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Distressed Hedge Funds in Secondary Sovereign Debt Markets of Emerging Economies: A Linchpin for Liquidity?

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Abstract: The paper aims to interrogate the effects of distressed hedge funds (DHFs) investments on the liquidity in the secondary market for sovereign debt of emerging economies. DHFs, or vulture holdouts, as they are informally known, have gained significant prominence in recent national debt crises. The primary complaint against them is that they exploit cooperative creditors and sovereign debtors by purchasing distressed debt at reduced prices, choosing not to participate in debt restructuring processes, and pursuing litigation to recoup the total debt amount. However, writers and industry experts have argued that although the activities of the holdout creditors, especially the DHFs, could disrupt the orderly sovereign debt restructuring in the debt market, much more beyond that, they promote the deepening and liquidity of the market. Thus, in pursuit of profits, distressed asset investors unintentionally contribute to the market's good by fostering market liquidity and indirectly helping the bondholders, sovereign borrowers defaulted sovereigns, and the societies of the debtor nations and the nations where the sovereign debt market is situated. This study is essentially non-empirical; hence, the literature review is used as the methodological tool. Specifically, an integrative review is used because the literature serves as the data.

Keywords: Distressed Hedge Fund; Sovereign Debt; Secondary Market; Liquidity; Emerging Economies

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1. Introduction

Sovereign borrowing and lending are essential components of development. As Borensztein et al. (2006) noted, sovereign debt is one of the most potent instruments for implementing domestic economic and social policy; it may be used to finance the development of human capital, physical infrastructure projects, the supply of necessities like food and water, education, and social security payments. It can redistribute resources from future generations to the present, mitigating the effects of brief economic downturns and poor loans from state-owned banks. Therefore, sovereign debt markets are important and essential to a country's macroeconomic health (Pandolfia & Williams, 2019, pp. 384-403).

Meanwhile, the primary motivation for establishing a sovereign debt market is to provide private resources to emerging market economies. While the primary segment of the market is where issuers initially offer bonds to investors to raise money, secondary markets transform government securities issued to meet long-term funding obligations into liquid instruments that market players can use as portfolios or collateral (Martinez et al., 2022, p. 5).

As a result, the liquidity in the secondary market is essential because it enables investors to sell their holdings at the best price and in the shortest possible time when needed. Besides, debtor countries rely heavily on secondary market liquidity for government bonds since it promotes primary market access and lowers the cost of sovereign borrowing (OECD, 2018, p. 46). In this regard, sovereign governments have recognized the significance of increasing liquidity in their domestic sovereign debt markets (Skinner, 2005). OECD (2019, p. 12) notes that reduced liquidity of government securities impairs primary market access and increases sovereign borrowing costs.

In the meantime, holdout creditors, especially DHFs, have been dubbed "demons of sorts" and accused of inducing holdouts during a sovereign default's debt restructuring. Among other "sins," Schumacher et al. (2015, pp. 585-623.) and Fisch and Gentile (2004, pp. 1047 - 1116.) admit that DHFs' opportunistic holdout actions cause delays in settlement, adversely impact the sovereign debtor's financial status, prevent access to international capital markets, and raise restructuring expenses.

On the contrary, it has been pointed out that holdout creditors, especially the litigious DHFs, promote the secondary market's deepening and liquidity (Muse-Fisher, 2014, pp. 1671-1725.; Shleifer, 2003, pp. 295-311). Specifically, they serve the market by purchasing bonds in the secondary market and providing liquidity, which allows

banks to sell off "bad" bonds to meet bank regulatory requirements, create opposition to the state's almost exclusive power in sovereign debt restructurings, and impose discipline on sovereign debtors (Goren, 2010, pp. 681-708).

In the context of these opposing views, this paper aims to interrogate the effects of DHFs on the liquidity in the secondary sovereign debt market of emerging market economies. Therefore, it will be argued that even though the DHFs could be disruptive of the orderly restructuring in the sovereign debt market, much beyond that, they promote the liquidity of the secondary market for sovereign debt and guarantee a sustainable flow of private credit to the emerging market economies.

2. Research Methodology

This study is essentially non-empirical; hence, the literature review is used as the methodological tool to answer the research question and address the research problem. To foster the development of fresh viewpoints or ideas, an integrative review is used to evaluate, analyse, and synthesize the body of related extant literature on the topic under review. Thus, the literature serves as the data in this paper. In addition, in enhancing the methodological rigour, a search protocol is formulated to guide the locating and retrieving pertinent published works from relevant databases. Furthermore, using keywords and phrases based on defined inclusion and exclusion criteria, relevant literature is systematically searched and reviewed for the discussion in the paper.

Accordingly, the paper integrates the results of the published works evaluated to make valuable contributions to scholarship and answer questions raised in the paper. In addition, different theoretical perspectives on the research topic are reviewed.

3. Explanatory Theories

Two vital theories that justify the paper's thesis are examined below.

The first crucial theory that is consistent with and illustrates the thesis of this paper is Adam Smith's Free Market theory.

3.1. Adam Smith's Free Market Theory

The core of Smith's thesis is that if individuals were left alone to pursue their interests (such as through enterprise), they would contribute to the well-being of society without intending to do so. According to Smith, the market is perfect for reasonable persons to meet and interact. Thus, he regarded the market system as a "mechanism for resolving basic economic problems and producing order without elaborate central direction" (Smith, 1776).

In Smith's view, "an individual's search for the most advantageous employment for whatever capital he can command… naturally, or rather necessarily leads him to prefer that employment which is most advantageous to the society. Smith stood for allocation of resources through market forces, a system that encouraged spontaneous economic activity," and efficiency - maximization of personal well-being and self-interest. He argued for a self-regulating free market. He birthed the idea of an invisible hand," which is one of the tenets of the Free Market Theory (FMT) that ensured the public good by way of healthy competition and compelled men to pursue self-interests in social rather than anti-social ways (Samuels, 1977, pp. 467-484).

Smith, therefore, views the market as a place where barter takes place - personal interests are protected while simultaneously, personal private needs are met. The invisible hand works in this environment and guides private enterprise for the public good. Although market participants in a free market purposely seek self-interest when making investment decisions, they might find themselves unintentionally contributing to the good of the public. Another way of summarizing the invisible hand argument: "…the result of everyone pursuing their interests will be the maximization of the interests of society. The free market's invisible hand will transform the individual's pursuit of gain into the general utility of society" (Samuels, 1977, pp. 467-484).

In a way, Smith's core thesis that if individuals were left alone to pursue their interests, they would contribute to the well-being of society without intending to do so arguably syncs with the core thesis of this paper that although the activities of the DHFs could be disruptive of the orderly government bond restructuring in the sovereign debt market, much more beyond that, in pursuits of profits, they unintentionally contribute to the good of the public, by improving market liquidity and efficiency, fostering the functioning of the secondary sovereign debt market and indirectly helping the bondholders, sovereign borrowers, defaulted sovereigns, and the societies of the debtor nations and the nation where the sovereign market is situated. Thus, they incentivize an efficient and functional secondary market for the

sovereign debt and enhance and guarantee a sustainable flow of private credit to the emerging market economies to finance the real sector, especially critical economic infrastructure assets.

3.2. Theory of Regulatory Litigation

The second theory relates to regulatory litigation.

Defining the concept of regulatory litigation as a theory and practice is problematic. Generally, the term "regulatory litigation" connotes diverse, disparate techniques. Regulatory litigation is a mechanism that "uses litigation and the courts to achieve and apply regulatory outcomes to entire industries" even though they refer to the concept as "regulation-by-litigation" (Moriss et al., 2009).

Generally, this theory explains the use of litigation to achieve specific regulatory ends. This mechanism is usually referred to as "regulatory litigation." It happens when a "diffuse set of regulators," including "private citizens, public regulatory bodies, nongovernmental organizations, and private market agents [,] regulate social harm" (Glover, 2012, pp. 1137-1217) by "us[ing] litigation and the courts to achieve and apply regulatory outcomes to entire industries" (Luff, 2011, pp. 173-215).

As indicated by Hodges (2009, pp. 78-85), regulatory litigation can also resolve other market inefficiencies, such as moral hazards by sovereign debtors in the sovereign debt market. Moral hazard issues may arise when debtor countries take out loans, spend the money carelessly, and wait for their creditors to "rescue" them from the financial crisis. Hence, DHFs and the attendant holdout litigations provide a "moral hazard counterbalance" to opportunistic sovereign default (Oluyeju, 2020, p. 146).

The theory of regulatory litigation is, therefore, consistent with the core argument of the authors of this article that the litigious DHFs somehow contribute to the market discipline and enhance the efficiency of the sovereign debt market.

4. Literature Review

4.1. Defining and Unpacking the Terms "Emerging Economies"

"Emerging economies" is frequently used interchangeably with "emerging markets" or "emerging market economies" (Wright et al., 2005, pp. 1-33; Xu & Meyer, 2013, pp. 1322-1346). These economies serve various business functions, such as

production bases within global value chains or home bases for emerging market's multinational enterprises (Grosse & Meyer, 2018).

Generally, emerging markets are low or middle-income nations with significant room for economic expansion. However, due to flaws in the institutional framework, also known as institutional gaps, they tend to be less stable and remain unsatisfactory in terms of the efficiency and impartiality of markets (Meyer & Peng, 2016, pp. 3-22; Grosse & Meyer, 2018). Hoskisson et al. (2000, pp. 249-267) agree with the above authors by stating that an emerging economy is characterized as a low-income nation that has experienced rapid economic growth because of government policy initiatives aimed at economic liberalization (Paul, 2019, pp. 446-468).

Nonetheless, emerging economies are the world's growth engines and often the primary targets for doing business in today's global economy (Bang et al., 2016, pp. 104-117; Mona & Sheth, 2018, pp. 217-224; Paul & Benito, 2018, pp. 90-115; Paul, 2019, pp. 446-468).

4.2. Sovereign Borrowing and Debt

Beitone et al. (2007) define sovereign or public debt as consisting of all loans made by the public sector - bank loans and bond issues made by public authorities, treasury bills, debts contracted by other public entities-to finance public spending, in the absence of a sufficient level of the public revenue, that comes essentially from fiscal fees and taxes. Jackson (2022, pp. 777-824) defines sovereign debt as the debt owed by a state (central government) to its creditors.

However, from a conceptual standpoint, the asset class known as "sovereign debt" has been called an "oxymoron" (Buchheit & Gulati, 2017, pp. 224-238) or "Janus-faced" (Eichengreen et al., 2019, p. 4). Similarly, Martinez et al. (2022, p. 5) explain that sovereign debt, or debt issued by governments, is an unusual type of asset. It is frequently seen as secure and liquid in the context of the domestic financial system—at least safer and more liquid than privately issued debt. The sovereign's ability to tax future income is the underlying cause.

Primarily, the capacity to issue debt is a valuable tool at the government's disposal, as sovereign borrowing can help protect the economy from adverse macroeconomic shocks. Indebtedness, on the other hand, can make a country vulnerable to financial distress, as recent crisis experiences have demonstrated (Mitchener & Trebesch, 2023, pp. 565-623).

Besides, sovereign debt has significant intergenerational and global redistributive ramifications, resulting in the allocation of international political power and economic growth (Bohoslavsky & Cernic, 2014).

For many nations, however, having significant sovereign debt levels can lead to complex moral, political, and legal issues (Bohoslavsky & Cernic, 2014). In addition, it can also enable widespread, systematic, and grave human rights abuses, like escalating international financial crises, plunging millions of people into poverty, supporting the celebrity lifestyles of select elites (especially in non-democratic regimes), and strengthening authoritarian governments that are effectively waging war on their citizens, as noted by the Human Rights Watch World Report (2013), and Bohoslavsky and Cernic (2014).

Bohoslavsky and Cernic (2014) note that states owe money to various creditors, including other governments, international financial institutions, and private individuals. According to the duo, private creditors are tied to sovereign debt in multiple ways. Furthermore, sovereign debt is owed to private creditors, whether directly or through bonds. Hence, sovereigns may receive direct loans from commercial banks. Nonetheless, since the 1980s, the bond market has absorbed almost all the claims made by private lenders (Barry, 2011, pp. 282-305).

According to Grund (2023), a noticeable increase in sovereign debt has occurred during the past thirty years. The average debt-to-GDP ratio in emerging market economies—typically more susceptible to high government intervention—was 64% in 2021, up nearly ten percentage points from the previous year (Grund, 2023).

However, one of the most significant changes in the specialized industry over the last forty years is that sovereign issuers gradually stopped using global banking houses' syndicated financing following the debt crises of the 1980s and 1990s. During the 1970s, syndicated bank loans were the primary source of sovereign funding. However, as petrodollars were transferred to emerging economies through the U.S. banking system (Wright, 2012, pp. 153-198), governments began to issue most of their (private) debts as tradable securities on global markets. Bonds quickly surpassed loans as the preferred funding source for states (Grund, 2023).

4.3. Sovereign Debt Market

The terms "sovereign debt market," "sovereign borrowing market," and "government debt market" all mean the same thing and are used interchangeably.

The sovereign debt market is the world's oldest and largest bond market. By the end of 2018, the total amount of global debt securities issued by governments had surpassed $45 trillion (Martinez et al., 2022, p. 5).

There are, however, many different types and sources of sovereign debt. Sovereign debt can take several forms: Domestic and foreign debt, bonds, syndicated loans, checks, trade credits, "garden variety" instruments, and more sophisticated, "tailor-made" products. The sovereign lenders might also differ in that they can lend funds through bilateral, multilateral, or private creditors (Kupelyants, 2018).

Despite this diversity of forms and sources, international markets shifted during the 1990s in favor of funding sovereigns primarily through bond markets instead of syndicated loans (Kupelyants, 2018).

The sovereign debt market is made up of primary and secondary markets. In primary markets, issuers initially offer investors bonds to raise money (Passadore & Xu, 2022, p. 4), regardless of whether the bonds are domestic or foreign. Existing bonds are then traded among investors on secondary markets.

The primary and secondary markets, however, complement one another because simpler offloading of securities on secondary markets boosts primary market participation (and pricing) (Passadore & Xu, 2022, p. 4), while issuance at key maturities in primary markets may help secondary market growth by creating a benchmark yield curve to support prices (Martinez et al., 2022, p. 5).

Consequently, primary subscribers can transfer their rights under the bonds to other financial market participants in the secondary markets. These assignees take risks expecting to reap financial rewards (Kupelyants, 2018). However, as indicated by Velde (2014, pp. 1151-1159), to continually raise money on the sovereign debt market, both the primary and secondary segments of the market must be liquid, and states must prioritize capital market development in their jurisdictions.

Nevertheless, sovereign debt markets of most emerging economies are underdeveloped, illiquid, and typically dysfunctional due to a lack of strong creditors' rights, among other factors (Shleifer & Vishny, 2003, pp. 295-311). Generally, debt markets are more liquid when creditor rights are preserved or not significantly curtailed (Bolton & Jeanne, 2007, pp. 901-924). In addition, the secondary markets in some of these economies are "thin, illiquid, and peripheral" (Anayiotos & De Pinies, 1990, pp. 1655-1669). However, Bolton and Jeanne (2007, pp. 901-924) noted that the upsurge in debt offerings through the capital markets and

the opportunities for arbitrage in the secondary markets induced exponential growth in the distressed debt investor industry.

4.3.1. The Secondary Market for Sovereign Debt

Fundamentally, one of the primary motivations for establishing the secondary market is its capacity to channel massive amounts of private financial resources to emerging market economies (Shleifer, 2003, p. 89). As the African Development Bank (AfDB) (2018) notes: "a secondary market for sovereign debt is a fundamental feature of sovereign borrowing and lending. When creditors can freely sell the debt, they hold in the secondary market, there is less risk involved in lending to sovereigns, and creditors are therefore more likely to provide the capital sovereigns need."

The secondary market sprung up and became appealing to investors unwilling to invest in bankrupt countries' equity markets. Thus, investors started purchasing sovereign debt instruments with the express purpose of betting on a debtor nation's debts to increase in value over the short term as its economy strengthened (Corrigan, 1994). Consequently, sovereign bonds shot to prominence in market-based public finance and played a critical role in the growth of capital markets (Waibel, 2011, p. 11). Accordingly, developed capital and sovereign bond markets became integral to the global financial system (Tyson, 2015). The 1980s debt crisis eventually spawned modern sovereign debt markets, critical to its resolution (Power, 1996, pp. 2701-2772).

The secondary bond market serves an essential signaling function (Yu, 2017, pp. 535-559). A well-functioning secondary market is essential; however, it has been argued that holdout creditors' activity imposes costs on distressed countries that much outweigh the advantages. According to Yu (2017, 535-559), they seriously undermine secondary markets' efficiency and equity, which has the potential to bring about the complete collapse of SDR.

As stated by Megliani (2018), the advent of these DHFs, a peculiar class of holders, has changed the dynamic of the secondary market for government debt. According to him, these funds are kept out of the restructuring processes, and they pursue their claims in court to recover the face value of the debt they purchased at a reduced market price from distressed sovereigns.

4.4. Sovereign Default and Restructuring (SDR)

Sovereign default and restructuring (or SDR) are as old as sovereign debt (Oosterlinck, 2013, pp. 697-714) and are a common occurrence in the present international financial system (Kupelyants, 2018).

Therefore, public sector borrowing has always been a vital component of the global economy and the process of growth and development on a worldwide scale (Reinhart & Rogoff, 2013).

Thus, nation-states can and do default on their sovereign debt regularly. When a State fails to make its payment obligations to its creditors, this is referred to as a sovereign debt default. It is nevertheless essential to draw attention to the various default incidences at this point. When an interest or principal payment is missed, default can occur. Other times, the borrower's failure to make a payment on time alone constitutes default. Defaults are typically caused by violating payment obligations and substantive covenants rather than warranties (Okamoto, 2020).

Writing on what constitutes a sovereign default, Ams et al. (2019, pp. 275-327) point out that rating agencies and researchers typically categorize a sovereign default as either (i) missing payments (a legal default) or (ii) a debt restructuring at terms that are worse than the original terms, implying creditor losses ("haircuts") and coercion imposed by the sovereign (Jackson, 2022, pp. 777-824). However, it is necessary to remember that debt restructuring is an essential aspect of sovereign defaults (Dvorkin et al., 2018, p. 1).

However, States occasionally run into financial difficulties paying back their obligations. While it is widely acknowledged that states have a contractual duty to pay back debts, there are situations in which this is not feasible. Therefore, they must modify the repayment conditions for at least a portion of their debt by making the terms more flexible or canceling all or part of it. Thus, sovereign defaults may be inescapable under the existing global financial system (Kupelyants, 2018).

Neither domestic nor international law defines the term "sovereign debt restructuring". For instance, in extant literature, it has been described as "the mechanism used by sovereign states to prevent or resolve debt issues and achieve debt sustainability levels" (Li et al., 2010, pp. 243-271) or as "a set of operations through which debtor countries seek debt relief from their creditors in the form of maturity extensions, face value reductions, and lower interest rates." (Viterbo, 2020).

SDR is essentially the change of payment arrangements for government debt instruments. In essence, SDRs reduce the amount of debt a State has by renegotiating contracts with creditors. Thus, the SDR provides debt relief to the bankrupt sovereign debtor, ensuring the loan's sustainability (Kupelyants, 2018).

Nevertheless, from a transactional standpoint, debt operations that change the repayment schedule (debt rescheduling or "reprofiling") or lower the face value of the instrument (debt restructuring) can be widely distinguished (Kupelyants, 2018).

A debt restructuring usually involves a "principal haircut" or the forgiveness of a portion of the outstanding principal amount (Wirtz, 2015, pp. 249-280). Debt rescheduling or reprofiling ordinarily involves using below-market interest rates and moratoriums on paying and forgiving accrued interest rates (Olivares-Caminal, 2009). As rightly noted by Buchheit et al. (2013, pp. 191-194), the overall purpose of restructuring negotiations is to involve creditors in providing debt relief.

Nonetheless, SDRs can be voluntary (with creditors agreeing to the proposed changes) or involuntary (by unilateral modifications or debt repudiation). When it comes to private debt instruments like bonds, involuntary restructurings typically result in a contractual event of default. This allows creditors to demand early payment of all unpaid interest and principal, file a lawsuit against the government, or start an arbitration process (Kupelyants, 2018).

However, the challenge with the SDR process is that a global legal structure is absent for restructuring sovereign debt, and the existing international endeavors are wholly optional. The legislation has not methodically addressed them with a set of logical regulations. Instead, sovereign debt bankruptcies are addressed ad hoc via contractual renegotiation of sovereign bonds (Kupelyants, 2018).

5. Holdout Creditors

Holdouts can be broadly classified as creditors in the official and private sectors. DHFs or vulture funds, real money investors, retail investors, and commodities traders are examples of private creditors who lend to governments. Holdouts in the official sector could include bilateral lenders outside of the Paris Club as well as State agencies like state-owned enterprises (SOEs) or central banks (in the context of currency unions) (Grund, 2023).

However, bondholders are generally far more distributed than bank lenders. While two types of holdout creditors (specialist hedge funds and retail investors) accounted

for most lawsuits in Argentina and Greece, other actual and potential holdouts have emerged (Grund, 2023).

Nonetheless, holdout creditors remain a primary concern for countries reorganizing their debt commitments. Holdouts were once considered "benign spurs to sovereign debtors from demanding excessive amounts of debt relief." But in the wake of a growing number of lawsuits against developing nations in the 1990s and 2000s, as well as the legal drama surrounding Argentina, their suppression has turned into "an imperative not only for sovereign debtors but also for the vast majority of other lenders" (Buchheit et al., 2019, p. 345).

Furthermore, the term "holdout creditor problem" describes a scenario in which a specific proportion of a sovereign debtor's creditors choose not to take part in a debt restructuring operation, obstructing or postponing the debt resolution process or, conversely, free riding on it to collect full payment (Grund, 2023).

Opportunistic creditors typically "withhold their essential vote in the hope of procuring a side payment from the transaction's proponents" (Roubini & Setser, 2004), free riding on the other creditors' acceptance of the proposed debt plan (Wheeler & Attaran, 2003, pp. 253-284). As noted by Sachs (1989), the implication of this is that "[holdouts] plague the readjustment of [public] debt claims, to the detriment of both creditors and debtors".

According to Buchheit and Gulati (2002, pp. 1317-1363), holdout creditor problems became a severe focus for policymakers in the 1990s when international sovereign bonds, also known as Eurobonds, supplanted syndicated loans as the principal form of external commercial debt to emerging market economies and Low-Income Countries. Grund (2023) notes that nations with restricted access to global capital markets have borrowed from various sources, including governments, foreign SOEs, private banks, bondholders, and (indirectly) central banks.

While in the recent restructurings, hedge funds and retail investors have actively pursued holdout methods, and in contrast, other creditors, such as commodity traders or official sector lenders, have used more covert means to obtain preferential treatment in debt operations (Wolf, 2014; Gelpern, 2021, pp. 345-416).

5.1. Distressed Hedge Funds (DHFs)

DHFs belong to a class of holdout creditors, often specialized hedge funds tagged "vulture funds" due to their predatory business model, which involves buying

defaulted sovereign debts at steep discounts (usually from nations that are already having difficulty financing infrastructure and public services), refusing to take part in debt restructurings, and aggressively pursuing repayment through litigation (often in multiple jurisdictions) of sums that are significantly more than what they originally paid for the debt (Lumina, 2019, p. 498; Kupelyants, 2018).

There are several ways to define DHFs. Once most (risk-averse) investors have left, these creditors buy distressed debt instruments on the secondary market. Economic factors and pursuing arbitrage opportunities resulting from low debt prices and higher (anticipated) recovery values are their guiding principles when making investment decisions (Grund, 2023).

DHFs, or vulture holdouts, as they are informally known, have gained significant prominence in recent national debt crises. They are not, however, a recent occurrence (Megliani, 2015). For example, in the 19th century, speculators targeted newly independent Latin American republics, buying distressed debt that would be restructured decades later and yield significant profits. These days, DHFs are typically hedge funds, with U.S. headquarters focused on bonded debt instruments subject to foreign legal regulations (Lumina, 2019, p. 498).

The primary complaint against DHFs is that they exploit cooperative creditors and sovereign debtors by purchasing distressed debt at reduced prices, choosing not to participate in debt restructuring processes, and pursuing litigation to recoup the total debt amount. The countries whose debt is sold at steep discounts are undoubtedly impoverished and in financial crisis, which explains why their debt was initially sold cheaply on the secondary market (AfDB, 2018).

As the AfDB (2018) noted, these creditors make restructuring more complicated, unpredictable, and time-consuming by holding out. As a result, excessive levels of uncertainty and the requirement to pay a small number of creditors, far more than the other creditors have consented to in a restructuring deal, harm sovereign debtors (AfDB, 2018).

Furthermore, Schumacher et al. (2015, pp. 585-623) and Fisch and Gentile (2004, pp. 1047-1116) agree that opportunistic holdout action causes delays in settlement, adversely impacts the sovereign debtor’s financial status, prevents access to international capital markets, and raises restructuring expenses. The holdout approach may also incite legal action from other creditors by making it apparent that the sovereign debtor’s assets are restricted.

As Megliani (2018) explained, paying the claims can mean fewer resources for the population's essential services in low-revenue debtor nations. This also results in a sizable development regression for underdeveloped countries.

Grund (2023) notes that DHFs' litigation may constitute a significant financial burden for certain nations, making it more difficult for them to utilize the cash for vital public initiatives. And, by persistently refusing to participate in the renegotiation process and actively litigating, they seek to recover the entire value of the debt purchased. As the AfDB (2018) noted, DHFs have typical recovery rates of 3-20 times the amount they spent to buy the debt, resulting in returns of 300-2,000 percent.

Citing Donegal International Limited as an example, Lumina (2019, p. 498) observes that DHFs are typically very secretive, both in terms of their ownership and their operations. Companies are frequently founded to pursue a single debt. Donegal International Limited is an example. Besides, he avers that many DHFs incorporated in offshore financial hubs and jurisdictions provide low or no taxation, banking, and financial secrecy to foreign individuals or entities (sometimes known as "tax havens").

Singh (2003) agrees that by exposing these assets to the possibility of attachment, holdout litigation may restrict the state's capacity to employ its resources overseas. The sovereign debtor is undoubtedly under pressure from these negative consequences, and the holdout creditor has the power to demand a high recovery rate. Bradley et al. (2010, pp. 312-317) also contend that aggressive holdout litigation may negatively affect sovereign bond pricing, and creditors may lower their prices for bonds with lower holdout litigation risk. Thus, DHFs have been dubbed "demons of sorts" by their antagonists for all these reasons.

A case that illustrates the issues raised about DHFs is the infamous litigation by NML Capital against Argentina (2013), where the United States (U. S.) Court of Appeals for the Second Circuit held that because of the *pari passu* clause in the bonds contracts that Argentina had defaulted upon, Argentina could not pay the holders of its restructured bonds without paying holdouts. Argentina was essentially forced to default on the restructured bonds and, eventually, had to settle with the holdouts because, either way, it would default on its debt (Schwarcz, 2016, pp. 343-385).

This case caused alarm among market participants, including paying agents, trustees, clearing agents, infrastructure providers, debtors, creditors who participated in Argentina's restructuring, and others in the official sector. The decision has also

created much uncertainty and has potentially made debt restructuring less attractive for creditors in the future (Jewett 2014, xix-xxv). There has been an outcry among academics and legal practitioners in the field against this decision and the interpretation of the *pari passu* clause that U. S. courts have accepted (Buchheit & Gulati, 2017, pp. 224-238).

With that said, then the question is: Would it be fair to say DHFs are just "spawns of the devil"? The answer to this question is discussed in the next section.

6. Results and Discussions

Writers and industry experts have argued that even though DHF operations cause holdout issues that impede debt restructuring procedures, DHFs are essential to the secondary market for various reasons.

First, they offer market liquidity, which is crucial because, as was already mentioned, investors and creditors are more willing to give credit or invest in debt when they know that the debt can be sold on the market if they need quick cash (Muse-Fisher, 2014, pp. 1671-1725) or need to recover their investment to fund other projects. This is consistent with Goren's (2010, pp. 681-708) position that DHFs play a specific role when they buy bonds in the secondary market, giving banks the liquidity they need to sell off "bad" bonds to meet bank regulatory requirements.

According to OECD (2023), market liquidity is the degree to which an asset can be traded without impacting its value and is paramount for markets to function efficiently. For debtor countries, the secondary market liquidity of government bonds is crucial since it helps to promote primary market access and reduce the cost of sovereign borrowing (OECD, 2018). Specifically, from the perspective of public debt management, market liquidity has significant implications: Reduced liquidity of government securities impairs primary market access and increases borrowing costs for sovereigns (OECD, 2019). As OECD (2018) pointed out, even small changes in the interest rate paid on a sovereign bond can result in significant costs or savings for taxpayers.

In addition, from the standpoint of an investor, the degree of liquidity of a security is a crucial trading characteristic. According to Keynes' liquidity preference theory, investors favour securities with better liquidity when all other circumstances are equal (OECD, 2018). Thus, liquidity is critical for investors since it enables them to sell their holdings at the best price and in the shortest amount of time when needed.

Sovereigns have sought to boost liquidity by issuing "plain vanilla" straight bonds with significant maturities and reducing interest expenditures by releasing low-coupon, liquid bonds (Skinner, 2005). Straight bonds pay interest regularly and, upon maturity, return the principal amount deposited (Chen, 2018). They are easier to value and trade and make up many government bonds. Concentrating bond issuance at significant maturities guarantees that the issue size grows. This helps improve liquidity since a higher issue size increases investors' likelihood to purchase and exchange bonds regularly. Against this backdrop, continuous, well-functioning secondary government debt markets are critical.

Besides, DHFs also help to impose discipline on sovereign debtors and create opposition to the state's nearly exclusive power in sovereign debt restructurings, as observed by Harrison and Huntriss (2015, pp. 135-141). As opined by Martinez et al. (2022), purchasing and selling sovereign debt assists economic actors in dealing with liquidity shocks, smoothing consumption, and identifying investment opportunities.

The broader stance of pro-DHFs, according to Kupelyants (2018), is based on the notion that restricting litigious hedge funds' activities too harshly could have negative long-term consequences. Writers like Shleifer (2003, pp. 295-311) have also stridently argued that the problems in sovereign debt markets stem from weak bondholders' rights. Thus, creditors' right to solicit debt repayment is believed to ensure debt market survival and long-term viability and encourage further borrowing.

Without this role, principal bondholders would have been much more vulnerable to the sovereign borrowers' extensive bargaining leverage. Thus, recalcitrant DHFs assume the duty of preventing "opportunistic defaults," or defaults in which the state can make the required payments but is unwilling to do so. Furthermore, a liquid secondary market may lower government borrowers' borrowing costs and yields (Kupelyants, 2018).

Some analysts have further stated that because DHFs "provide a safety net" for other investors who may otherwise suffer enormous losses in the event of a sovereign debtor default, they are essential to stabilizing sovereign debt markets (UNCTAD, 2016).

In response, the antagonists refute this claim by arguing that the individual rights of creditors serve the interests of wealthy and well-connected entities that have the resources and expertise to ensure that judgments are upheld, leaving the remaining

bondholders without the full benefit of enforcement rights (Haseler, 2007, p. 9; Buchheit et al., 2007, pp. 1201-1262). However, it is overstated to say that sophisticated hedge funds are the only parties that file lawsuits on sovereign debt—regular bondholders may also file lawsuits (Kupelyants, 2018).

Additionally, because they can investigate their claims, DHFs uncover corruption and other dishonest actions by debtor governments in disbursing loan funds (Muse-Fisher, 2014, pp. 1671-1725; Rahn, 2010).

In summary, DHFs' participation in the market may guarantee that debtor countries' access to the market is not impeded because of their default. If creditors cannot recover their money, debtor nations' credit ratings plummet, reputational risk is suffered, and market access for future borrowing is restricted (Oluyeju, 2020, p. 146).

Importantly, DHFs address the moral hazard issues that may arise when debtor countries take out loans, spend the money carelessly, and then wait for their creditors to "rescue" them from the financial crisis (New York Times, 2016). DHFs and holdout lawsuits, therefore, provide a "moral hazard counterbalance" to sovereign default by doggedly pursuing sovereign debtors for their claims, preventing sovereigns from accessing capital markets. When an individual or government accepts certain risks with the expectation that another individual or entity would be blamed for such risks, this is known as a moral hazard (Wozny, 2017, pp. 697-747).

7. Implications

This article will have implications for policymaking, regulation, and activities of players in the sovereign debt market. Therefore, it is aimed inform policy and legal reforms at the national and global levels. In addition, the paper dispels misconceptions about the role of distressed debt investors in the sovereign debt market. It attempts to prove that the activities of these category of investors have salutary effects on the efficiency of the market and the secondary sovereign debt market liquidity. Importantly, it also proves that distressed debt investors play a crucial role in ensuring emerging markets have access to resources for capital formation. Thus, the findings are relevant and applicable.

Another logical implication is that rather than demonizing DHFs and throwing the baby out with the bathwater, a normative framework should be put in place to regulate the activities of holdout creditors especially DHFs, aimed at suppressing

their perceived exploitative tendencies and advancing their benefits to promote efficiency in the market for a guaranteed flow of private credit for capital formation in the developing world.

8. Value

This paper presents a unique argument that challenges the prevailing belief that litigious distressed debt investors are detrimental to the sovereign debt market. Instead, it argues that they are essential linchpins for an efficient sovereign debt market, highlighting the novelty and value of the research. Thus, the core contribution of this article is that distressed debt investors are linchpins of the international financial system and a "cholesterol" for an efficient sovereign debt market that guarantees the flow of private credit for capital formation in developing countries.

9. Conclusion

This article has set out to interrogate the role of DHFs as linchpins for liquidity in the secondary sovereign debt market. As shown above, DHFs have been accused of allegedly creating holdout problems during debt restructuring of sovereigns and, therefore, dubbed as "demons of some sort." In contrast, some commentators have stoutly argued that DHFs play a crucial role in stabilizing distressed debt markets as they provide needed liquidity in the secondary market for sovereign debts. The authors concur with the latter view. It is submitted that although DHFs create holdout problems during sovereign debt restructuring processes, they remain linchpins for market liquidity and guarantee the flow of private credit for capital formation in emerging market economies. The authors, therefore, argue that DHFs are a curate's egg in the sense that they have their advantages and disadvantages. They are, thus, not the "spawns of the devil" but linchpins of sorts for the liquidity of the secondary market and the entire sovereign debt space.

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