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Elusive certainty

Implications of Donegal v Zambia

On February 15, the English High Court opened a new chapter in sovereign debt litigation. The judgment in *Donegal v Zambia* (2007) suggests that national courts may grant discretionary debt relief to heavily indebted developing countries. Donegal sued for $55 million, despite acquiring the debt for only $3.2 million at the time Zambia was scheduled to receive substantial debt relief under the Heavily Indebted Poor Countries Initiative (the HIPC Initiative). The judgment represents a partial victory for Donegal because the court affirmed Zambia's liability in principle.

Since February, the case has generated considerable controversy, due to perceived abuse of the HIPC Initiative. For a decade, the World Bank and the International Monetary Fund have coordinated international debt relief under the HIPC Initiative and the Multilateral Debt Relief Initiative. The official sector is concerned that commercial creditors might take advantage of fiscal space freed up by official debt relief. Official debt relief could encourage a wave of sovereign debt litigation in the hope of full repayment.

In the past, national courts and international tribunals dealt with sovereign debt litigation in three ways. First, they declined to examine these claims for lack of jurisdiction. The 19th and early 20th centuries marked the heyday of this avoidance technique. As sovereign immunity from jurisdiction gradually receded, courts more readily accepted claims against sovereign debtors. Even after the move to restricted sovereign immunity in the 1970s, courts occasionally declined to exercise their jurisdiction based on doctrines such as comity and the act of state.

Claims that condemn sovereign debtors to pay the full face value of the outstanding debt form a second category. Most recent sovereign debt cases, including *Allied Bank* (1985) and *Elliot Associates v Peru* (1998), fall within this category. Thirdly, there are creditor lawsuits that fail on substantive grounds.

Successful defences by sovereign debtors come in two forms. The first, an analogy to municipal bankruptcy law, is rare. Claims typically fail on narrow technical grounds, such as Article VIII Section 2(b) of the IMF Articles of Agreement or the separate legal status of the government and the instrumentalities that borrow on its behalf (for example, central banks).

Donegal v Zambia represents a structural break from past sovereign debt litigation. It is the first time a national court has awarded less than the full face value of the debt, despite affirming liability in principle. Previously, courts refused to find that secondary market purchases of sovereign debt at large discounts ruled out full repayment. *Donegal v Zambia* raises the question whether a sovereign creditor is entitled to full repayment independent of the discount at which the debt was acquired on the secondary market. Judge Smith appears to have answered it in the negative.

The case

Donegal is a special-purpose offshore vehicle based in the British Virgin Islands. The US-based Debt Advisory International incorporated the investment entity for the sole purpose of holding Zambian debt acquired from Romania.

Starting in 1992, Romania and Zambia negotiated to restructure official bilateral debt arising from a sale of agricultural machinery in 1979. Michael Sheehan, a principal stakeholder in Debt Advisory International, first approached Romania about acquiring the Zambian debt in 1997, suggesting a 90% discount. Subsequently, Donegal requested that Romania obtain formal confirmation of the debt's commercial nature and its amount. The restructuring negotiations progressed slowly. In 1998, Zambia offered to buy back Romania's debt through a World Bank facility at 11%.

Early in 1999, Romania told Zambia that it would assign the debt to a secondary market purchaser if there were no restructuring agreement by January 31 1999. This agreement came to naught, among other things because a high-ranking Zambian official did not refer it to her superiors in a timely manner. Zambia maintained that Donegal swayed her by subsidizing the former Zambian president Frederick Chiluba's favourite housing project. Her crucial memorandum on the Romania debt proposal was missing from Zambian government files. Zambia accepted the restructuring in early 1999. By the time the acceptance reached the desk of the responsible Romanian official, however, the assignment to Donegal had already been completed.

Subsequent negotiations between Donegal and Zambia failed. Donegal put forward several proposals for debt

conversion, which Zambia rejected on the grounds that they would not benefit the country. In 2001, Donegal proposed an immediate cash settlement at 37%, about $30 million. Zambia responded with a 10% offer consistent with the comparable treatment under the HIPC Initiative, which Donegal called completely unacceptable.

In 2003, Donegal and Zambia's former finance minister Emmanuel Kasonde concluded a settlement, which essentially served to confirm the validity and amount of Zambia's debt. The settlement agreement is central because it provides Donegal with a cause of action independent of the original debt. It also contains a broad waiver of sovereign immunity, opening up additional avenues for lawsuits. Zambia then proposed to buy back the entire debt for $14.8 million or 33% of the nominally outstanding debt.

Zambia only made a few payments under the settlement agreement. After Donegal terminated the agreement, and in response to requests for payment, Zambia said that its Task Force on Corruption was investigating the debt's validity, saying the finance minister lacked authority to sign the settlement without approval by the attorney-general. The jurisdiction of English courts over Zambia turns on whether the settlement, with its broad waiver of immunity, is valid. Donegal brought legal action in the British Virgin Islands and later in the UK for $55 million, including interest.

The first phase of litigation

Judge Smith rejected Zambia's application for dismissal, and struck down injunctions over assets of Zambia and Mofed, a private company owned by the Zambian finance ministry. The Court concluded that Donegal provided misleading information to courts in three countries. Donegal's witnesses provided dishonest and thoroughly unreliable testimony and were at times deliberately evasive. The Court also noted that, throughout the process, Romania had been "less than candid" with Zambia about its parallel negotiations with Donegal.

At the outset, Judge Smith highlighted that "the proceedings arouse strong feelings". In apparent concern about the law's stringency, he declared that his task was limited to the legal questions raised by the claimant, not questions of morality or humanity. After the ruling, international debt campaigners vocally called for a boycott of Donegal. World Bank president Paul Wolfowitz, Gordon Brown, and the Paris Club commented in public on the case.

Donegal's business practices

The High Court closely examined Donegal's business practices, and found Donegal's actions in obtaining confidential information about the validity of the debt from government officials cavalier, unlawful and immoral. Through a local intermediary, Donegal hired two formerly high-ranking Zambian officials as consultants, who were entitled to a performance fee of 15% of the recovered sum.

One consultant, the former mayor of Lusaka, told the official signing the acknowledgment "there is something in it for all of us". He was later paid $4,000 in cash. Judge Smith, on the balance of probabilities, declined to qualify this payment as a bribe. It was also not improper for a responsible finance ministry official to be made aware of the subsidy to the president's favourite housing initiative. Bribes are, by their nature, secret, Judge Smith emphasized, which was not the case here.

The settlement was also not contrary to public policy, despite Donegal's improper influence over Zambia's political process. Because the improper retrieval of confidential information was only remotely causal for the settlement, the settlement remained valid. The Court found that Zambia freely concluded the settlement agreement. The finance minister had authority to conclude the settlement without approval by the attorney-general (Article 54 of Zambia's constitution). An eventual violation of that provision would also not invalidate the settlement.

Zambia suspended payment under the settlement at the recommendation of its Task Force on Corruption, set up to investigate misappropriation of public funds under former president Chiluba. Subsequently, the US District Court for the District of Columbia subpoenaed Sheehan on behalf of the Zambian Task Force on Corruption. Since the judgment became public, the US administration has taken a particular interest in this aspect of the case. Donegal is reportedly under investigation for violation of the US Foreign Corrupt Practices Act.

The decision's implications

Judge Smith deferred the extent of Zambia's liability to the second phase. So far, he had determined that the interest rate provisions in the settlement agreement were penal. There are indications that Zambia's liability will fall short of Donegal's $55 million claim. The Court reached the tentative conclusion that "Donegal are entitled to some relief in respect of what Zambia agreed to pay". The practical implications of this sibyllic statement are unclear.

Hopefully the Court will set down clear guidelines for how to assess damages due to default on sovereign debt purchased on the secondary market. Given the first judgment in this case, actors in the sovereign debt market will

find it difficult to know in advance their legal entitlements to repayments. The fact that sovereign debt litigation is often across different jurisdictions is likely to further increase this uncertainty. Still, the judgment does not deal a fatal blow to the business model of funds investing in distressed sovereign debt.

Participants in international finance need to be able to assess the likelihood of repayment *ex ante*. *Donegal v Zambia* throws the balls of sovereign finance into the air. However, the High Court's 137-page ruling contains a remarkably detailed description of the secondary market for sovereign debt. Pending the Court's final determination of liability, the legal basis in English law to award less than the debt's nominal amount remains murky. Future decisions will need to clarify repayment obligations on secondary market purchases.

By upholding the validity of the settlement, the Court leaves improper influence on Zambia's political process without sanction. This finding is questionable because the confidential information enabled Donegal to form a much better view of the likelihood of repayment. Donegal is party to both contracts and comes before the tribunal with unclean hands. In these circumstances, piercing the contractual veil of the settlement agreement could be warranted. The recent Icsid award in *World Duty Free v Kenya* (2007) is a case in point.

Two further problematic aspects of Judge Smith's ruling are interrelated. First, he fails to give any serious consideration to comparability of treatment. His decision grants preferential treatment to a single creditor, without convincing explanation. Unlike other judgments, he fails to even consider an analogy to municipal bankruptcy law. In some cases, US courts transposed equal treatment from domestic bankruptcy law to sovereign debt restructurings. The likely effect of the judgment on the behaviour of distressed debt funds is to trigger a rush to the courthouse to obtain preferential repayment on sovereign debt obligations.

A second likely effect is a rush for validation. Donegal's motivation for obtaining the settlement agreement seems to have partly been an attempt to immunize its repayment claim from any challenge to validity or amount outstanding. This conclusion creates incentives for creditors to reach settlement agreements for the sole purpose of detaching the debt obligation from the original claim. Post settlement, the court foreclosed any possibility for reviewing the validity of the obligation.

By Michael Waibel of the London School of Economics

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