CHAPTER 1

Vulture Funds

We particularly condemn the perversity where vulture funds purchase debt at a reduced price and make a profit from suing the debtor country to recover the full amount owed – a morally outrageous outcome.

Gordon Brown, speaking as UK Chancellor of the Exchequer, at the United Nations in 2002[2]

The term 'vulture fund' describes how private investment firms and hedge funds prey on poor countries on the brink of debt relief – like vultures waiting to swoop down on a rotting carcase. This chapter defines vulture funds and their origins. It examines their culture and the legitimacy of their operations, to show why so many people condemn them.

1.1 What is a vulture fund?

Vulture funds are commercial creditors which buy up the debts of poor countries at a cheap rate and then sue them to secure a high return, which is the sole reason for their investment. Vulture funds have become increasingly retrogressive since they began impeding the progress of debt relief in many heavily indebted poor countries.

Market practitioners would probably prefer to describe the funds as 'distressed debt investors' and would regard the vulture metaphor as too harsh. However, in 2002 Gordon Brown (then UK Chancellor of the Exchequer and subsequently Prime Minister), speaking at the UN, described vulture funds as perverse and immoral. The reason for this is their shrewdness when it comes to profiting from the problems of a sovereign government.

The IMF has defined vulture funds as companies which buy the debt of poor nations cheaply when it is about to be written off and then sue for the full value of the debt plus interest – which may be ten times what they paid for it.[3] The key characteristics of a vulture fund are:

- It is not the primary lender of the money;
- It acquires the title deed of the debt through the purchase of the money owed on a secondary market; and
- It goes to court to sue the sovereign debtor for the full value of the debt, plus interest, generally making a profit of 3 to 20 times its investment.[4]

1.2 The rise of vulture funds

Sovereign states used to enjoy immunity from litigation. So how have vulture funds come to play their current role?

In 1996 the international financial institutions introduced the HIPC Initiative, with a call to all creditors to write off the debts of HIPCs. It has been argued that the leniency of this initiative gave rise to more lawsuits and highlighted the fact that litigation was the easiest way of obtaining a good return. But this is not the only reason for the rise of vulture funds. Investment in distressed funds as a lucrative business had been happening secretly for some time.

Historically, the major debt crisis of the 1980s in Latin America gave birth to the vulture fund operations which are now affecting almost every HIPC country around the world. What lay behind this? The reason for the rise of vulture funds was the mode of borrowing at that time. Borrowing by least developed countries used to be through syndicated banks, and not through bond lending as today. In the 1970s, commercial banks began to lend to developing countries directly. Commercial loans were an attractive and sophisticated form of borrowing. However, there were drawbacks, as commercial loans carried high interest rates, coupled with a variable rate that was passed on to the borrower.

Following the debt crisis of the 1980s, the US Federal Reserve began to tighten its monetary policy. This led to an increase in nominal interest rates. Borrowing countries were forced to repay at very high interest rates and the debt profiles of many borrowing countries became unsustainable. Restructuring measures were brought in to mitigate these problems of huge indebtedness. From 1982 to 1989 there was a long period of restructuring sovereign debt. However, by 1989 it became clear that in spite of these measures the Latin American states' financial position was not improving.

The debt restructuring process that then took place, known as the Baker Plan, was not successful. The rescheduling of loans between banks and sovereign debtors became a more complex issue than had been predicted. The banks foresaw an endless cycle of rescheduling and debtor countries began to tire of the process.

In March 1989, US Treasury Secretary Nicholas Brady designed the Brady Plan in an attempt to address the debt crisis. Under the Plan, loans were exchanged for sovereign bonds that could be freely traded. By 1998 it was evident that sovereign debt had been converted from syndicated bank loans to securitised bonds. Brady bonds became a generic term for bonds issued during sovereign debt restructuring, but they referred specifically to the exchange of commercial bank loans for bond instruments.

These bonds were offered to the public and the proceeds of the bond offering were used to repay the borrowing country's outstanding bank loan indebtedness. However, with the creation of the sovereign bond market, non-bank investors began to hold substantial amounts of sovereign debt. This changed the dynamics of sovereign debt restructuring.

When commercial bank syndicated loans were unpaid, there was an orderly process for restructuring the loan in the case of indebtedness. The restructuring of the loan under the terms of the Brady Plan was done by the debtor country and an ad hoc committee of the largest institutional creditors, known as the Bank Advisory Committee. The latter would commit to restructuring on agreed terms. The bank would undertake to roll over the debt to avoid declaring default on the debt on its balance sheet. It also indirectly helped the country's economy to perform better, which kept the borrowing country tied to the bank in the long term. However, other creditors were under no obligation to accept these terms.

Despite their advantages, the Brady bond restructurings undermined the orderly restructuring process. They also broadened the base of investors. Such investors, with their divergent interests, grew in number and became increasingly difficult to manage. Large banking institutions are often interested in ensuring that developing countries commit to IMF-approved economic policies as a condition of obtaining finance or refinance. However, small hedge funds and smaller investors have a different approach. They also find it much easier to break away from the group and ask for immediate repayment. This means there are fewer factors to deter vulture funds from purchasing the defaulted debt when it is about to be written off by the primary lender, or when a restructuring plan is ongoing between the primary lender and the sovereign debtor.

Vulture funds became prominent in the mid-1990s. They were first introduced by the US-based billionaire Paul Singer, who runs the biggest vulture fund, known as Elliott Associates. In 1996, Elliott spent almost US$12m on the purchase of 'distressed' Peruvian debt and four years later forced Peru to pay over US$55m to redeem it. Singer is reputedly worth £8bn.[5]

Elliott Associates' success in *Elliott Associates, LP v Banco de la Nacion and The Republic of Peru*[6] (see Chapter 3, Lawsuits) shifted power to the vulture fund creditors.

By holding out in Peru's debt restructuring process, Elliott Associates successfully sued and claimed the full amount owed, with interest and costs. Peru had to settle by paying Elliott Associates US$56.3m for a debt originally worth US$11.4m, so that it could restructure with the other creditors. Other investors found this mode of operation extremely profitable.

This case proved that the actions of the vulture funds are very profitable. It gave rise to the actions of many other vulture funds that threaten most of the distressed sovereign states in today's world.

According to the IMF, litigating creditors are concentrated in the USA and UK, and in the UK protectorate tax haven, the British Virgin Islands (BVI).[7] Another vulture fund, Kensington International Ltd, based in the Cayman Islands, sued the Democratic Republic of Congo (DR Congo) for US$30m in the High Court in London. A more recent vulture fund case was brought against the Republic of Zambia by Michael Sheehan, Director of Donegal International Ltd, which is based in BVI (see Chapter 3, Lawsuits, for further details).

These examples of how the funds undertake aggressive litigation after purchasing debt at huge discounts illustrate the litigious culture of the vulture funds. In the interests of sovereign states, litigation should not be the first option, but rather a last resort to be avoided at all costs. Sovereign debtors need to be aware of the underlying litigious culture of vulture funds and be prepared to take alternative steps (for example those discussed in Part II, Actions and Responses).

Several campaigning groups have lobbied energetically for debt relief. The Jubilee Debt Campaign is one such group that campaigned against the actions of Donegal International Ltd after it sued Zambia in 2007. The UK Government acknowledged the work of the campaigners, releasing a press statement in which, for the first time, the damaging effects of lawsuits were recognised.[8] The Jubilee Debt Campaign has also called for UK legislation to stop lawsuits being brought by vulture funds.

Another effective campaign has been through two BBC *Newsnight* programmes featuring the journalist Greg Palast. Palast tried to obtain interviews with vulture fund owners about their litigious actions. The first programme was in February 2007, after Donegal International Ltd won its case against the Republic of Zambia. The second was in February 2010, after the vulture funds Hamsah Investments and Wall Capital Ltd won their case against Liberia. Both these broadcasts are available at Greg Palast's website.[9]

1.3 Legal rights of vulture funds

Vulture funds are usually secondary owners of a debt. As secondary owners they have a lawful right to repayment. This is similar to the undisputed right of the primary lender who originally lent the money to the sovereign debtor fulfilling all necessary legal requirements. The vulture fund creditor takes over the rights of the primary lender through the purchase of the debt, since a debt can be traded as a property right and can be validly sold or purchased.

A pertinent question that has been raised at Commonwealth Secretariat Legal Debt Clinic seminars is whether a debt that is purchased or assigned is still valid. If a debt is purchased on the secondary market or has been validly assigned, even at a much discounted rate, the legal claim nevertheless remains valid. This has been confirmed by a judgment in the case of *Pravin Banker Associates Ltd v Banco Popular del Peru* (1997),[10] where the court ruled that the claim of this vulture fund was valid and enforceable.

In the most recent case of *Donegal International Ltd v Republic of Zambia & Anor*[11] (see Chapter 3, Lawsuits), the judge noted that although Donegal was deliberately withholding documents and although he had to order Donegal to disclose them, its actions were not strictly speaking illegal. Again, a valid judgment was given in favour of Donegal. So even if the vulture fund's activities can be described as immoral – as many people in Zambia are living on less than a dollar a day – Donegal had a legal right to its claim. This example highlights the fact that in any discussion of vulture funds there may, on the one hand, be moral arguments and, on the other, legal and financial arguments, so that the discussion takes place on two different levels.

In an interview with Greg Palast on the BBC *Newsnight* programme,[12] the director of Donegal, Michael Sheehan, responded as follows:

> Greg Palast: *Aren't you just profiteering from the work of good people who are trying to save lives by cutting the debt of these poor nations?*
>
> Michael Sheehan: *Well there was a proposal for investment. That's all I can talk about right now.*

In their defence, the vulture funds claim that they function as distressed debt funds, which are a necessity on the financial market. The funds argue that they allow private sector lenders to advance further loans to HIPC countries although they know that the sovereign country may default in the future. Big institutional investors do not like suing sovereign countries and therefore can obtain some return by selling their defaulted debt to vulture funds. Thus it can be argued that the presence of vulture funds is essential in economic terms.

Conclusion

This chapter has explained what vulture funds are, how they came into being and the way they operate, including an assessment of the legality of their actions. It has touched on several important legal cases and concepts which will be discussed more fully in later chapters. Vulture funds have a valid right to their title when indebted countries fail in their legal obligations under their contractual loan agreement. Nevertheless, there has been increasing recognition, including by some courts, that HIPC countries should be helped to resolve their unsustainable debt. The prime aim of the whole mechanism of debt relief through debt restructuring and the HIPC Initiative has been to help heavily indebted countries to come out of unsustainable debt. Only successful debt relief will allow an equal distribution of economic resources and help indebted countries embark on a path towards sustainable development. Chapter 7, Legislation, and Chapter 8, International Initiatives, highlight international action to write off debt. When there is such a concerted international effort, can it be right for the vulture funds to benefit from debt relief?

Two key lessons emerge from this chapter:

- Sovereign debtors need to be aware of the underlying litigious culture of vulture funds and be prepared to take alternative remedies (see Part II, Actions and Responses);
- The actions of the vulture funds, though unethical, unfair and exploitative, remain legal.

Further reading

- Meirion Jones, 'Vulture Fund Threat to Third World – How Corporations Continue to Rape the World's Poor', BBC *Newsnight*, 14 February 2007, available at http://www.informationclearinghouse.info/article17070.htm
- Jubilee Debt Campaign, http://www.jubileedebtcampaign.org.uk/
- Greg Palast, http://www.gregpalast.com
- Felix Salmon, 'In Defense of Vulture Funds', Saturday, 24 February 2007, http://www.felixsalmon.com/000667.html
- Ian Vásquez, 'The Brady Plan and Market Based Solutions to Debt Crisis', *The Cato Journal*, No. 16, Vol. 2, http://www.cato.org/pubs/journal/cj16n2-4.html