

BRIEFING NOTE FOUR
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Vulture Funds and Poor Country Debt: Recent Developments and Policy Responses



Debt cancellation provides the chance for impoverished countries the opportunity to start fresh and allocate additional resources to essential health, education, and other spending. Under pressure from Jubilee campaigners and global civil society, the U.S. government and other shareholders at the IMF and World Bank created the Heavily Indebted Poor Countries (HIPC) Initiative, which was designed to alleviate impoverished countries of some of their unpayable debts. In 2005, The Multilateral Debt Relief Initiative (MDRI) was established to augment these efforts by canceling more debt.

But while the international community was extending debt relief to some impoverished countries, a new form of business emerged, with the purpose of speculating in and profiteering from poor country debt in default. This new business by so-called “vulture funds” comes at the expense of the citizens of these indebted countries — some of the poorest in the world — as well as taxpayers in countries like the United States, who have been supporting in part the cost of debt relief. The Jubilee USA Network, along with other groups in the U.S., the UK and across Africa, Asia, and Latin America, is increasingly monitoring the activity of vulture funds and working to publicize and curtail their activity.

WHAT IS A VULTURE FUND?

‘Vulture fund’ is a name given to a company that seeks to make profit by buying up debt in default on the secondary market for pennies on the dollar, then trying to recover up to ten times the purchase price, often by suing impoverished countries in U.S. or European courts. Such companies often describe themselves as ‘distressed debt funds.’ Some target failing companies, but Jubilee USA Network is focused on those that target the sovereign debts of impoverished countries. These vulture fund companies tend to be quite secretive, and many of them are based in tax havens such as the British Virgin Islands. Some are owned by large, often U.S.-based, financial institutions such as hedge funds. In other cases, there is limited or no information on who owns them. Often subsidiary companies are set up by these larger hedge funds simply to pursue one debt, then shut down after winning those assets.

HOW DO VULTURE FUNDS OPERATE?

When an impoverished country has outstanding debt owed to a government or a commercial creditor that has not been cancelled or restructured according to HIPC or MDRI terms there is a chance that a private financial organization will attempt to buy that debt at a steep discount and take legal action to seek repayment of the original amount and more. Firms call this capitalizing, but debt campaigners consider this vulture activity. Vulture fund activity has increased in the past three years with the provision of debt cancellation, as vulture funds seize on the opportunity presented by resources newly freed or about to be released by debt relief. Vulture fund activity has resulted in a large and growing number of lawsuits against HIPCs.

THE CASE OF *DONEGAL V. ZAMBIA*

The most recent vulture fund case is that of Donegal International vs. the government of Zambia. In 1979, Zambia purchased agricultural equipment and services from Romania on credit. Being unable to service this debt, in 1999 Zambia and Romania agreed to liquidate it for \$3.28 million. But before Zambia could seal the deal, a vulture swooped in. Donegal International is registered in the British Virgin Islands, its only business being pursuit of the Zambian debt. Donegal’s director is Michael Sheehan, owner of Debt Advisory International, a Washington, D.C.-based consultancy. Mr. Sheehan’s company bought Zambia’s debt for \$3.28 million and sued the Zambian government for \$55 million seven years later, after the Zambian government had received debt cancellation. The British High Court ruled that the government of Zambia pay Donegal \$15.4 million, 65 percent of what Zambia was saved in debt relief delivered through the MDRI in 2006.¹

A GROWING PROBLEM, A TREMENDOUS SOCIAL COST

At least 20 Heavily Indebted Poor Countries (HIPCs) have been threatened with or been subject to legal actions by commercial creditors and vulture funds since 1999. The debtor governments have almost always lost. When they lose, impoverished countries have been obliged to pay the original debt, interest and fees accrued since the debt entered arrears, as well as the hefty legal costs of the plaintiff.

As of late 2007, 11 of 24 HIPCs surveyed by the IMF were facing litigation from 46 different commercial creditors. Of these, 25 creditors had received court judgments against HIPCs amounting to about \$1 billion on original claims of \$427 million.²

The amounts judged owed by poor countries to commercial and vulture creditors in 2006 varied from 1 to 6.5 times the original value of the debts, roughly from \$1 million to \$152 million. The average judgment was for 2.8 times the original value of the debt. Eight settlements exceeded \$50 million, a huge sum to pay in one year, especially when compared to other crucial spending needs.³

¹ “Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation,” IMF Report, August 21, 2006, p. 65.

² “Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation,” IMF Report, October 15, 2007, p. 32-34. Please note that not all commercial creditors reported as litigating in the IMF Report are engaging in vulture activity.

³ Original calculations by Jubilee USA Network, using statistics from “Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation,” IMF Report, October 15, 2007, p. 33.

One study estimates that on average for the HIPC countries being sued, “the potential cost of lawsuits represents 18 percent of annual health and education spending, 59 percent of debt service and 5 percent of budget revenue.”⁴ Considering these costs comparatively:

- Ethiopia, Nicaragua and Niger had a ratio of lawsuit costs to debt service obligations in one year of over 200 percent.
- In Niger, lawsuit costs were 52.2 percent of health and education expenditure.
- Cameroon’s budget revenue totaled \$52.6 million, while lawsuit costs totaled \$51.7 million, or 98.3 percent of revenue.⁵

More than two-thirds of the lawsuits brought by vulture funds are adjudicated in US or UK courts. In the majority of cases, vulture funds sue in courts located in New York, Paris and London because these courts are viewed as more creditor-friendly and more efficient. But an increasing number are brought at the national level in the debtor countries themselves, where weaker legal systems are easily overwhelmed by the level of technical detail involved in adjudication of these cases.

WHICH COUNTRIES ARE VULNERABLE?

According to the IMF, the HIPC countries facing lawsuits from the greatest number of private creditors in 2007 were the Republic of Congo, Cameroon and Uganda, which were being pursued by eight, seven, and six vulture creditors respectively.⁶

Also of special concern are countries rich in natural resources, and which have therefore attracted more lending from private creditors, including the Democratic Republic of Congo and Sierra Leone.

However, the IMF only tracks private creditor lawsuits for HIPC eligible countries that have reached decision or completion point. Pre-decision point countries, as well as impoverished countries excluded from the HIPC initiative⁷ have a high burden of vulnerable debt. Current countries in this category include Liberia and Côte d’Ivoire, though it is not clear how much litigation these countries currently face, nor how much of the private sector debt is held by vultures.

DONEGAL [A VULTURE FUND] BOUGHT ZAMBIA’S DEBT FOR \$3.28 MILLION AND SUED ZAMBIA FOR \$55 MILLION SEVEN YEARS AFTER IT RECEIVED DEBT RELIEF. THE BRITISH HIGH COURT RULED THAT ZAMBIA PAY DONEGAL \$15.4 MILLION — 65% OF WHAT ZAMBIA SAVED IN DEBT RELIEF.

**IMF HIPC & MDRI STATUS OF IMPLEMENTATION REPORT
AUGUST 2006**

RECOMMENDATIONS FOR POLICY CHANGE

There are a number of measures that could be taken to curb vulture fund activity:

1. Limit profits. Vulture funds invest in sovereign debt because they expect an extremely high rate of return if they win in court. By legally limiting the amount of money a fund can make on sovereign debt, the incentive for hedge funds to pursue vulture activity is drastically decreased. The limit for profits could be the purchase price of the debt plus a reasonable rate of interest. As most vultures sue in courts in the United States, the U.K. and France, laws limiting profits in those countries would be a significant step toward curtailing vulture activity.

2. Increase transparency. Vulture funds’ modus operandi tends to be very secretive. In some cases, vultures have filed suits without notifying the debtor country at all. There are currently no requirements for disclosure or transparency related to vulture activity. A certification regime would require all U.S.-based transactions involving sovereign debt, including purchase, sale or litigation to be publicly filed with the U.S. Treasury Department. By requiring transparency of creditors purchasing or litigating a sovereign debt claim in the U.S., vulture activity here could be significantly reduced.

3. Creditors should commit not to on-sell claims. In a May 2007 press release, Paris Club countries committed not to sell their claims on HIPC countries to creditors who do not intend to provide debt relief under the HIPC initiative. However, until more creditors agree to participate and sign onto the commitment, it will do little to prevent vulture activity. The U.S. administration and the president of the World Bank, among others, should put pressure on additional creditor countries to sign a pledge similar to the Paris Club commitment not to on-sell sovereign debt owed by low-income countries. These discussions should include creditors like Romania and other Eastern European countries, Iraq, Yugoslavia, Libya, and other non-OECD countries that have been on-selling their debt holdings.

⁴ Coumba Fall Gueye, et al. “Negotiating Debt Reduction in the HIPC Initiative and Beyond,” Publication No. 11, Debt Relief International Ltd., February 2007.

⁵ Ibid at p.70.

⁶ Ibid.

⁷ For example low income countries eligible for International Development Assistance (IDA) from the World Bank, but ineligible for HIPC because they do not meet the debt to export ratio criteria and lower-middle income countries with extremely high levels of poverty such as Peru and Indonesia that are excluded for the same reason.

4. Vulnerable debt buy-backs by responsible creditors. The World Bank's Debt Reduction Facility (DRF) founded in July 1989 provides grant funding to eligible governments to buy back — at a deep discount — the debts owed to external, commercial creditors. The DRF has recently become more active, purchasing the private debt of Nicaragua and Mozambique, eliminating debt that had been vulnerable to purchase by vulture funds. In Mozambique, the DRF buy-back extinguished all remaining eligible debt. In Nicaragua, with the participation of more than 99 percent of financial institutions; and all four of the commercial financial institutions holding court judgments, the DRF buy-back covered 95 percent of the country's eligible debt. Overall, the DRF has supported 22 completed buyback operations, extinguishing about \$8 billion of external commercial debt.

However, the DRF could be significantly strengthened to better address the vulture fund issue. Currently, only countries that have reached decision point in the HIPC program are eligible to receive assistance from the DRF. This leaves many impoverished, indebted countries (many of which will be future beneficiaries of debt relief) vulnerable to vulture activity. All countries at risk from vulture funds should be eligible for DRF grants to help with legal costs and buy-backs of their vulnerable debt. Moreover, in future DRF buy-backs the official policy of the World Bank should be to ensure the participation of all major litigators and 95 percent to 100 percent of commercial creditors before moving forward. In this way, second buy-back operations, like those completed recently for Nicaragua and Mozambique, will not become precedent, creating an incentive for some creditors to opt out of the initial buy-back process in order to profit later on. The IDA Board is currently evaluating whether to allow preparation grants to help with the legal costs of pre-decision point countries, but this does not go far enough.

Finally, the current financing mechanism of the DRF is insufficiently stable to ensure that buy-backs can be completed efficiently. In the current system, the DRF receives funding through a number of sources including World Bank International Bank for Reconstruction and Development (IBRD) income, beneficiary country resources, IDA credits and IMF financing while retaining a strong reliance on voluntary donor country contributions. This funding structure makes each buy-back a political process that can take many months to complete, leaving indebted countries vulnerable to litigation. For example, the second round of buy-backs for Nicaragua took a year as the DRF waited for donor countries to provide funding, and Norway was the sole donor country to contribute to Mozambique's buy-back. In order to ensure timely and adequate funding for this important program, the World Bank should establish a trust fund to finance grants for legal assistance and commercial debt buy-backs for an expanded number of impoverished, indebted countries with at-risk debt. The U.S. Congress should do its part to ensure sufficient funding of such a trust fund if and when it is established.

IN THE MAJORITY OF CASES, VULTURE FUNDS SUE IN WESTERN COURTS BECAUSE THESE COURTS ARE VIEWED AS MORE CREDITOR-FRIENDLY AND MORE EFFICIENT. AN INCREASING NUMBER ARE BROUGHT AT THE NATIONAL LEVEL IN DEBTOR COUNTRIES, WHERE WEAKER LEGAL SYSTEMS ARE EASILY OVERWHELMED.

5. International bankruptcy framework. One of the key features of domestic bankruptcy frameworks is that they are binding on all creditors. In case of sovereign default, all creditors should likewise be required to sit down together and negotiate the "haircut" each one must take. In the current system, vulture funds act as 'rogue creditors' by taking advantage of funds freed up by the debt restructuring negotiated by other creditors, taking their claims to court with the goal of winning full repayment and more. While it will take some time to create the political will for this step, ultimately, a fair and legally binding international bankruptcy framework is the strongest way to force all creditors to the table and address the problem presented by free-riders.

6. Provide funds for legal representation. The costs of vulture activity go beyond what a country must pay as the result of a judgment or arbitration award. Because most vultures sue in U.S., U.K. or French courts, impoverished countries are forced to hire legal firms and financial advisors in these locations at great cost. A trust fund to pay for legal consultation for at-risk countries and legal representation in the case of a lawsuit or arbitration would significantly minimize this additional harmful impact of vulture suits.

7. Corporate campaigns. Most vulture funds are subsidiaries of hedge funds which make the majority of their money in other investments, with sovereign debt profiteering limited to 1 percent to 3 percent of the value of their portfolio. Just a few large investors threatening divestment might be sufficient incentive for these hedge funds to cease vulture activity.

⁸ "\$153.2 million of Mozambique's External Commercial Debt Cancelled." World Bank Press Release, October 11, 2007. Available: <http://go.worldbank.org/IE91S0CX70>.