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Sovereign Debt and Vulture Funds

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To dismiss the role of vulture funds in the international sovereign debt process is to fundamentally oversimplify the sovereign debt process and misrepresent borrowers (i.e. sovereigns) and creditors (i.e. banks; private equity houses; governments; trusts) as mutually exclusive in their status of victimhood. This can be illustrated by the 2001 Argentinian financial crisis whereby it is to mischaracterise vulture funds and the Argentinian socio-political situation as *causes* of victimisation. Rather, they are *effects* of a larger cause: the current institutional framework governing the sovereign debt restructuring process. For the purposes of this essay, the current institutional framework is defined

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in terms of its legal features: the nature of the contractual debt relationship between parties and the international legal structure governing sovereign debt restructuring (SDR).

As this essay will demonstrate, incomplete contracts existing within an international legal vacuum engender inefficiencies, perverse incentives and uncertainty, producing an environment in which vulture funds and socio-political discontent thrive. Restructuring therefore comes "too little, too late" and takes "too long", harming both debtors, who suffer from severe economic distress and creditors, who stand to lose out on their investment in the process.[2] The essay will begin by contextualising SDR within the Argentinian case study in order to demonstrate how incomplete

[2] Guzman and Stiglitz, 2015:3

contracts and the lack of an international legal framework victimise sovereign debt actors.

Argentina provides a particularly interesting case study, illustrating the collective action problem creditors face in the event of sovereign debt default. In 2001, Argentina went through the largest sovereign debt default in history, leaving international creditors with drastically reduced returns on their investments. By placing creditors in this position, certain 'rogue' creditors were incentivised to take advantage of the system, selling their over-valued bonds at a discount to so-called 'vulture funds' who could then sue the Argentinian government for repayment. Using the Argentinian example, the essay will unpack the theoretical assumptions behind the statement, questioning its apparent reliance on a realist model of International Political Economy (IPE), before turning to the

future to ask where there is potential for meaningful reform.

SDR is the renegotiation and settlement process for debt repayment prior to, or in the event of a default. That is, where a borrower is no longer willing or able to repay the debt they issued to creditors at the terms negotiated in the debt contract.[3] As the current institutional framework for SDR stands, where a borrower breaches, or intends to breach the terms of his debt contract, he is subject to the renegotiation or settlement of their outstanding debt, potentially lowering or extending the repayments. While simple enough in theory, with contracts governing myriad forms of debt issued to thousands of creditors across a large number of jurisdictions, in practice, SDR negotiations become highly disordered, politicised

[3] Das, Papaioannou and Trebesch, 2012

and time-sensitive.[4] Negotiations carried out against a setting of conflicting national legal regimes, with parties holding varying degrees of political power, leads to outcomes that rely more on power dynamics than legal and economic principles.[5]

Sovereign Debt Contracts – Complex or Careless?

Looking first to the nature of the contractual relationship between parties, it will be argued that the problem of incomplete contracts creates gaps in the SDR architecture which incentivise short-term utility maximising self-interested behaviour on the part of creditors, while simultaneously constraining debtor behaviour.[6] Incomplete contracts is a concept borrowed from the microeconomics literature, that explains contractual arrangements will necessarily

[4] Tomz 2007:3
[5] Guzman and Stiglitz, 2015: 3
[6] *Ibid.*:4

be incomplete as they lack the capacity to anticipate all contingencies that may arise with regards to the terms of the arrangements.[7]

In SDR, contractual incompleteness manifests itself in the insufficient protections granted to majority creditors against potential holdout behaviour by minority creditor groups in the restructuring process. Holdout behaviour refers to the incentive for a minority of creditors to refuse negotiations/settlement in an attempt to claim full payment or secure more than their originally contracted share of the eventual settlement pay-out.[8] With debt contracts during the Argentinian crisis primarily being drafted with 'unanimity clauses', in order for negotiations to be completed, all creditors across all kinds of credit had to agree to

[7] Hart (1995)
[8] Schwarcz, 2012:98

the changes discussed, giving holdout creditors a great deal of influence over negotiations. At their most destructive, these holdouts can buy up cheap sovereign debt with intention to bring litigation in a creditor-friendly jurisdiction, claiming full repayment of the debt, as NML Capital Ltd. successfully did in the case of Argentina.[9] In doing so, these creditors – also referred to as vulture funds – go one step further, bypassing the formal creditor repayment structure, undermining the provisions governing creditor priority in repayment, and the contracts as a whole.[10]

Were these contracts drafted more effectively, minimising their degree of incompleteness, they could mitigate uncertainty by disincentivising holdout behaviour and facilitating

[9] Vernengo, 2014:47
[10] *Ibid.*

negotiation across different sets of creditors.[11] The contracts governing Argentinian debt were unable to discinentivise holdouts or facilitate negotiations, as they used unanimity clauses to govern the decision-making procedures for renegotiation of debt terms[12]; in other words, these contracts failed to mitigate uncertainty. Due to the ineffective contractual structure, constructive negotiations between creditors with different interests become much more difficult, resulting in restructuring that comes "too little, too late and ... too long".[13] Therefore, while Argentina cannot be said not to be a victim of so-called vulture funds, given their holdout behaviour, as motivated by personal interests, this behaviour can be understood as actually being engendered by the contractual

[11] Tomz, 2013:12
[12] Guzman and Stiglitz, 2015:11
[13] *Ibid*.:3

framework in which vulture funds (and creditors more generally) operate.

On the other side of the drafting table, incomplete contracts have important implications for debtors as well. As inefficiencies in the negotiation process at creditor-level draw out the SDR process, social and political preferences at the government-level are apt to change. The longer a debtor takes to restructure, the higher the actual costs of restructuring and foregone costs of domestic investment become.[14] An important distinction arises here between the international lenders on one hand and domestic creditors on the other. With domestic creditors often holding a large proportion of a sovereign's debt, default proceedings directly affect the national economy in terms of these loans

[14] Krueger (2002)

as well.[15] By overlooking the effect of domestic creditors on SDR, the statement mischaracterises Argentina as wholly refusing to meet their loan obligations, suggesting an unwillingness to repay anyone, a characterisation which essentially misjudges the Argentinian socio-political situation in 2001.

Facing both internal and external pressures, governments in dire economic straits appear to be faced with a choice between protecting their citizens and protecting their external relations. While it may make more sense to repay foreign creditors first, protecting the domestic creditors from a default[16], States often choose to treat domestic creditors more favourably than foreign creditors.[17] This was the case in Argentina, with domestic residents being

[15] Erce and Diaz-Cassou (2011)
[16] Broner, Martin and Ventura (2010)
[17] Tomz, 2013: 23

afforded the opportunity to switch their debt into new legal instruments, which later received better treatment than the foreign-held instruments.[18] Hence, governments are forced to choose between servicing foreign or domestic debt. Given the inefficient and time-sensitive nature of the current SDR process, SDR exacerbates political tensions, pitting desperate sovereign States on the brink of economic collapse against creditors with much larger pockets.[19] Microeconomic contract theory provides further insight into this deep political and economic imbalance, claiming that at the point of renegotiation, parties with access to external assets (i.e. money) hold superior bargaining power in incomplete contracts.[20]

[18] Gelpern and Sester, 2004:794
[19] Guzman and Stiglitz, 2015:19
[20] Hart (1995)

Therefore, although the Argentinian people may have chosen not to repay, it is unclear to what extent their choice was entirely their own. It would be to overlook the nuances of SDR to Exclusively focus on international lenders and assume Argentina simply 'refused' to repay its debts. A more complete understanding of the institutional SDR framework demonstrates that as opposed to prioritising short-term self-interest maximisation, directly *causing* international lenders to suffer, the Argentinian decision was *caused* by the larger institutional inefficiencies of SDR – thereby indirectly harming lenders by *effect*.

Anarchy in the SDR

As such, if incomplete debt contracts allow vulture funds to arise and force governments into difficult choices, without mechanisms to oversee

and enforce these debt contracts, vulture funds derive the means through which to survive within the institutional SDR framework. Then, governments may not have the incentives to follow through on their contractual promises.

Interestingly, vulture funds have defended their actions as providing sovereigns with a form of accountability for their borrowing patterns through their litigation processes.[21] While it is questionable to what extent they succeed in providing such accountability, this justification raises important questions regarding international accountability more generally. Just as borrowers should be held to account for implementing morally hazardous fiscal policies[22], so lenders should be held to account for their predatory behaviour. Without an international

[21] Moore (2014)
[22] Schwarcz, 2012:97

mechanism through which to be held formally accountable for their decisions, lavish spending habits, irresponsible taxation policies and relaxed fiscal discipline take place without concern for the future.[23] Argentine officials made the decisions they did, surrendering the sovereignty of future governments in return for easy money, with no "shadow of the future" to constrain them[24], knowing the costs of restructuring would likely be borne by future governments.

In light of the latter, the assumption of short-term self-interested utility maximisation on behalf of both creditors and debtors appears to naturally indicate the application of realist theory to SDR. Without an international legal framework to operate within, and self-interest as the sole guide for actor

[23] Blustein, 2005:6
[24] Axelrod, 1984:12

behaviour[25], one would be forgiven for hastily characterising the world of SDR as a realist world. However, as soon as this assumption is called into doubt, realism looks increasingly like an overstatement of the perils faced by actors in SDR, overlooking that existing structures guide actor behaviour far more than pure self-interest. Given the hostile institutional framework in which the Argentinian crisis took place, this essay argues that where short-term self-interested utility maximisation takes place, it is caused by something other than the realist race to survive in a world constantly at war. Instead, it is the lack of legal frameworks and incomplete contracts which give rise to holdout creditors and constrain government behaviour, in turn engendering situational short-term self-interest utility maximisation. SDR, after

[25] Donnelly, 2000:131

all, is not a zero-sum game.[26] Cooperation and negotiation are not only possible in SDR, but desirable – where they cannot take place, it is because actors are prevented by their institutional frameworks.

Questioning the necessary conditions to allow cooperative agreements to be reached, maintained and enforced[27], rationalist institutionalism provides a more truthful model for SDR, placing it within its appropriate context. Where they work effectively, institutions (i.e. contracts and international legal structures) help mitigate adverse negotiating environments and reduce transaction costs of exchange.[28] In so doing, they enhance efficiency while simultaneously addressing uncertainties and providing positive

[26] Guzman and Stiglitz, 2015:24
[27] Cooley, 2010:48
[28] Keohane (1984)

incentives for parties to negotiations. Nevertheless, the realist might question to what extent institutions are able to affect the behaviour of international entities – how can we be sure it is not just that actors are inherently self-interested, seeking to maximise their short-term utility?[29]

Considerations of State reputation demonstrate that short-term utility maximisation is not inherent to international actors in SDR, hence addressing this concern.[30] In theory, consideration for reputation of States suggests that actors should cooperate today to ensure good relations in the future and the avoidance of political or economic sanctions by upset parties.[31] Reputation is particularly important in the SDR context, as both parties have a vested interest in continuing the

[29] Mearsheimer, 1995:7
[30] Tomz, 2007:6
[31] *Ibid.:2*

creditor/debtor relationship into the future, even if the current institutional framework does not accommodate for these future interests. As will be explored in more detail below, even with the flawed institutional structure in place, actors have taken concerted steps to implement reforms. This movement for reform itself provides compelling evidence for the argument that there *is* a meaningful dialogue between actors, institutions and actual circumstances; one far more in line with the rational institutionalist (or even perhaps constructivist) than the realist model of IPE.

Too Little, Too Late, Too Long

So far, this essay has set out the case for how incomplete contracts in a legal vacuum create vulture funds (including holdout behaviour more generally) and engender socio-political problems

within debtor governments. In this SDR world, creditors and debtors alike appear too interested in maximising their own short-term objectives, ignoring the long-term benefits of an orderly and timely restructuring process. The foregoing may paint a bleak picture of the sovereign debt landscape, but it is important to keep in mind the dialogue between actors, institutions and actual circumstances. has manifested itself in the push for institutional reforms taking place within SDR since 2001.

While the international community has yet to implement an international legal structure for SDR, important progress has been made in reviewing the language of sovereign debt contracts. To protect majority creditors from holdout behaviour, Collective Action Clauses (CACs) have

been introduced into contracts.[32] The Argentinian debt crisis itself appears to have been an important driving force in this progress, with 95% of New York-issued debt excluding CACs pre-Argentina, compared to only 21% post-Argentina.[33] Such provisions allow a supermajority of creditors to agree to changes in arrangement terms, effectively overruling holdout creditors attempting to block negotiations.[34] This is not to say all sovereign debt contracts are created equal; as the aforementioned 21% evidences, CACs are still not always included in contractual arrangements, with potentially disastrous consequences. In Greece alone, approximately 90% of debt was not governed by CACs.[35] However, continued calls for reform have been taken up by the International Monetary Fund

[32] Guzman and Stiglitz, 2015:15
[33] Choi, Gulati and Posner (2012)
[34] *Ibid.*
[35] Schwarcz, 2012:105

and the International Capital Markets Association respectively.[36]

Nonetheless, contracts are still only as strong as the enforcement and oversight structure in which they exist. With or without CACs, parties have no higher legal authority to turn to, in the event of a breach of contract by either side. This issue has been recognised throughout the SDR world, beginning with Krueger's appeal to the international economics community to architect a new structure for SDR in 2002, culminating in the 2014 General Assembly resolution 68/304 'Towards the establishment of a multilateral legal framework for SDR processes'. Drawing inspiration from the US Bankruptcy Code, the proposed framework aims to encourage an orderly and timely restructuring process through facilitated negotiations, guarantees

[36] IMF 2014; ICMA 2014

of debtor protection from holdout behaviour, along with creditor protection from unfair treatment by debtors.[37] By introducing international legal principles and obligations to SDR, parties are incentivised to cooperate, given the high actual and reputational costs of failure to uphold contractual promises.[38]

Conclusion

With its incomplete contractual arrangements and lack of international legal framework, the current SDR system engenders, if not entirely encourages self-interested behaviour in both debtors and creditors, placing a premium on the achievement of short-term objectives over long-term goals. As such, it is not that the Argentinian

[37] Krueger (2002)
[38] Schwarcz, 2012:114

government victimises creditors or that vulture funds victimise the Argentines, rather it is the system that victimises them all. It is important to note that this is not to absolve Argentina or vulture funds of responsibility, but to understand the underlying structure of SDR in order to prevent another Argentina or another set of vulture creditors from arising in the future. Institutional features, rather than individual intentions appear to have a stronger role in shaping actor behaviour in SDR, allowing us to isolate important areas in need of institutional reform in the hope that future countries with a similar experience to Argentina, will have strong contractual arrangements and an international legal framework within which to enforce them, rendering questions of 'who is a victim of whom' irrelevant.

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