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Abstract

Vulture funds and rogue creditors put in question the sustainability of the sovereign debt market by creating confusion and uncertainty in the global financial system. On the one hand, they take advantage of indebted countries' economic hardship to profit at the expense of bondholders who participate in debt restructurings. On the other hand, vulture funds' predatory behavior and litigation tactics keep the market alive by discouraging moral hazard and forcing sovereign states to be more responsible in managing public finances. However, the absence of clear rules on sovereign lending and debt restructuring has created the need for a more regulated sovereign debt market. Many experts question the ability of courts to make decisions about which defaults are allowable and which creditors should be fully reimbursed. Throughout the last three decades, the Baker Plan, the Brady Plan and the IMF's Sovereign Debt Restructuring Mechanism sought to address the tension between capacity and willingness to pay without succeeding in defining the framework within which public and private entities should operate. This research paper seeks to address the following questions: how much power do rogue creditors have? And what are the obstacles that vulture funds face in collecting sovereign assets? Finally, is the establishment of international debt restructuring rules the solution to the lack of regulation? The paper examines the legal tactics and strategies that vulture funds pursued against Argentina and Greece before and after their debt restructurings and analyzes the far-reaching consequences of the two countries' financial policy on the viability of the sovereign debt market.

Keywords

vulture funds, Greek sovereign debt crisis, holdouts, financial markets, rogue creditors

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1. Introduction

Throughout the last three decades, vulture funds and rogue creditors changed the business of sovereign debt by taking advantage of sovereign defaults. Vulture Funds are hedge funds that buy distressed debt of highly indebted countries at a discount in the secondary market. The primary holders of the debt are usually more than willing to rid themselves of the bonds even at a lower selling price since they are aware that the countries in question will face debt restructuring negotiations soon. When the countries default on their debt and arrive at the point of writing it off, vulture funds sue the debtor government for the full value of the debt plus interest. Vultures seek to recover the full face value of the bonds they purchased and make excessive profits. They are usually based in offshore tax heavens and their activities are undertaken through informal channels and without proper supervision.

The Latin American debt crisis was a turning point that changed private investors' attitude towards sovereign states, inspiring them to take a very determined approach to getting their contracts enforced. Through specific legal interventions and aggressive strategies, rogue creditors seek to make excessive profits at the expense of poor countries that cannot serve their debt obligations. The default of Argentina in 2002 highlighted creditors' determination to collect sovereign assets and revealed the importance of litigation as a means to collect sovereign assets. Vulture funds question the fundamentals of the sovereign debt market. On the one hand, it is argued that vulture investors take advantage of countries' economic hardship. On the other hand, vulture funds and their litigation strategies keep the market alive by discouraging moral hazard and forcing sovereign states to be more responsible in managing public finances.

Simultaneously, the financial transformation of the world and the liberalization of capital challenged the states' sovereign power vis-à-vis individual creditors. The role of these creditors in the global economy becomes more important in terms of influencing economic policy-making and disrupting debt restructuring processes. The absence of clear rules in the international arena and the lack of institutional structures have created the need for a more regulated sovereign debt market that prevents, manages and resolves debt crises more effectively.

2. Private Creditors and the Sovereign Debt Market: Historical Evolution

During the first decades after the Second World War the sovereign debt market was limited to loan agreements. Before 1970 lending to sovereign countries was in the form of government-to-government loans or development aid funds offered by international organizations, such as the World Bank and the International Monetary Fund[1]. From the mid-1970s commercial banks emerged as the principal financial intermediaries and started allocating credits to developing countries in the form of syndicated loans. The rise in the price of oil during this period generated huge surpluses for oil-exporting countries, which needed to be recycled to oil-importing countries in the form of capital flows[2]. Thus, commercial banks sought to recycle the petro-dollar funds and finance the Least Developed Countries (LDCs) of the world.

The transition from government-to-government loans to commercial bank syndicated credits was based on the general belief that the governments of industrial countries guarantee the loan offers to the developing countries. The misleading perception about the guarantees on the syndicated loans led commercial banks to take excessive risks and to ignore the credit quality of debtor countries[3]. However, banks did not pursue vulture strategies because of the strict bank regulation and the use of monitoring mechanisms that prevented them from suing sovereign governments in the event of a default. Moreover, sovereign immunity was protected and the enforcement of debt contracts was complicated by the increasing difficulty of creditors to collect sovereign assets.

From the late 1970s private sector lending expanded and governments decided to help the sovereign lending market develop by making it more flexible and restraining the definition of sovereign immunity. The United States' Foreign Sovereign Immunities Act of 1976 and Great Britain's State Immunity Act of 1978 guaranteed the right of foreign creditors to seize assets abroad and allowed governments to borrow under the legal systems of developed countries[4]. The Latin American debt crisis of the mid-1980s that started with Mexico's inability to service its external debt

[1] Michael P. Dooley, "A Retrospective on the Debt Crisis", in *Understanding Interdependence: The Macroeconomics of the Open Economy*, edited by Peter B. Kenen, 1995

[2] Anthony Sanders and Marcia Cornett, "Financial Institutions Management", McGrawHill/Irwin, 6th edition, 2008, p. 425

[3] Michael P. Dooley, "A Retrospective on the Debt Crisis", in *Understanding Interdependence: The Macroeconomics of the Open Economy*, edited by Peter B. Kenen, 1995

[4] Jeremy Bulow and Kenneth Rogoff, "Cleaning Up Third World Debt Without Getting Taken to the Cleaners", Journal of Economic Perspectives, Winter 1990, p. 40

was the turning point in the deregulation of the market and emergence of vulture creditors. James Baker, the US Treasury Secretary, proposed the Baker Plan, which called international economic organizations, mainly the World Bank and the IMF, to increase their lending to developing countries in exchange for market-oriented reforms[5]. The Plan illustrated the belief that economic growth was the key to resolving debt problems and, for this reason, sought to restore private capital inflows to heavily indebted countries. The market-oriented reforms were also supported by commercial banks that provided refinancing to distressed debtor countries. Despite the series of debt rescheduling that followed the Plan, these measures were not enough to reestablish the financial stability needed in emerging markets.

The failure of the Baker Plan led the US and international financial institutions to rethink their strategy and redesign the structure of the sovereign debt market. In 1986 the US Treasury Secretary Nicholas Brady put in place the Brady Plan, which constituted the basic loan restructuring mechanism of developing countries. The Brady Plan called for the US and the IMF to exchange dollar loans for dollar bonds issued by heavily indebted developing countries[6]. These bonds had longer maturity and lower coupon yield than the original loans. In order to reduce sovereign risk and to ensure that private sector creditors will get their money back in the event of a default, the principal was backed by collateral in the form of the issuing country's purchased US Treasury bonds. Consequently, in the event of a default, the buyers of the bonds had access to the dollar bonds held as collateral.

The conversion of bank loans into Brady bonds has allowed Mexico to access financial markets again and to reduce its debt. The debt forgiveness and the guarantees of the US Treasury on the collateral of the Mexican oil reserves have freed resources for development and economic growth and improved the prospects for better debt servicing in the medium term[7]. However, the implications of the Brady Bonds on the sovereign debt market have been much more serious. By the mid-1990s sovereign debt had been converted from syndicated bank loans into sovereign bonds that could be traded in the secondary market. With the creation of the sovereign bond market, private sector creditors and private investors started

[5] Michael Dooley, "A Retrospective on the Debt Crisis", in *Understanding Interdependence: The Macroeconomics of the Open Economy*, edited by Peter B. Kenen, 1995

[6] Anthony Sanders and Marcia Cornett, "Financial Institutions Management", McGrawHill/ Irwin, 6th edition, 2008, p. 443

[7] Huw Pill, "Mexico: The Tequila Crisis 1994-1995", HBS Case 9-702-093, October 2002

lending to both the developing and developed countries[8]. The increasing participation of private creditors has exposed the market to new risks and has allowed vulture funds and rogue creditors to take advantage of the system. Their growing number has also undermined the efforts to manage holdouts and has eliminated regulatory pressures on the legal tactics and strategies that hedge funds use to sue sovereign countries.

3. Vulture Funds: Legal Tactics and Lobbying Strategies

a. Litigation

Litigation is the main form of dispute resolution that vulture funds use to enforce their debt contracts. Although the notions of state sovereignty and sovereign immunity have always been considered an impediment to suing governments, the first successful litigation of Allied Bank against Costa Rica in 1981 opened the door to vulture tactics and demonstrated that sovereign states are not protected in the event of a default. In 1981 the Costa Rican government missed the payment of a 29-member bank syndicate and negotiated a debt restructuring that was accepted by all debt holders, except Allied Bank[9]. US courts offered Allied Bank a favorable court ruling, which concluded that the repayment obligations of Costa Rica remained "valid and enforceable" despite the debt restructuring. The Costa Rican case created a precedent and changed the power relations between sovereign states and private investors.

As the emerging markets' debt crisis of the 1980s was unfolding, it became clear that the race to the courthouse delayed and disrupted debt restructuring. By the mid-1990s vulture funds had won enough court rulings to officially validate their right to litigate on the basis of a claim acquired in the secondary market. However, with the creation of Brady bonds and the increasingly regulated restructuring mechanisms, courts began to acknowledge the importance of smooth and undisputable debt negotiations under the Brady Plan. Even though courts recognized the validity of the holdouts' argument about the enforcement of their debt contracts, they suspended any litigation conducted during the Brady deal negotiations. The controversy, which

[8] EMTA Trade Association for the Emerging Markets, "History and Development", available at www.emta.org/template.aspx?id=34, last accessed 1 July 2014
[9] Arturo C. Porzecanski, "From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default", p. 330, available at: 128.118.178.162/eps/if/papers/0510/0510010.pdf

the above-mentioned decision carried, is well illustrated by the case of Peru. In 1992 the Peruvian state bank Banco Popular was liquidated and went through a complex debt restructuring process. Pravin Banker Associates, a New York investment boutique, sued Banco Popular to recover the full face value of the debt it held[10]. For the first time the US courts issued two stays of litigation, halting further legal process and postponing the proceedings indefinitely. When Peru reached an agreement with creditors and completed the debt restructuring deal, Pravin Banker Associates was ultimately successful in getting a favorable judgment from the court.

b. Pari Passu Clause

Holdouts have also managed to manipulate the interpretation of specific legal clauses. The *pari passu* clause that is included in most debt contracts and the lack of clarity in its interpretation has delayed and disrupted debt restructurings. The *pari passu* clause requires the equal treatment in bankruptcy for holders of unsecured and unsubordinated debt and assumes that the debt must be repaid pro rata among all creditors[11]. It constitutes a contractual protection against favored creditors because it acknowledges that no creditor can be deprived of their proportionate share. In the case of debt restructuring and holdout litigation, the clause forbids governments to pay only to those creditors who accepted the restructuring without also paying the holdouts. Vulture funds use the *pari passu* clause to secure face value recoveries on debt contracts that have been restructured. According to the legal expert Andreas Lowenfeld, who supported the vulture fund Elliot Management Corporation before the court, "if the Republic of Peru pays principal or interest to holders of the Brady Bonds or some of them, it is obligated to make a payment of a proportionate amount to all holders of affected debt… including Elliott"[12].

c. Foreign Law vs. Domestic Law Bonds

Vulture funds and rogue creditors always prefer bonds governed by UK or US law. Foreign law bonds are more secure than domestic law bonds since their terms cannot be easily changed by third party governments. Under foreign law, changes in

[10] Federico Sturzenegger and Jeromin Zettelmeyer, "Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings, 1998-2005", IMF Working Paper 05137, July 2005

[11] Charles G. Berry, "Pari Passu Means What Now?" New York Law Journal; Corporate Restructuring and Bankruptcy, 6 March 2006

[12] Ibid

the terms of a debt contract, including debt restructuring, rescheduling or the inclusion of special legal clauses, require separate agreements with all bondholders. Therefore, foreign law contracts undermine the government's ability to refuse a payment and force it to coordinate its actions with creditors. In the event of a unilateral change in contract terms, bondholders have the right to file legal proceedings and to successfully claim the full face value of their bonds.

Domestic law bonds, however, can be easily manipulated at the expense of bondholders, who are unable to sue the government under the UK or US law. In the event of an imminent default, the government can change the domestic legislation and the terms of the contract, unilaterally inflicting damages to bondholders. These bonds facilitate debt restructuring by allowing the state to exert its sovereignty and impose its legal jurisdiction over creditors' rights. The majority of the Greek sovereign debt consisted of domestic law bonds, whose terms were changed by the Greek government in February 2012, a month before the debt restructuring[13]. The Greek parliament voted for the introduction of retroactive collective action clauses (CACs), which allowed the government to change the bonds' terms if two thirds of the creditors agreed. According to the proposed legislation, if bondholders representing more than 85% of the debt accepted the swap deal and participated in the debt restructuring, then the new terms would become binding to all Greek law bondholders.

d. Lobbying

The legal tactics used in the sovereign debt market are complemented with the political lobbying strategies in countries where lawsuits are usually filed. In May 2009, Eric Massa, a Democratic US Congressman representing the state of New York, proposed a legislation that sought to punish Argentina for not surrendering in its legal battle against vulture funds. The main goal of the proposed legislation was to undermine Argentina's access to US capital markets[14]. Eric Massa is believed to have very close ties with the American Task Force Argentina (ATFA), a lobby group created by former members of the American administration that seek to put pressure on the US Congress. According to the group's website, ATFA is an alliance of organizations working with "lawmakers, the media, and other interested parties to encourage the United States government to vigorously pursue a negotiated settlement with the

[13] Branimir Gruic and Philip Wooldridge, "Enhancements to the BIS debt securities statistics", Bank for International Settlements Quarterly Review, December 2012, p. 67
[14] Mark Weisbrot, "Vultures circle Argentina", The Guardian, 5 June 2009

Argentine government in the interests of American stakeholders"[15]. The Elliot Associates LP, the FH International Asset Management fund and the Bracebridge Capital fund are among its current members and supporters. In a similar example, Paul Singer, the founder and CEO of the hedge fund Elliott Management Corporation, is considered one of the largest donors of the US Republican Party. He had close political connections with the American administration and donated more than $1.7 million to presidential campaigns[16].

The legal and investment strategies of vulture funds are also coordinated and managed by advisory firms providing debt-related services to financial institutions and private corporations investing in emerging markets. Their role is not limited to advising and managing emerging market debt funds, as they are also purchasing and selling debt as a principal and broker[17]. The role of Debt Advisory International (DAI), an advisory firm representing vulture funds, in suing governments and lobbying in favor of their interests has been significant given the size and the extent of their operations in Asia, Eastern Europe, Latin America and Sub-Saharan Africa. DAI's connections with key policy-makers and lobbyists in Washington have allowed it to use pressure tactics to influence politics. To illustrate, DAI was paying $240,000 a year to highly influential lobby firms in the American administration[18]. Consequently, the legal tactics and the influence that these groups exert on the political structures and institutions are significant tools in their battle against defaulted countries.

4. Facing the Vultures

a. Argentina

After its failure in achieving the necessary economic adjustment and tackling the increasing burden of its debt, Argentina officially defaulted on January 3, 2002, when it missed the payment of a $28 million bond. At that time, the IMF had suspended the disbursement of aid funds due to the government's unwillingness to impose

[15] American Task Force Argentina, "About us" website section, available at: www.atfa.org/about-us/, last accessed 5 July 2014
[16] Jesse Jackson, "Time to Clip the Wings of Vulture Funds", Chicago Sun-Times, 20 February 2007
[17] Debt Advisory International, available at www.debtadvisory.com, last accessed 5 July 2014
[18] Meirion Jones, "Vulture funds, threat to developing world", BBC News, 14 February 2007

austerity measures[19]. The devaluation of the Argentine peso had exceeded 40% and the burden of the debt had exploded given that most of it was denominated in dollars. A year later, in September 2003, the newly elected President Nestor Kirchner proposed a 75% debt restructuring with no recognition of past-due interests. Argentina's creditors formed the Global Committee of Argentina Bondholders (GCAB), which convened in Rome in January 2004 to negotiate Kirchner's proposal. Despite their disagreements, the government convinced the largest creditors to approve the haircut by adding a GDP-linked clause stating that "10% of all GDP growth above 3% would be split between increased interest payments and the amortization of outstanding debt"[20].

While 76% of the bondholders accepted the restructuring, some holdouts sought to disrupt the negotiations and prevent the exchange offer. EM Ltd, a distressed debt fund controlled by Dart Capital and NML Capital Ltd., an offshore fund owned by Elliott Associates, managed to get favorable court judgments that called for Argentina to pay more than $900 million. Moreover, in March 2005 the same two bondholders managed to attach assets on their claims and won a freeze on $7 billion in old defaulted Argentine bonds that had been placed in the Bank of New York as part of the swap deal[21]. However, the Appeals Court recognized how important the successful conclusion of the debt restructuring is and lifted the freeze. The Appeals Court's decision was also supported by the U.S. government, which was against the broad interpretation of the *pari passu* clause in cases, which are pending[22].

The unsuccessful efforts of holdouts to collect their dues by attaching assets forced them to negotiate a new restructuring. In 2010, another 17% of the bondholders participated in a new exchange leaving just 7% of holdouts demanding $1.4 billion[23]. Argentina adopted an aggressive strategy against holdouts and refused to pay despite a succession of court rulings in favor of its creditors. The debt holders, in turn, were actively striving for recovery of their assets. In October 2012, NML Capital filed a lawsuit in Ghana, demanding the seizure of a ship owned by the Argentine Navy, which would be used as partial repayment for the debt[24]. Holdouts pursued

[19] Rafael Di Tella & Fernanda Miguel, "Breaking Bad (the Rules): Argentina Defaults, Inflates (and Grows), 1997-2013", Harvard Business School Case 714-036, December 2013
[20] Ibid
[21] Dow Jones staff, "Argentina battles bond holdouts in new asset freeze case", 01 February 2006, available at www.offnews.info/verArticulo.php?contenidoID=3094
[22] Laura Alfaro, "Creditor Activism in Sovereign Debt: Vulture Tactics or Market Backbone", Harvard Business School Case, 9-706-057, December 2007
[23] Ibid
[24] Jacob Goldstein, "Why a hedge fund seized an Argentine Navy Ship in Ghana", Planet Money, 22 October 2012

Argentina's assets around the globe and tried to collect their dues by locating and seizing any state asset that was placed abroad. When Argentina's presidential plane was sent to the United States for maintenance in 2007, a group of bondholders filed a lawsuit and ordered an American Court to seize the plane and its fuels[25]. Nerstor Kirchner, at the time President of Argentina, argued that the plane was under diplomatic immunity and counter-sued in California's Court, which finally declared that the presidential plane was immune from seizure. In 2012, in another attempt to seize state assets, NML Capital Ltd blocked Argentina from launching two satellites. It sued the government in a Californian District Court and tried to seize the two commercial contracts, claiming that the purchase of satellites was a commercial act, which was not protected by sovereign immunity laws.

Buenos Aires repeatedly refused to negotiate with holdouts and appealed to all court rulings. Presently, twelve years after its first sovereign default, Argentina still refuses to surrender to holdouts' demands, which resulted in its second default. On June 16, 2014, the US Supreme Court decided that the *pari passu* clause, which guarantees the equal-treatment obligation of the debtor, is valid and the Argentine government must pay ahead the holdout hedge funds before it makes the reduced payments to the restructured creditors[26]. It also forbade all New York banks from executing bond payments to any other creditor until the holdouts are satisfied. Argentina President Cristina Fernandez refuses to comply with the US Court's decision and seeks alternative ways to serve Argentina's debt without paying the holdouts. The strategy elaborated by the government includes the launch of a new bond swap, which will allow Buenos Aires to exchange the restructured US-law-governed debt for bonds issued under domestic law and paid through an Argentine public bank[27]. Cristina Fernandez seeks to avoid isolation from the global financial market by bypassing the US Court's verdict and resolving the new default crisis through direct negotiations with the creditors.

Even though the court's decision accelerates a resolution to a dispute that lasted more than 12 years, it sets a precedent and changes the power relations between the global financial markets and sovereign states. It became obvious that the aggressive strategy against vulture funds has led Argentina to a dead-end, undermined its long-term prospects for economic growth and deprived it of

[25] Agustino Fontevecchia, "The Real Story of how a hedge fund detained a vessel in Ghana and even went for Argentina's Air Force One", Forbes, 10 May 2012

[26] Ken Parks, Nicole Hong, Brent Kendall, "Supreme Court sides with creditors in Argentina debt case", The Wall Street Journal, 16 June 2014

[27] Bob Van Voris, "Argentina's Bond Swap Plan Called Illegal by U.S. Judge", Bloomberg, 22 August 2014

important financial resources. This case demonstrates how unpredictable and unregulated the global debt market is and exposes the risks both states and creditors take when they participate in debt deals.

b. Greece

Since the beginning of the Eurozone crisis, Greece pursued a conciliatory strategy and sought not to battle against vulture funds. In light of the increasing debt and the growing deficits that put in peril the very existence of the euro zone, Athens decided to restructure its debt under the auspices of the European Stability Mechanism. The European Stability Mechanism was set up to safeguard financial stability in Europe and to provide financial assistance to the EU member states. In March 2012 Greece restructured $206 billion of its debt by offering bondholders new bonds worth 31.5% of the old bonds with lower interest rate and longer maturities[28]. The 75% haircut was accepted by 97% of private creditors, mainly European banks, while $6 billion was held out. Greek and European officials announced several times that holdouts would not receive any payments. During the last six months preceding the haircut, vulture investors bought foreign law bonds, on which Greece could not activate the collective action clauses. These foreign law bonds offered more protection to private creditors and undermined the restructuring by requiring a separate agreement for each one of them[29].

Nevertheless, in May 2012, just a month after the completion of the haircut, the Greek government decided to pay 435 million euros ($552 million) of a bond to investors who had refused to participate in the exchange[30]. Government officials justified their decision by stating that it was the only possible option given the domestic political turmoil and the inconclusive elections that had been conducted a week before the maturity date of the holdout bond. Despite Greek announcements that the future government will not pay the rest of the holdouts, the May 2012 decision had set a precedent. The newly elected government decided to pursue the same conciliatory strategy towards vulture creditors. The second holdout payment worth 790 million euros was made in June 2013, followed by a third payment worth 540 million a month later[31]. The three holdout payments upset the bondholders, who accepted the exchange in the largest bond swap in history. It gave incentive to

[28] Jeromin Zettelmeyer, Christoph Trebesch, Mitu Gulati, "The Greek Debt Restructuring: An Autopsy", Working Paper Series, Institute of International Economics, August 2013
[29] Landon Thomas, "Greece is a Face-Off with its Bond Holdouts", New York Times, 3 April 2012
[30] Renee Maltezou, "In about-face, Greece pays bond swap holdouts", Reuters, 15 May 2012
[31] "Greece set to pay another holdout bond, worth 540 million euros on Friday", ekathimirini.com, 01 July 2013

future vulture funds to pursue similar strategies with other countries and strengthened their position in the sovereign debt market. The Greek case risks to undermine the outcome of future restructurings as private creditors have no incentive to accept a haircut based on their knowledge that, there is a higher probability to recover the full face value of their bonds through holding out.

According to financial analysts and European officials, however, not paying the holdouts could have catastrophic consequences for the future of the Greek financial market and the stability of the euro zone. $4 out of the $6.6 billion of holdouts was covered by cross-default clauses, which could be triggered in the event of a non payment[32]. The activation of the cross-default clauses would mean that the holders of the other foreign law bonds that held out could have demanded immediate payment despite the fact that they had not matured yet.

Moreover, according to officials from the European Stability Mechanism and the Greek government, Greece was expected to return to international bond markets by 2015. The conciliatory strategy vis-à-vis holdouts was a strategic decision, which allowed Greece to regain market access in April 2014. The recent return of the Greek government to debt markets with a 5-year bond[33] would not be possible with pending court rulings and lawsuits filed by vulture creditors. A Greek default on the non-restructured part of its debt would send negative sings to financial markets and perpetuate the European economic and financial turmoil with serious repercussions for the other south European economies and the rest of the euro zone. The main difference between the debt crises in Argentina and Greece is that the latter is backed by a group of European countries with strong economies and the necessary leverage to convince the markets about the viability of the Greek case. At the same time the interdependence of the European economies and the risk of contagion commits Greece to a more responsible and conciliatory strategy.

5. Sovereign Debt Market: Reform and Regulation

The successive economic and financial crises of the last three decades and the expansion of the sovereign debt market with the inclusion of private investors have increased the need for reform of the international financial architecture. The recent

[32] Renee Maltezou, "In about-face, Greece pays bond swap holdouts", Reuters, 15 May 2012
[33] Reuters, "Greece confirms return to Debt Markets with 5-Year Bond", International Business Times, 09 April 2014

euro zone crisis demonstrates that the adoption of debt instruments and the creation of institutions that can facilitate debt restructurings are of paramount importance. The sovereign debt market can be regulated through the adoption of specific debt instruments, the creation of regional or international debt restructuring mechanisms and the reform of domestic legal frameworks that could manage and resolve debt crises more effectively. The following is a sample of the most prominent proposals for this reform.

a. Debt Contract Clauses

The modification of debt contracts with the inclusion of collective action clauses (CACs) would enhance creditor coordination and clarify debt restructuring. The U.S. Under Secretary of Treasury for International Affairs John Taylor, in a speech that he gave at the Institute for International Economics in April 2002 stated that "a more predictable sovereign debt restructuring process for countries that reach unsustainable debt positions [….] would lead to better, more timely decisions, reducing the likelihood of crises occurring and mitigating crises that do occur"[34]. First of all, John Taylor suggested that inclusion of Majority Action clauses would force the minority of holdouts to participate in the debt restructuring process. The Majority Action clauses would allow the majority of creditors (usually 75%) to bind all creditors in the event of a haircut. Secondly, the creation of a clause describing the process of negotiation between creditors and debtors through the appointment of a creditor representative was also recommended. The delegation of power from all bondholders to the creditor representative would facilitate the negotiations and clarify the responsibilities and rights of both parties. Thirdly, John Taylor suggested an inclusion of a clause specifying the technical aspects of negotiations and a specific timeframe during which the restructuring could take place. By establishing a period of temporary suspension or deferral of payments, both creditors and sovereign countries would have enough time to initiate and organize the restructuring.

b. IMF's Sovereign Debt Restructuring Mechanism

Another proposal involved the creation of a Sovereign Debt Restructuring Mechanism under the auspices of the International Monetary Fund, which would

[34] John B. Taylor, "Sovereign Debt Restructuring: A U.S. Perspective", speech at the Institute for International Economics, Washington, D.C., 2 April 2002

guarantee a predictable process for sovereign debt deals. The Mechanism was supported by the Deputy Managing Director of the IMF Anne Krueger, who adopted elements from the domestic corporate bankruptcy legal framework of the United States and adjusted them to the specific characteristics of the sovereign debt market[35]. The first element of this proposal involved the mandatory inclusion of collective action clauses to all debt contracts regardless of the legal jurisdiction of the bonds. The "majority restructuring" would prevent litigation from holdouts and create an orderly and predictable process. The second element of the mechanism involved a creditor enforcement stay clause, which would prevent litigation by individual bondholders after the suspension of payments and during the negotiations. To counterbalance the privileges given to debtors by the first two elements, the third feature included a creditor protection mechanism, which guaranteed that debtor countries would pursue macro-economically stable policies and would refrain from payments to non-priority creditors. The fourth and last provision involved a mechanism, which would facilitate capital inflows and financing during the period of negotiations. The four features of the Debt Restructuring Mechanism would be supervised by a separate independent judicial body established by the IMF. Even though the project was strongly supported by the governments of developing countries, its implementation was considered impossible given the complexity of the institutional reforms and the international consensus needed for its establishment.

c. Domestic Legislation Reform

The regulation of the sovereign debt market and the protection of sovereign states from vulture creditors can be strengthened at the domestic level through the modification of domestic legal frameworks. In 2010 the UK passed the Debt Relief Act, whose main goal is to protect the poorest developing countries and prohibit the collection of sovereign assets in the UK. Mark Hoban, the UK's Financial Secretary to the Treasury stated that "the government is committed to ensuring that the poorest countries are protected from the exploitative practices of vulture funds and this Act will ensure that they have no place in the British legal system"[36]. As a consequence, vulture funds can no longer use the UK courts to file lawsuits against sovereign countries. The Act also guarantees that all creditors provide their share of debt relief

[35] Anne Krueger, "New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking", International Monetary Fund, Washington D.C., April 2002, p. 14
[36] HM Treasury, "Government acts to halt profiteering on Third World debt within the UK", Press release, 16 May 2011

under the Heavily Indebted Poor Countries (HIPC) Initiative. The initiative started in 1996 as a collaborative project between the International Development Association of the World Bank and the IMF in order to strengthen the management of debt and public finances of developing countries. The same legislative initiative was taken in the Unites States where Representatives M. Waters, S. Bachus and J. Biggerts introduced the Stop Vulture Funds Act (H.R.6796)[37]. The bill that was presented at the House of Representatives focused on discouraging vulture creditors from making excessive profits at the expense of heavily indebted and poor countries.

6. Conclusion

Since the late 1980s the nature of the sovereign debt market has profoundly changed due to the expansion of the market and the inclusion of private creditors. More and more countries face challenges in managing their debt and coordinating their macroeconomic policy in a sustainable way. Motivated by these developments, this paper explored the cases of Argentina and Greece, which demonstrate the two different strategies that sovereign states can pursue vis-à-vis vulture creditors. While an aggressive policy against holdouts prevents states from returning to the international capital markets, a conciliatory strategy sets precedents and strengthens the position of rogue creditors in the market.

The following conclusions can be deduced from the conducted research. First of all, it becomes clear that the balance of power within the debt market has profoundly shifted. Vulture funds have acquired significant power since creditors are more able to hold a government liable for not paying its non-restructured debt. The June 2014 verdict of the US Supreme Court obliges all countries to respect the *pari passu* clause and pay both the restructured and non-restructured parts of their debt. Despite the harsh criticism of the Argentine government against US Judge Thomas Griesa, his contribution to Argentina's second default is limited solely to the interpretation of the *pari passu* clause, which is validly based on the precedent set by earlier cases (eg. *Elliot Associates vs. Republic of Peru*). The real causes leading to the empowerment of vulture funds are related to the very structure of the sovereign debt market, the use of standard debt contracts with no risk-sharing clauses built in and the lack of rules regarding risky lending. After a 12-year battle, Buenos Aires now

[37] H.R. 6796, Stop the Vulture Funds Act, House of Representatives, 01 August 2008, available at: www.gpo.gov/fdsys/pkg/BILLS-110hr6796ih/pdf/BILLS-110hr6796ih.pdf

has two options: either to pay both the restructured and non-restructured bonds or continue its struggle against vulture funds by inventing new financial instruments and strategies. At this point, both options can trigger a new economic crisis and domestic instability that would undermine the medium- and long-term prospects for a rapid economic recovery.

Secondly, Argentina's dead-end and the Greek conciliatory strategies have discouraged creditors from accepting and participating in future debt deals. The current balance of power undermines future cases of debt restructuring and promotes predatory behavior, due to the fact that bondholders have more reasons to file lawsuits against indebted governments given the high probability of getting favourable court rulings. Consequently, creditors that generally do not pursue vulture tactics and intend to participate in debt deals have to face not only the burden of the imposed haircut but also the possibility that their restructured payments will be blocked by vulture funds. This development further discourages the large majority of conciliatory hedge funds, which may use the threat of litigation to negotiate for better restructuring terms.

Thirdly, an aggressive strategy against holdouts entails more costs than benefits for the financial life of a sovereign state in the global economy. The defiant debtor loses access to the sovereign debt market, which has far-reaching consequences on the economy's capacity to generate growth. Moreover, the return to the global financial markets is possible not necessarily when public finances are back on track but when market investors have a level of confidence high enough to take the risk of investing. While the Argentine economy has performed better and grew faster compared to the performance of the Greek economy after the restructuring, its positive economic figures are not reflected in its relations with the debt market. Governments that run away from their debt are regarded as not trustworthy even when their economy does well. On the other hand, countries like Greece, with a stagnant economy and unsustainable public finances, can benefit from the guarantees of the European Stability Mechanism and the positive confidence leverage of the European institutions over the psychology of the market.

A serious discussion about the power and the role of vulture funds has to be conducted at the international level. The lack of consensus on how to treat holdouts undermines the sustainability of the market and creates confusion and uncertainty. Given the absence of global bankruptcy law and the lack of any legal procedures in international law for a sovereign debt default, market actors need to define again their roles and the legal framework within which public and private entities operate. Simultaneously, the correction of these imbalances can be made by adopting transparent lending principles and discouraging countries from living beyond their means. The establishment of institutions and the introduction of universal rules that regulate sovereign lending and debt restructuring are necessary steps to bring stability back to the global financial markets.

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