an international framework to deal with sovereign debts, vulture funds can start litigation through the courts that are the most favourable to their arguments. This strategy would be ineffective if a new international debt court were created. We therefore urge that:

- The Parliaments put pressure on the European Commission and the Member States of the European Union to take the initiative to create a debt work-out procedure.<sup>12</sup>
- This procedure should be organised by a permanent body, under the supervision of an independent body, such as the United Nations<sup>13</sup>.

### Regulate the debt secondary markets

Better regulation of secondary markets through national or EU-wide legislation would prevent vulture funds from acquiring debt bonds from distressed or poor countries. A regulation of the secondary markets should prohibit the sale of debt bonds on the secondary markets:

- Without the consent of the authorities of the debtor country<sup>14</sup>.
- If the buyer has been identified as a vulture fund.
- The buyer has previously refused to participate in agreed debt restructuring.

### Lessons learned: Past legislative action to fight vultures' reckless behaviours

Legislative responses to the actions of vulture funds have already been carried out by some countries. In 2008, Belgium passed a law preventing development cooperation funds being seized by vulture funds<sup>15</sup>. This was an attempt to avoid a repetition of the case of Kensington International against the Republic of Congo in which this vulture fund managed to seize a Belgian cooperation fund destined to the Republic of Congo. In 2010, the UK parliament passed legislation to prevent vulture funds from making exorbitant profits out of debt restructurings<sup>16</sup>. The Debt Relief (Developing Countries) Act limits how much vulture funds could sue for in UK courts to the amount they would have received if they took part in HIPC debt relief; effectively enforcing the HIPC debt

restructuring terms on all creditors. This legislation has subsequently been replicated in Jersey, Guernsey and the Isle of Man. There is an urgent need to deepen existing vulture funds legislation and expand its scope to the whole European Union.

An efficient EU legislative initiative against the vulture funds should include the following points:

- Improve the transparency of the vulture funds. Some of them are located in tax heavens and their owners are usually unknown. This affects the capacity of targeted countries to deal with their actions. The creation of public registries of vulture funds would be a good solution to this problem.
- Prevent vulture funds from making exorbitant profits from their actions. Using the model of the UK Debt Relief (Developing Countries) Act, legislation should ensure that any existing national debt re-structuring agreements also apply to such funds.
- Make development cooperation funds non-assignable and elusive, as well as funds that European enterprises must transfer to foreign states and assets of states and enterprises that are on the European territory
- Prohibit commercial or public entities based in the EU to invest in vulture funds
- Prevent any juridical action from vulture funds in European courts

## Endnotes

- 1 <http://www.theguardian.com/business/2002/may/06/politics.economicpolicy>
- 2 [http://www.un.org/esa/ffd/doha/documents/Doha\\_Declaration\\_FFD.pdf](http://www.un.org/esa/ffd/doha/documents/Doha_Declaration_FFD.pdf)
- 3 <http://www.economist.com/node/21533453>
- 4 <http://blogs.ft.com/beyond-brics/2014/03/10/guest-post-argentinas-day-in-court/>
- 5 <https://www.project-syndicate.org/commentary/joseph-e--stiglitz-and-martin-guzman-argue-that-the-country-s-default-will-ultimately-harm-america>
- 6 <http://www.mediapart.fr/journal/international/020814/largentine-en-defaut-de-paiement-et-dans-une-situation-ubuesque>
- 7 <https://www.imf.org/external/np/pp/eng/2013/042613.pdf>
- 8 <http://www.reuters.com/article/2013/03/07/us-spain-banks-asset-sales-idUSBRE92615L20130307>
- 9 [http://www.nytimes.com/2012/05/16/business/global/bet-on-greek-bonds-paid-off-for-vulture-fund.html?\\_r=0](http://www.nytimes.com/2012/05/16/business/global/bet-on-greek-bonds-paid-off-for-vulture-fund.html?_r=0)
- 10 <http://daccess-dds-ny.un.org/doc/UNDOC/GEN/G12/128/80/PDF/G1212880.pdf?OpenElement>
- 11 [http://www.unctad.info/upload/Debt%20Portal/Principles%20drafts/SLB\\_Principles\\_English\\_Doha\\_22-04-2012.pdf](http://www.unctad.info/upload/Debt%20Portal/Principles%20drafts/SLB_Principles_English_Doha_22-04-2012.pdf)
- 12 Eurodad (September 2014) Managing the next debt crisis: Recent Reform Proposals
- 13 Eurodad has published a report examining what would be the principles of a fair and transparent debt work-out procedure
- 14 These recommendations are part of Eurodad's *Responsible Finance Charter*
- 15 <http://www.senate.be/www/?Mlval=/publications/viewPub.html&COLL=S&LEG=4&NR=482&VOLGNR=3&LANG=fr>
- 16 <http://www.legislation.gov.uk/ukpga/2010/22/contents>



This briefing has been produced with the financial assistance of the European Union. The contents of this publication are the sole responsibility of Eurodad and can in no way be taken to reflect the views of the European Union.

## Contact

### Eurodad

Rue d'Edimbourg 18-26  
1050 Brussels  
Belgium

Tel: +32 (0) 2 894 4640  
[www.eurodad.org](http://www.eurodad.org)

[www.facebook.com/Eurodad](http://www.facebook.com/Eurodad)  
[twitter.com/eurodad](https://twitter.com/eurodad)