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Out Of The Desert And To The Oasis: Legislation On Predatory Debt Investing

Ryan E. Avery

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OUT OF THE DESERT AND TO THE OASIS: LEGISLATION ON PREDATORY DEBT INVESTING

Ryan E. Avery*

I. INTRODUCTION.....	267
II. BACKGROUND.....	269
A. <i>The Modern Origins of Sovereign Debt in Latin America</i>	270
B. <i>The Dynamics of the Immediate Response to the Sovereign Debt Crisis</i>	272
C. <i>The Brady Plan and the Evolution of a Secondary Debt Market</i>	275
D. <i>The Development of Vulture Funds and Subsequent Litigation</i>	276
E. <i>Heavily Indebted Poor Country (“HIPC”) Initiative</i>	278
III. LEGISLATION.....	279
A. <i>Europe</i>	279
B. <i>United States</i>	280
IV. ANALYSIS	281
A. <i>Benefits of VFs Compared to Modern Framework</i>	281
B. <i>Reducing U.S. Localization of VF Cases</i>	282
C. <i>A Need to End Further Erosion of Sovereign Immunity</i>	283
D. <i>New Legislation Corroborates With the Current U.S. Position on International Debt Management</i>	286
E. <i>Reduced Judicial Intervention with Market Activity</i>	288
V. CONCLUSION	289

I. INTRODUCTION

Regulating sovereign debt worldwide has improved substantially in the thirty years since Mexico sparked a crisis that would span across Central and South America. Much of this success can be attributed to the mutual cooperation between creditors, sovereign debtors, multinational institutions, and grassroots efforts. In some instances, however, a single holdout creditor can indefinitely delay a sovereign’s entire economic reformation effort, thereby undermining legitimate attempts to bring about financial, political, and social stability. In the advent of a secondary market for sovereign

debt, these holdout creditors – known as vulture funds (“VFs”) – are responsible for taking opportunistic measures in an effort to make an enormous profit from distressed debt.

VFs are particularly polarizing due to their unscrupulous business behavior when making choice investments. Many courts in the United States and United Kingdom have nevertheless failed to correlate this behavior with illegal conduct, and have in fact rendered substantial judgments favoring VFs participation as voluntary creditors. Others argue that VFs are an integral component in the remaining debt reorganization markets of Latin America, Africa, or other areas afflicted by third-world conditions. Proponents suggest that VFs are necessary to prevent opportunistic defaults, as well as to uncover devious corrupt practices within these governments.¹ As a result of the complex issues raised in these cases, as well as the history contributing to a secondary market for securitized debt, recent legislation has been drafted in both the U.S. and Europe in order to curb potential recoveries by VFs against impoverished nations.

Such legislation purports to provide its remedies by curbing the latitude that VFs are afforded. Although the legislation may seem to “re-write” the contract – generally disfavored as a matter of contract law – this is a reasonable remedy considering that courts lack the financial expertise to render proper judgments, especially considering the broad effect that these decisions have on international markets. This Note argues that the Stop VULTURE Funds Act in the U.S. should be adopted, in light of the failure of courts to adhere to U.S. policy regarding international debt management, and to prevent further damage to international financial markets. Part II of this Note outlines the background of sovereign loan markets, paying special attention to the Latin American debt crisis of the early 1980s. This debt crisis prompted many of the VF cases in their present

* Ryan E. Avery is a litigation associate at Foreman Friedman, PA, in Miami, Florida. Thank you to my family and colleagues for supporting me in this endeavor and special credit goes to my colleague Aaron L. Warren, University of Miami School of Law, Class of 2011, for drafting.

¹ See generally Elizabeth Broomfield, Note, *Subduing the Vultures: Assessing Government Caps on Recovery in Sovereign Debt Litigation*, 2010 COLUM. BUS. L. REV. 473, 508 (2010).

form. Previous VF cases have established the groundwork leading to the current legislation. Part III identifies the current legislation in effect in Europe, specifically in Belgium and the U.K., which are examples of two large VF litigation forums. This section also examines the proposed U.S. legislation, the Stop VULTURE Funds Act, which is particularly meaningful in light of the VF cases heard in U.S. courts. Part IV argues the various justifications supporting U.S. legislation, such as preventing the further erosion of sovereign immunity and to keep judges and juries from making financial decisions where they arguably lack proper expertise. This Note then closes with examples of how judicial opinions in the U.S. have confused the legislative intent specifically enacted to protect sovereigns through the restructuring process and suggests a better interpretation.

II. BACKGROUND

VF litigation raises a mix of challenging issues affecting the rights of creditors and sovereigns alike, and the issues generally include legal, political, humanitarian, public policy, foreign policy, and economic dimensions.² It should go without saying that the proposed U.S. legislation, and the active European legislation, embodies these same concepts. Thus, in order to evaluate the broad issues as they arise, it is necessary to understand the major developments that have shaped the sovereign loan markets, particularly in the latter half of the 20th century.

Part A will proceed by discussing a brief timeline of events affecting sovereign lending, culminating with the infamous Latin American debt crisis of the early 1980s. Next, Part B identifies the effects of this crisis on commercial lenders as well as sovereign governments, evaluating the failed restructuring efforts implemented for the remainder of the 1980s. Part C will begin by discussing the Brady Plan introduced in 1989, emphasizing its swift success as a restructuring mechanism. This will be followed by a discussion of the rise in a secondary market for securitized debt as a means for reducing regional debt. Finally, Part D will conclude by describing

² See Philip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings*, 64 *FORDHAM L. REV.* 2701, 2704 (1996).

the evolution of VFs and their participation in the secondary debt market, while also examining the modern status of VF litigation.

A. The Modern Origins of Sovereign Debt in Latin America

Until the early 1970s, less-developed countries ("LDCs") worldwide received the bulk of funding under the multinational arrangement as it was designed under the auspices of the Bretton Woods System ("Bretton Woods").³ Under Bretton Woods, an LDC could receive loans through three distinct channels: (1) short term funding provided by the International Monetary Fund ("IMF"), (2) national infrastructure loans issued by the World Bank, or (3) special project loans provided by Western, industrialized governments.⁴ Much of the funding occurred through the IMF channel, but the system enforced structural limitations on borrowing.⁵ For example, loans were directly capped by a sovereign's annual contribution to the IMF, or they were indirectly limited by enforcing compliance with strict austerity guidelines.⁶ These policies underscored the belief that developing economies were unstable, thus requiring greater oversight especially during turbulent economic times.

Until the late 1960s, the broad policies under Bretton Woods strengthened the IMF's pedagogy by curtailing overvalued currencies and payment deficits and implementing a fixed rate of exchange.⁷ Beginning in the early 1970s, however, the IMF lost considerable control over the distressed loan market as a growing rate of inflation reduced the agency's ability to issue loans compared to previous years.⁸ While the IMF was losing its share of market demand, private institutions such as banks and investment houses were gaining strength. In particular, banks located in Western economies utilized their "petrodollar" wealth, which had been generated during the 1970s, to invest in LDC loans throughout Latin

³ Theodore Allegaert, *Recalcitrant Creditors Against Debtor Nations, or How to Play Darts*, 6 MINN. J. GLOBAL TRADE 429, 433 (1997).

⁴ *Id.*

⁵ See Jessica W. Miller, Comment, *Solving the Latin American Sovereign Debt Crisis*, 22 U. PA. J. INT'L ECON. L. 677, 678-79 (2001).

⁶ *Id.*

⁷ Allegaert, *supra* note 3.

⁸ *Id.*; see also Miller, *supra* note 5, at 679.

America.⁹ Funding was fueled by the creditor's confident perception that Latin America was a credit-worthy risk,¹⁰ and LDCs increasingly sought larger amounts of capital to sustain the region's "ideology of growth."¹¹ The IMF's position was then degraded further as commercial banks began to issue loans unconditionally - a strategy in direct competition with the IMF's policy of austerity, and by 1980 a whopping 70 percent of external debt originated from private banks.¹²

As Bretton Woods eroded as a system of financial regulation, banks and governments were suddenly enabled to engage in particularly risky behavior during the investment boom in Latin America.¹³ Commercial banks significantly neglected general creditor controls, such as analyzing profit margins on sovereign projects or limiting the scope of sovereigns' investment on their loans.¹⁴ This behavior was a stark deviation from the practices of the IMF, and as a result LDCs frequently invested in inefficient state-owned industries that lacked the necessary revenue capability for servicing the loans.¹⁵ To make matters worse, banks were eager to extend their loans, fortuitously believing sovereigns were immune from bankruptcy risks and servicing defaults.¹⁶ The IMF's diminished role as a universal watchdog exacerbated these risks, resulting in a region marked by overvalued currency and delinquent payments across many nations.¹⁷

By August 1982, the debt crisis in Latin America publicly surfaced when Mexico became the first sovereign to announce its inability to make future payments on the country's billion dollars of

⁹ Miller, *supra* note 5, at 679-80.

¹⁰ *Id.*

¹¹ Allegaert, *supra* note 3, at 434 (suggesting that Latin LDCs were conversely impacted by the oil shocks which had provided significant capital for banks in the Western world).

¹² Miller, *supra* note 5, at 680.

¹³ See Alberto Gonzalo Santos, Note, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. REV. 66, 72-74 (1991).

¹⁴ *Id.* at 73-74.

¹⁵ See *id.* at 74.

¹⁶ *Id.*

¹⁷ See Allegaert, *supra* note 3, at 434.

debt.¹⁸ Mexico's disclosure rippled throughout the Americas and even the world. Within the following year, fifteen additional countries abandoned their debt obligations totaling approximately \$90 million in debt;¹⁹ among the other Latin sovereigns were Brazil, Venezuela, Argentina, and Bolivia.²⁰ Economists have estimated that external debt ballooned roughly sevenfold in Latin America from 1973 to 1983, escalating from approximately \$48 billion in 1973 to nearly \$350 billion by 1983.²¹

B. The Dynamics of the Immediate Response to the Sovereign Debt Crisis

Creditor banks were among the first entities to devise a response to the crisis, although motivated largely by a desire to protect their own assets and holdings.²² At the outset, these creditors were faced with severe monetary ramifications, including bankruptcy, as the crisis had illuminated the grim reality that bank loans far exceeded their capital reserve requirements.²³ Moreover, a default of this magnitude meant that creditors were forced to declare each original loan as a "nonperforming" asset, a situation that would result in immediate lost profits on quarterly earning statements.²⁴ With massive principals due on these loans and very little reserve capital to cover losses, financial institutions faced an inevitable, potentially system-wide collapse.

In devising a response, the banks recognized the fact that sovereigns could entirely avoid default if they were at least capable

¹⁸ Miller, *supra* note 5, at 680; *see also* James M. Hays II, Note, *The Sovereign Debt Dilemma*, 75 BROOK. L. REV. 905, 913-14 (2010); Power, *supra* note 2, at 2708; Nora Claudia Lustig, *Mexico in Crisis, the U.S. to the Rescue. The Financial Assistance Packages of 1982 and 1995*, THE BROOKINGS INSTITUTION, Jan. 1997, available at http://www.brookings.edu/articles/1997/01development_lustig.aspx.

¹⁹ Hays, *supra* note 18.

²⁰ Miller, *supra* note 5, at 680; *see also* Gonzalo, *supra* note 13, at 71-75.

²¹ Miller, *supra* note 5, at 680; *see also* Gonzalo, *supra* note 13, at 71-75.

²² *See* Miller, *supra* note 5, at 681; *see also* Gonzalo, *supra* note 13, at 71-75; Hays, *supra* note 18, at 914.

²³ *See* Miller, *supra* note 5, at 682; *see also* Gonzalo, *supra* note 13, at 71-75; Hays, *supra* note 18, at 914.

²⁴ Miller, *supra* note 5, at 681; *see also* Alan Riding, N.Y. Times, March 11, 1984, available at 1984 WLNR 505425; Power, *supra* note 2, at 2710-11.

of paying their still-massive interest within a 90-day window.²⁵ Utilizing this information, creditors proposed a scheme that prevented sovereigns from defaulting and enabled banks to declare their loans a performing asset. Known as “bridge loans,” the lending banks that provided the excessive loans initially responded to the crisis by awarding new, secondary loans for the singular purpose to pay interest that was due on the note. Remarkably, this measure succeeded during the interim – original loans were still recognized as performing assets for the lenders, and this kept both sovereigns and creditors afloat long enough to develop a structural adjustment for debt recovery.²⁶

During the next stage, creditors engaged with Latin American finance officials in order to implement restructure and repayment schedules.²⁷ Restructuring usually “wrote-off” a substantial portion of outstanding debt, reconfigured contract terms and payment deadlines, and otherwise allowed both parties to completely renegotiate the contract on terms amenable to the distressed borrower.²⁸ In addition, restructuring promoted voluntary cooperation among joint parties, and avoided unnecessary court intervention that had the undesirable effect of obtaining judgments against the very sovereigns that were unable to service the original debt.²⁹ Finally, the ideal restructuring provided incentives on both sides: the borrower evaded the burden of excessive debt and economic chaos, while the lender was guaranteed a structural repayment program for a portion of the debt.³⁰ Indeed, restructuring efforts throughout the late 1980s reflected general cooperation among banks and sovereigns, resulting in over forty successful restructurings between 1982 and 1984.³¹

Nevertheless, restructuring ultimately failed as a comprehensive solution due in large part to the emergence of the holdout

²⁵ Miller, *supra* note 5, at 681-82; *see also* Power, *supra* note 2, at 2710.

²⁶ *See* Miller, *supra* note 5, at 681-82; Power, *supra* note 2, at 2710-11; *see also* Hays, *supra* note 20, at 914.

²⁷ *See generally* Allegaert, *supra* note 3, at 436-37; Miller, *supra* note 5, at 682-84; Hays, *supra* note 18, at 914-15.

²⁸ Agasha Mugasha, *Solutions for Developing-Country External Debt: Insolvency or Forgiveness?*, 13 L. & Bus. Rev. Am. 859, 866 (2007).

²⁹ *See id.* at 867.

³⁰ *See id.* at 866.

³¹ Hays, *supra* note 18, at 915.

problem.³² Since restructuring depends on full cooperation between all other parties and joint parties alike, small rogue creditors routinely posed a challenging threat to a successful restructuring agreement.³³ For example, smaller banks – which hold a smaller portion of the outstanding sovereign’s debt – might reasonably believe that a court-ordered default was the least-burdensome choice with respect to the debt they owned. Since a creditor could only restructure their portion of the debt voluntarily, the small bank could enforce a court proceeding against the sovereign at any time following an event of default. Large banks, by contrast, would rarely consider a court-ordered default, because larger banks controlled a larger portion of the debt, which made it less likely to have their judgment satisfied. Simply put, sovereigns could satisfy a smaller judgment easier than they could a larger judgment. Therefore, larger banks were more likely to endorse restructuring agreements, yet these sentiments were routinely disrupted by recalcitrant creditors.³⁴

In addition to the private efforts to restructure sovereign debt, the multinational IMF also offered additional, though limited, financial assistance.³⁵ Prior to receiving an IMF loan, however, the recipient sovereign was required to adhere to strict economic austerity guidelines calling for a pre-defined “structural adjustment program.”³⁶ After a long struggle, though, these standards ultimately proved too abrasive for the unstable Latin LDCs. Combined with recalcitrance from the private lending sector, the debt crisis stagnated and LDCs reencountered similar challenges such as those in the early 1980s. Most LDCs fell back into high levels of unemployment and widespread poverty, while other nations became forums of social discontent through violent protests and political coups.³⁷

³² *Id.*; see also Miller, *supra* note 5, at 682-83 .

³³ See Hays, *supra* note 18, at 915; see also Miller, *supra* note 5, at 682-83.

³⁴ See Miller, *supra* note 5, at 683.

³⁵ *Id.*

³⁶ *Id.* at 684-85.

³⁷ *Id.* at 685 (hundreds of people died during Venezuelan protest against severity of austerity programs imposed by government on behalf of creditors); see also Jonathan Fuerbringer, *Brazil and Banks Reach Agreement on Reducing Debt*, N.Y. Times, July 10, 1992, at A1 (describing a thwarted coup in Venezuela and accusations of corruption in Brazil).

C. The Brady Plan and the Evolution of a Secondary Debt Market

Following multiple failed attempts to restructure burgeoning regional debt, the Brady Plan was introduced by United States Secretary of the Treasury, Nicholas Brady, in 1989.³⁸ The Brady Plan, like the restructuring efforts before, encouraged voluntary participation of bank creditors, “to reduce the debt obligations . . . by restructuring old debt and providing new loans.”³⁹ Conversely, sovereigns were required to reduce inflation, open economies to foreign investment and follow the IMF’s guidelines for austerity.⁴⁰ The financing model was facilitated by converting old loans owed by sovereign debtors into newly minted “Brady Bonds,” and Brady Bonds were offered for sale to the general public as securitized U.S.-backed Treasury Bonds.⁴¹ The money generated from Brady Bonds was used to pay back the sovereign’s debt obligations, although the value of the debt was typically reduced well below its actual value.⁴²

Through the issuance of Brady Bonds, a “secondary sovereign debt market” was effectively created for the investment of LDC debt, particularly in the emerging markets of Latin America.⁴³ The securitization of sovereign debt created this ancillary financial market for trading and buying Brady Bonds, harmonizing greater flexibility and diversity of the sovereign debt with adequate loan forgiveness for the sovereign borrowers. The Brady Plan also increased the number of market participants holding debt, therefore providing more resources for repayment, and further opportunity to successfully restructure.⁴⁴

By 1992 the status quo had improved markedly, as several Latin LDCs, including those hardest hit, enjoyed remarkable success in reducing sovereign debt and restoring confidence in financial

³⁸ Miller, *supra* note 5, at 685.

³⁹ *Elliot Associates, L.P. v. The Republic of Panama*, 975 F. Supp. 332, 334 (S.D.N.Y. 1997).

⁴⁰ See Fuerbringer, *supra* note 37.

⁴¹ Miller, *supra* note 5, at 685-86.

⁴² See *Id.* at 686.

⁴³ *Id.*; see also Hays, *supra* note 18, at 915-17 ; Mugasha, *supra* note 28, at 868.

⁴⁴ See Hays, *supra* note 18, at 915-16.

markets.⁴⁵ Former Federal Reserve Board chairman Paul Volcker stated, "the Latin American debt crisis is no longer a crisis," citing renewed growth patterns and debt manageability.⁴⁶ At a time when many feared that Latin America would never recover from their debt crisis, the Brady Plan and a new securitized debt market made a bold statement that debt relief was indeed achievable.

D. The Development of Vulture Funds and Subsequent Litigation

Despite the broad success of the Brady Plan, some countries were nevertheless derailed during their Brady restructuring due to the emergence of so-called "vulture funds" ("VFs").⁴⁷ In the context of sovereign debt, VFs are defined as investment companies seeking profits by purchasing distressed (or "decaying") debt in secondary sovereign markets at substantial discount.⁴⁸ Rather than participate with other creditors per the Brady Plan, the VFs holdout during negotiations and may allege immunity from regulatory penalties or assert their valid right to refuse consent.⁴⁹ In recent years, VFs have become notorious for being litigious against not only distressed nations, but also against some of the poorest and most unstable economies in the world.⁵⁰

VFs typically operate by strategically purchasing distressed debt after a sovereign has committed a technical default, and often wait for a period of months to determine whether the market will rise or fall in relation to the value of the debt. An improving market works to the benefit of VFs in two-ways: on one hand, the VF is now holding a profitable investment compared to the debt they originally purchased; on the other hand, VFs have a stronger negotiating

⁴⁵ See Fuerbringer, *supra* note 37 (Mexico, Argentina, Venezuela, Costa Rica, and Brazil are among the nations that attribute their success to the use of Brady Bonds).

⁴⁶ *Id.*

⁴⁷ See Broomfield, *supra* note 1, at 484-86; see also Hays, *supra* note 18, at 918-19.

⁴⁸ Broomfield, *supra* note 1, at 485-86.

⁴⁹ See Hays, *supra* note 18, at 918-19.

⁵⁰ See Lydia Polgreen, *Unlikely Ally Against Congo Republic Graft*, N.Y. TIMES (Dec. 10, 2007), available at http://www.nytimes.com/2007/12/10/world/africa/10congo.html?_r=1&pagewanted=all ("Such investors, running what critics derisively call vulture funds, have been widely denounced by the World Bank and the International Monetary Fund for forcing poor countries to fend off costly lawsuits rather than build classrooms and clinics.").

position and are more affective at holding out against the sovereign's restructuring.⁵¹ By riding on the coattails of legitimate commercial banks eager to forge a Brady Plan, VFs can potentially earn enormous profits on their investment.⁵² In recent studies, the U.S. heard eleven cases against African LDCs as well as Nicaragua, demanding \$695 million on primary debt, and collecting judgments that totaled \$659.4 million.⁵³

The judicial opinions supporting VF rights reflect the notion that U.S. courts will hold sovereigns accountable irrespective of their intention to sincerely adopt legitimate recovery measures.⁵⁴ However, these opinions assert contradictory positions in the context of authoritative bodies purporting to establish economic principles for international debt relief – examples include the IMF, the World Bank, and even commensurate U.S. legislation establishing a guide to international debt recovery.⁵⁵ Although the 1980s Latin American debt crises has been declared dead, there are recent examples

⁵¹ See generally Power, *supra* note 2, at 2752-53 (citations omitted).

⁵² See e.g., Michael Cooper and Leslie Wayne, *Publicity-Shy Giuliani Backer Is Thrust Into Spotlight*, N.Y. TIMES, Nov. 22, 2007, available at 2007 WLNR 23099010 (“Mr. Singer [VF owner] is perhaps best known for the fight he put up – and the money he made – in his battle over Peruvian debt. In 1996, he paid \$11.4 million for \$20 million worth of discounted, government-backed Peruvian bank debt. Then, rather than joining with 180 other Peruvian creditors who agreed to a plan using bonds to forgive some of the impoverished country’s debt, Mr. Singer held out for bigger payments He battled in the courts. At one point he hired an Albany lobbying firm and got New York State to change an obscure law to strengthen his position. When the dust had settled, Mr. Singer ended up getting \$58 million for his Peruvian investment.”)

⁵³ Broomfield, *supra* note 1, at 507.

⁵⁴ See, e.g., *Elliott Associates v. The Republic of Panama*, 975 F. Supp. 332 (S.D.N.Y. 1997) (holding that a VF could enforce its default claims against Panama, who had taken “advantage of the Brady Plan and restructured much of its external debt” by the time the lawsuit was instituted).

⁵⁵ See, e.g., Polgreen, *supra* note 50, at A1 (reporting that “vulture funds, have been widely denounced by the World Bank and the International Monetary Fund for forcing poor countries to fend off costly lawsuits rather than build classrooms and clinics”); 22 U.S.C. § 5322(1) & (8) (2006) (Congressional “findings” asserting that the international debt problem threatens the safety and soundness of the international financial system, threatens the stability of international trading, and that new debt approaches should focus on a reduction in current debt service obligations by debtor nations).

suggesting that VFs continue to enjoy success, reaping benefits against poor nations defaulting on their debt.⁵⁶ Thus, VF legislation provides ample room for lively debate; in light of legal ramifications and foreign policy concerns, international economic policies would clearly benefit by such legislation.

E. Heavily Indebted Poor Country ("HIPC") Initiative

Anne Krueger, as First Deputy Managing Director of the IMF, commented recently, if "a country's debts become truly unsustainable, it is in everyone's interest that the problem is addressed promptly and in an orderly way."⁵⁷ These sentiments would appear to ring true for even the most heavily indebted nations throughout the world and have surely led to the on-going support for the HIPC. The HIPC is an initiative that was created in 2006 by the International Development Association (IDA), a subdivision of the World Bank.⁵⁸ The program seeks to annually identify the world's poorest economies, in an effort to design sustainable and responsible fiscal policies to rid them of debt.⁵⁹

In late 2010, the report isolated 40 countries worldwide, primarily throughout Africa and Latin America, as consisting of the most heavily indebted nations in the world.⁶⁰ Among these extremely poor nations, the report identified 17 ongoing cases by rogue creditors seeking monetary judgment against their distressed debt.⁶¹

⁵⁶ See, e.g., *Vulture Fund Awarded \$100m in Jersey Court*, JUBILEE DEBT CAMPAIGN.ORG (Nov. 4, 2010), [http://www.jubileedebtcampaign.org.uk/Vulture%20Fund%20awarded%20\\$100m%20in%20Jersey%20court+6486.twl](http://www.jubileedebtcampaign.org.uk/Vulture%20Fund%20awarded%20$100m%20in%20Jersey%20court+6486.twl) (reporting that a court in Jersey made a \$100 million judgment in favor of a U.S. VF against the Democratic Republic of Congo).

⁵⁷ Anne Krueger, *Should Countries Like Argentina Be Able to Declare Themselves Bankrupt?*, INTERNATIONAL MONETARY FUND, Jan. 18, 2002, available at <http://www.imf.org/external/np/vc/2002/011802.htm>.

⁵⁸ See Broomfield, *supra* note 1, at 490-91.

⁵⁹ *Id.* at 491.

⁶⁰ See INTERNATIONAL DEVELOPMENT ASSOCIATION AND INTERNATIONAL MONETARY FUND, HEAVILY INDEBTED POOR COUNTRIES INITIATIVE (HIPC) INITIATIVE AND MULTILATERAL DEBT RELIEF INITIATIVE (MDRI)—STATUS OF IMPLEMENTATION, at 7 (2010), available at <http://www.imf.org/external/np/pp/eng/2010/091410.pdf> (last visited Jan. 17, 2010) [hereinafter HIPC Initiative].

⁶¹ *Id.* at 20.

It should be noted, however, that this figure clearly does not include vulture litigation targeted against other very poor nations, as the HIPC only focuses on those nations in the very bottom echelon of third-world countries. Thus, in sovereigns ravaged by civil war, political upheaval, and social chaos, VFs nonetheless enjoy court protection in seeking to gain a monetary judgment against both their interest and the interest of others through international markets.

III. LEGISLATION

A. Europe

In 2008, Belgium became the first country to pass national legislation targeting VFs in an effort to protect debt restructuring efforts held hostage by VFs.⁶² This occurred in reaction to several VFs increasing litigation activity within Belgium, beginning around 2007.⁶³ In addition, Belgium legislatures have passed a broader, non-binding agreement purporting to call on the World Bank and IMF to implement multinational programs to aid in prohibiting creditor litigation.⁶⁴ Such measures would most likely mimic the recently proposed Sovereign Debt Restructuring Mechanism (“SDRM”), which was first introduced by Anne Krueger of the IMF in 2002 but has since failed to gain international traction.⁶⁵ Although the SDRM is a broad policy well beyond the scope of this paper, it should be briefly noted that prominent academics have attributed criticism for the SDRM to the “steadfast opposition . . . by the major financial industry associations.”⁶⁶

On April 8, 2010, the United Kingdom passed similar legislation to Belgium laws, entitled the Developing Country Debt

⁶² Broomfield, *supra* note 1, at 503-4.

⁶³ *Id.* at 503.

⁶⁴ *See Id.* at 504.

⁶⁵ *See* Anne Krueger, *A New Approach to Sovereign Debt Restructuring*, INTERNATIONAL MONETARY FUND, April 16, 2002, available at <http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/index.htm> (last visited Jan. 17, 2010).

⁶⁶ Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 *Geo. J. Int'l L.* 299, 391-92 (2005) (also citing, e.g., the absence of progress in incremental contractual approaches within the SDRM framework, and the distinction between U.S. policies and European policies in attempting to curb sovereign debt)

Bill ("Recovery Bill").⁶⁷ This legislation is effective for one year, at which time Parliament will vote on whether to extend the law, and if so, whether to modify any of its terms.⁶⁸ The "Recovery Bill" is notable for its emphasis protecting HIPC countries against creditor litigation, which the UK has identified as particularly vulnerable to the damages by VFs.⁶⁹ The legislation comes in the aftermath of at least seven recent HIPC cases heard in the U.K. jurisdiction.⁷⁰

B. United States

Legislation in the U.S. has lagged well behind that of Europe; a statistic that is unsurprising considering that European countries, unlike the U.S., are now resolving their financial issues through quick, nonpartisan, and broad reform measures and treaty obligations.⁷¹ This delay coupled with the fact that governments in middle-income and poor countries owned more than \$300 billion in outstanding bonds governed by either New York or English law.⁷² Consequently, U.S. Representative Maxine Waters (D-California) introduced the "Stop Vulture Funds Act" ("Vulture Act") on August 1, 2008, which sought to enforce government caps on VF-obtained judgments.⁷³ Under this bill, VF funds have limited recovery in U.S. courts; the limitation being based on the purchase price on their debt plus 6% accrued interest.⁷⁴ Interestingly, sovereigns lose protection from the Vulture Act if they "commit gross violations of human rights, engage in excessive military spending, support terrorism, or fail to cooperate with the United States on narcotics control

⁶⁷ Broomfield, *supra* note 1, at 477.

⁶⁸ *See Id.*

⁶⁹ *Id.* at 506.

⁷⁰ *Id.* at 504.

⁷¹ Hagan, *supra* note 66, at 391.

⁷² Anna Gelperin, *Innovation After the Revolution: Foreign Sovereign Bond Contracts Since 2003*, Rut. S. Law (forthcoming) at 3, available at <http://ssrn.com/abstract=1272464>.

⁷³ Press Release, *Congresswoman Waters Introduces Bill to Protect Poor Countries from Vulture Funds* [hereinafter Press Release], http://www.house.gov/apps/list/press/ca35_waters/PR080801_vulturefunds.html, (last visited Jan. 17, 2010).

⁷⁴ Broomfield, *supra* note 1, at 507.

matters.”⁷⁵ Passing the Vulture Act bill is currently discussion in the U.S. Congress.⁷⁶

IV. ANALYSIS

A. Benefits of VFs Compared to Modern Framework

Although VFs pose a grave risk to the stability and restructuring of sovereign nations, there are several reasons justifying the benefits of VFs. First and foremost, proponents liken the value of VFs to their ability to expose corruption within the poorly indebted sovereign.⁷⁷ Indeed, one example attributes VFs with successfully uncovering \$82,000 in fraud, perpetrated by the Congolese government.⁷⁸ Moreover, supporters argue that VFs help ensure that sovereigns are prevented from engaging in opportunistic defaults or coercive restructuring offers.⁷⁹ In this way, VFs have been most effective at deterring recalcitrant sovereign behavior, while concepts such as “reputational harm” have simply failed at a theoretical level.⁸⁰

In light of these arguments, it appears that multinational agencies have increasingly moved in a direction that will negate these one-time institutional failures. As noted in Part III.A above, organizations spearheaded by the World Bank, IMF, and IDA, have implemented procedures designed to increase transparency of the actions of heavily indebted nations. Other agencies, including grassroots movements, call for an end to the debt crises and unscrupulous VFs through various mediums that create heightened public awareness and bring VFs to the international spotlight.⁸¹ Due to these programs, corruption is more likely to be identified during the stages

⁷⁵ Press Release, *supra* note 73.

⁷⁶ See Broomfield, *supra* note 1, at 507.

⁷⁷ See *id.*

⁷⁸ Cooper & Wayne, *supra* note 52; see also Broomfield, *supra* note 1, at 516-17 (noting that the Elliott fund, in the course of its attempt to seize Congolese assets, uncovered corruption in the Congo that otherwise would have continued unreported).

⁷⁹ See Broomfield, *supra* note 1, at 514-15.

⁸⁰ See *id.* at 515.

⁸¹ See, e.g., JUBILEE DEBT CAMPAIGN, <http://www.jubileedebtcampaign.org.uk/Our%20mission+2245.twl> (last visited Jan. 18, 2011).

of restructuring, with or without the participation from vulture funds.

In addition, the proposed U.S. Vulture Act would prevent corrupt sovereigns from ever enjoying the benefits under the new legislation.⁸² Of course, this would come at a small cost – prior to litigation, lawyers would need to establish whether the sovereign involved in litigation was linked to the enumerated behavior under the statute. In this way, though, the Vulture Act attempts to weed out any illegitimate nations who would unfairly benefit under the proposed protection, thus negating the supposed “value” of VFs. Considering the significant success that creditors have enjoyed in U.S. courts, many legitimate countries would experience drastic benefits under this new bill, including their ability to restructure debt, build new schools, construct new roads, or otherwise begin the process of rebuilding their economies.⁸³ The benefits should be weighed heavily against the small costs attributed to isolating the potentially opportunistic sovereign cases.

B. Reducing U.S. Localization of VF Cases

Due to the fact that legislation has already passed in the U.K., it is imperative for U.S. courts to at least make a salutary attempt to reflect commensurate change. As it currently stands, VFs are prohibited from litigating HIPC cases in U.K. courts, a jurisdiction which has been distinguished as one of the most common forums for litigation.⁸⁴ In addition, VFs are specifically prohibited from litigating in Belgium, a nation that saw increasing creditor court activity leading up to the passage of its current legislation. Thus, the U.S. is now the most creditor friendly forum for HIPC cases - perhaps VFs altogether - and this may lead to many undesirable consequences for U.S. courts and foreign policy.

Among the leading consequences is a possible adverse effect to the judicial economy because a vastly increasing number of VF cases would seek U.S. jurisdiction. When litigated in U.S. courts, VF

⁸² See Press Release, *supra* note 73.

⁸³ See, e.g., Polgreen, *supra* note 50, at A1.

⁸⁴ See Broomfield, *supra* note 1, at 485-86 (stating that jurisdictions in New York, Paris, and London are most common for VF lawsuits).

cases are remarkably successful; obtaining judgments totaling almost 95% of claimed damages in recent HIPC cases.⁸⁵ The anticipated increase in U.S.-based litigation would lead to further delays in debt restructuring, debt repayment, and HIPC reorganization. As the HIPC itself has noted a drop in accessible funds to fight litigation,⁸⁶ it is imperative for leading economic nations to initiate domestic measures, such as the Vulture Act, which is designed to prevent detrimental HIPC litigation.

C. A Need to End Further Erosion of Sovereign Immunity

VF litigation has resulted in particular erosion from the doctrine of sovereign immunity, and continued litigation without government caps poses a substantial risk to further erode this doctrine when it is not desirable. Generally speaking, a sovereign state is immune from the courts in a foreign jurisdiction in relation to an act of sovereign authority.⁸⁷ Normally, this would have prevented many of the VF cases from being heard in U.S. courts, since these cases tend to arise against the interest of sovereign debt holders. Nevertheless, governing law in foreign jurisdictions can limit the scope of this protection, such as the Federal Sovereign Immunities Act ("FSIA"),⁸⁸ which provides for the governing law, and explicitly provides for exceptions to the immunity privilege in U.S. courts. Notably, these exceptions are relevant to sovereign debt litigation to the extent that U.S. courts can exercise jurisdiction over sovereigns in the context of a "commercial activity."⁸⁹ In a series of recent federal cases, the courts have attempted to define this elusive concept, though in doing so they have gradually chipped away many immunity rights traditionally afforded to foreign nations.

⁸⁵ See *id.* at 507 (creditors claimed \$695 million on HIPC debt, with original face-value of \$195.9 million, obtaining favorable judgments that amounted to \$659.4 million).

⁸⁶ See HIPC Initiative, *supra* note 60, at 21.

⁸⁷ See Caroline Bradley, *The International Financial System: Sovereigns*, at 48, available at <http://beta.blenderlaw.umlaw.net/wp-content/uploads/2010/01/infinmats2010.chap2.pdf> (working paper).

⁸⁸ 28 U.S.C. § 1605 (2008) [hereinafter "§1605"].

⁸⁹ See § 1605(a)(2).

Most prominently, the Supreme Court has held that commercial activity exists where a sovereign has participated in a bond market for the sole purpose of refinancing their national debt.⁹⁰ Thus, in *Weltover*, the majority for the Court determined that Argentina did not have immunity and therefore performed a commercial activity (under the meaning of the FSIA §1605(a)(2)), where the sovereign's conduct concerned the issuance of debt instruments for the private market.⁹¹ The opinion focused on the "nature" of the activity as opposed to its "purpose," and then determined, "that it is irrelevant *why* Argentina participated in the bond market in the manner of a private actor; it matters only that it did so."⁹² In rejecting Argentina's contention that their activity was precluded since it did not involve "raising capital or financing acquisitions," the Court observed that private parties often participate in these markets and issue bonds with the intent for "refinancing debt."⁹³

The Court's opinions also addressed the ambiguity of *De Sanchez v. Banco Central de Nicaragua*,⁹⁴ where the Fifth Circuit held that Nicaragua's "purpose" was indeed necessary in determining whether the failure of the national bank to honor a check was sufficiently commercial.⁹⁵ Perhaps *Weltover* is most distinguishable, however, because there was never a genuine dispute whether Argentina engaged in purely market activity – in contrast, *De Sanchez* concerned a noticeable degree of ambiguity, thus requiring further evaluation by the court. Nevertheless, the ambiguity begs the question of where the Court will draw the line, especially considering the rise in secondary bond trades which have diversified the number of sovereign bond holders who may subject those sovereigns to U.S. jurisdiction.

Two earlier cases have also illustrated the courts' reluctance to grant immunity, in both the context of waivers and comity. Although these cases arose in general creditor suits, they are nonetheless reflective of the general trend adopted by VF cases such as

⁹⁰ See *Republic of Argentina v. Weltover*, 504 U.S. 607 (2002).

⁹¹ See *id.*

⁹² *Id.* at 614-16 (emphasis added).

⁹³ *Id.* at 616.

⁹⁴ 770 F.2d 1385 (5th Cir. 1985).

⁹⁵ See 504 U.S. at 616-17.

Weltover. In *Libra Bank Ltd. v. Banco Nacional de Costa Rica, S.A.*,⁹⁶ Banco Nacional passed a resolution prohibiting payments from state owned entities to foreign creditors.⁹⁷ Libra Bank, however, sought payment on a \$40 million loan, then initiated a default proceeding in New York state court, and ultimately attached Banco's property there.⁹⁸ Banco removed the action to federal court and sought immunity, but the court responded by rejecting the defense and holding Banco accountable for waiving their immunity.⁹⁹ In more recent litigation, a 2009 opinion struck another blow against sovereign's rights to immunity by refusing to recognize an ambiguity defense where the waiver omitted the explicit jurisdiction.¹⁰⁰

In addition to these waiver decisions, the courts have expressly failed to grant immunity through the doctrine of comity. In U.S. courts, comity is defined as giving effect to the actions of a foreign state, so long as those actions are in conformity with the laws of the U.S.¹⁰¹ For example, *Allied Bank International v. Banco Credito Agricola de Cartago*¹⁰² concerned a dispute where Allied's agent, Fidelity Union, refused to agree to a restructuring that was already accepted by other creditors.¹⁰³ In rejecting Allied's comity defense, the court held that Costa Rica's unilateral behavior designed to repudiate private obligations was inconsistent with U.S. policy.¹⁰⁴ Thus, this decision, like *Weltover* and *Libra Bank*, effectively served to strip Costa Rica from their immunity in court proceedings.

Due to these decidedly pro-creditor opinions, VFs and other similar creditors have responded by increasingly bringing their

⁹⁶ 570 F. Supp. 870 (S.D.N.Y. 1983).

⁹⁷ *Id.* at 875-77.

⁹⁸ *Id.* at 885.

⁹⁹ *Id.* at 897.

¹⁰⁰ See *Capital Ventures Int'l v. Republic of Argentina*, 552 F.3d 289 (2d Cir. 2009) (holding that a waiver to immunity was not ambiguous even though the language never explicitly stated that Argentina was waiving immunity in the U.S.).

¹⁰¹ Christopher C. Wheeler & Amir Attaran, *Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation*, 39 STAN. J. INT'L L. 253, 254 (2003).

¹⁰² 566 F. Supp. 1440, 1441 (S.D.N.Y. 1983), *aff'd*, 733 F.2d 23 (2d Cir. 1984) (per curiam), *rev'd on reh'g*, 757 F.2d 516 (2d Cir. 1985).

¹⁰³ *Id.*

¹⁰⁴ See *id.*

claims in U.S. federal courts. Undoubtedly, VFs will continue to do so as long as national legislation does not prevent them. Thus, VF legislation purporting to cap recoveries is particularly important now, considering the judicial trend to grant enormous judgments in favor of VFs.¹⁰⁵ Furthermore, the quicker VF legislation is enacted in the U.S., the sooner these courts are prevented from interfering with restructuring procedures in these cases.

It is noteworthy that at least one "Working Group" for the ABA has expressed minor discontent with the *Weltover* standard; the group indicates that they would recommend a heightened standard by requiring a "substantial" and direct effect in the context of the "commercial activity" exception.¹⁰⁶ Such a standard would promote VF legislation since it would reduce the likelihood that sovereign could be hauled into court for merely issuing bonds in the secondary debt market. Nevertheless, this proposal may not have any practical effect, considering recent empirical data that estimates that poorer sovereigns hold hundreds of billions of dollars in outstanding loans in the markets of New York and London.¹⁰⁷ This type of economic activity strongly suggests that many sovereigns would indeed satisfy the heightened economic activity standard, although a legitimate question still remains as to whether their behavior was "direct" as defined under *Weltover*. Since VF legislation is largely unnecessary to begin with, however, further case law purporting to erode sovereign immunity under ambiguous standards such as *Weltover* is simply undesirable.

D. New Legislation Corroborates With the Current U.S. Position on International Debt Management

In the recent VF litigation, court opinions have attempted to support pro-creditor arguments by stating that these decisions are aligned with current U.S. interests on international debt manage-

¹⁰⁵ See generally Broomfield, *supra* note 1, at 487-91.

¹⁰⁶ See Bradley, *supra* note 87, at 58-59 ("Report on the U.S. Foreign Sovereign Immunities Act" by a Working Group of the International Litigation Committee of the Section of International Law and Practice of the American Bar Association, April 2001, available at <http://www.abanet.org/intlaw/policy/civillitigation/foreignsovereignimmunities.pdf>).

¹⁰⁷ Gelperin, *supra* note 72, at 3.

ment. These justifications are incorrect, however, as competing literature suggests that the U.S. position is currently in favor of reducing damage awards for VFs, rather than promoting litigation in creditors' favor. In one prominent example, *CIBC Bank and Trust Co. (Cayman) Ltd v. Banco Central do Brasil*,¹⁰⁸ the district court held in favor of a breach of contract claim instituted by a VF against a sovereign.¹⁰⁹ This was astonishing, partly because the U.S. Government issued a "Statement of Interest" in that case, declaring that VFs "may seek through litigation to benefit from voluntary debt reduction previously agreed to by the commercial banks . . . rather than negotiate a restructuring with the debtor in the orderly manner that the United States described in its *Allied* brief and has supported consistently since 1982 . . ." ¹¹⁰ As a result, while the *Allied* court seemed to adopt the positions supported by the U.S. in that case, the *CIBC Bank* court would appear to depart from the prevailing U.S. position. These factors are particularly instructive because they reflect the court's modern desire to pursue its own interpretation as these cases arise.

It should be briefly noted that the *Allied* case concerned a lawsuit initiated by a syndicate of commercial banks, whereas *CIBC Bank* merely concerned the interest of a secondary market debt holder (in other words, a VF).¹¹¹ Observing the fact that *Allied* was heard in 1984 and *CIBC Bank* was heard well after the Brady Plan in 1995, the U.S. Government's position in *CIBC Bank* was that "while in 1984 banks rescheduled debt with the expectation of eventual full repayment, the widespread acceptance of the Brady Plan, which calls for commercial debt service and debt reduction, has generally changed this expectation."¹¹² Thus, the U.S. policy changed in order to evolve with the international markets, yet the courts retained old principles of contract law that are arguably ineffective at promoting economic stability.

In light of this perspective, it was unremarkable when the court held in favor of the VF, Elliot Associates, in the widely

¹⁰⁸ See 886 F. Supp. 1105 (S.D.N.Y. 1995).

¹⁰⁹ See Power, *supra* note 2, at 2745-51.

¹¹⁰ *Id.* at 2752-53 (citations omitted).

¹¹¹ See *id.* at 2737.

¹¹² *Id.* at 2752 (citations omitted).

recognized case *Elliot Associates, L.P. v. Banco De La Nacion*.¹¹³ It was interesting, however, when the court took notice of two competing U.S. interests in the underlying litigation: first, that the U.S. encourages participation in the success of IMF resolutions, and second, that the U.S. has a strong interest in enforcing valid debts under the principles of contract law.¹¹⁴ In the context of VF litigation, however, it seems confusing to say that the U.S. has any interests other than the position espoused in the "Statement of Interest" in *CIBC Bank*, where the U.S. effectively supported IMF management policies. Furthermore, national legislation, albeit nonbinding, bolsters this argument by purporting to guide U.S. policy in light of international debt management.¹¹⁵ Thus, it is reasonable to assume that the U.S. interest in contract law principles was actually assumed in the enactment of legislation regarding international debt management. The *Elliot* court and other decisions asserting pro-VF positions suggest the court's desire to go out of their way to justify holding sovereigns accountable for their defaulted payment, even in light of clear statements suggesting an alternative U.S. position.

E. Reduced Judicial Interovention with Market Activity

Due to judicial opinions asserting a pro-creditor stance, the effects of these decisions may be undesirable on the international markets, where judges and juries lack the financial expertise to make effective decisions. In one sense, this goes as far back as the "bridge loans" issued in the aftermath of the debt crisis, where the courts passively allowed banks to engage in the same exact unethical behavior that prompted the debt crisis to begin with. Some commentators have recently asserted that these "rescue loans" increased "moral hazard" because investors were allowed to engage in

¹¹³ 194 F.3d 363 (2d. Cir. 1999).

¹¹⁴ Bradley, *supra* note 87, at 37.

¹¹⁵ See 22 U.S.C. § 5322(1) & (8) (1988) (Congressional "finding" asserting that the international debt problem threatens the safety and soundness of the international financial system, threatens the stability of international trading, and that new debt approaches should focus on a reduction in current debt service obligations by debtor nations).

speculative activity despite knowing their high-risks.¹¹⁶ As a result, a judicial trend was established which essentially acquiesced and allowed this type of behavior to continue. Indirectly, therefore, the courts left an impression on financial markets, and perhaps created situations that led to unintended consequences affecting many nations through international markets. The lack of penal oversight also led to strict austerity measures that ultimately forced Latin nations such as Argentina, Mexico, Venezuela, and Brazil into deep recession and eroded their ability to meet future debt obligations.¹¹⁷

In contrast, the IMF policies on pre-debt crisis reflected the notion that underdeveloped economies were weak and unstable, and that they required enhanced regulatory oversight. This system saw relative success up until the 1970s, when inflation prevented its further development. Accordingly, one should question whether the courts are even the correct forum for these disputes – after all, these opinions provide little insight into their intended effect on international markets. In contrast with the IMF's policies of looking to global management over international debt, U.S. judicial opinions emerge narrow and shortsighted.¹¹⁸ Assuming that U.S. courts are indeed the proper forum for these cases, there is considerable evidence suggesting that strict limitations should be enforced in order to protect international markets from further crisis.

V. CONCLUSION

In light of the historical developments leading to a sovereign debt crisis and the evolution of a secondary debt market, U.S. judicial opinions have failed to ensure broad safeguards for international financial markets. As such, VFs have seen their day in court, and will continue to enjoy profitable success at the expense of developing economies, and perhaps world trade markets, unless government caps are enforced on their recoveries. With other \$300 billion in bonds held in New York and London markets, it is especially imperative that U.S. lawmakers encourage judicial limitations to

¹¹⁶ *The Financial Crisis of Latin America and the New International Financial Architecture*, THIRD WORLD NETWORK, <http://www.twinside.org.sg/title/twr122f.htm>.

¹¹⁷ See Riding, *supra* note 24.

¹¹⁸ The U.S. Congress' debates on the Vulture Act are heading on the right direction, however.

prevent further delay in developing country restructurings. A policy emphasizing VF reform is in direct accord with U.S. foreign and public policy, thus reflecting the appropriate position as an economic world leader.