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DONEGAL V. ZAMBIA AND THE PERSISTENT DEBT PROBLEMS OF LOW-INCOME COUNTRIES

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I

INTRODUCTION

Although it may sound somewhat clichéd, we live in historic times. The global financial crisis will have deep and long-lasting effects on the global economy in general, and on debt dynamics in particular. A key characteristic leading to the crisis was the explosion of private debt in advanced economies. As history teaches, after the "boom" must surely come the "bust." In order to address the private-debt bust, governments have stepped in to cushion the financial dislocation—but in so doing, governments have stretched the limits of their own finances through engaging in massive fiscal stimulus and credit easing, accompanied by bailouts in the financial, corporate, and household sectors.

The International Monetary Fund (IMF) has been intensively engaged in responding to the financial crisis, drawing lessons for policymakers and financial regulators, and increasing financial support not just to advanced and emerging economies, but also bolstering concessional financing to low-income countries, with up to $17 billion[1] committed over five years and zero-interest rates through 2011.[2]

What does this account of the recent history of the global financial crisis have to do with sovereign debt problems in low-income countries? The answer is too little, yet too much. Too little, sadly, because few in developing countries have experienced the exuberance associated with riding at the top of a "boom." For them, the depths of "bust" have been unrelenting. Sadly also, too much because the recent financial crisis threatens to increase poverty and debt vulnerabilities in a number of developing countries. Despite their limited access to the international capital markets, these countries have become further integrated in the world economy more broadly and have suffered falling

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1. The symbol "$" in this article designates U.S. dollars.

2. Int'l Monetary Fund, *IMF Backs New Package to Support World's Poorest During Crisis*, IMF SURV. MAG., July 29, 2009, *available at* http://www.imf.org/external/pubs/ft/survey/so/2009/pol072909a.htm.

exports, less foreign direct investment, fewer remittances, and diminishing aid flows as a consequence of the financial crisis.[3]

The litigation between Donegal and Zambia[4] continues to illuminate all-too-familiar controversies of the benefits and limitations of international, voluntary debt-relief initiatives, the ineffectiveness of low-income sovereign debtors trying to litigate their way out of debt problems, and the elusiveness of other viable solutions.

II

DONEGAL V. ZAMBIA—THE CLAIM

The debt claim underlying the Donegal and Zambia litigation originally arose from a $15 million credit facility provided in 1979 by Romania to Zambia for the purchase of agricultural machinery from Romania. Zambia fell into arrears on repayments, and repeated negotiations from 1984 onwards failed to conclude in a rescheduling agreement on Paris Club terms. In 1997, Donegal, the so-called vulture fund based in the British Virgin Islands, approached Romania and offered to purchase the debt. At the same time, Zambia sought to renegotiate a settlement of the claim with Romania. By early 1999, Romania had offers from both Donegal and Zambia to acquire the debt. Donegal was very much aware of Zambia's likely participation in the Heavily Indebted Poor Countries (HIPC) Initiative[5] and pitched its offer to Romania slightly above the amount that Romania would recover assuming Romania provided HIPC debt relief to Zambia. Although Zambia's offer to Romania was slightly higher than Donegal's, Romania chose to sell the claim to Donegal, rather than be exposed to Zambia's credit risk. Accordingly, Romania duly assigned the debt to Donegal for $3.28 million, representing eleven percent of the $29.8 million face value.[6]

Fast forward to 2002: After repeated discussions between Donegal and Zambia to convert the debt into equity investments failed, Donegal commenced litigation in the British Virgin Islands, seeking $42 million. This litigation led to a settlement agreement whereby, in return for Donegal's discontinuing the B.V.I. legal proceedings, Zambia agreed to pay $15 million over three years. The agreement included a stipulation that if Zambia failed to remain current on the installment payments, the original debt plus interest would be due. Zambia also waived sovereign immunity with respect to liability and enforcement of foreign country judgments arising from the settlement agreement. After Zambia defaulted on the payments in 2005, Donegal commenced litigation in

3. INT'L MONETARY FUND, THE IMPLICATIONS OF THE GLOBAL FINANCIAL CRISIS FOR LOW-INCOME COUNTRIES, at vii (2009), *available at* http://www.imf.org/external/pubs/ft/books/2009/globalfin/globalfin.pdf.

4. Donegal Int'l Ltd. v. Zambia, [2007] EWHC (Comm) 197, [2007] 1 Lloyd's Rep. 397.

5. *Debt Relief under the Heavily Indebted Poor Countries (HIPC) Initiative*, INT'L MONETARY FUND (Feb. 18, 2010), http://www.imf.org/external/np/exr/facts/hipc.htm [hereinafter *Debt Relief*].

6. *Donegal*, paras. 6, 74, 104, 200, 203, 1 Lloyd's Rep. at 397, 412, 417, 431, 432.

England based on the terms of the settlement agreement, seeking judgment for $55 million, representing the reinstated original principal plus interest.[7]

Final chapter of the litigation: The English High Court ruled substantially in favor of Donegal. The court rejected Zambia's defenses, including the argument that the Zambian Minister of Finance had no authority to conclude the settlement agreement, and rejected allegations that the settlement agreement was tainted by corruption—allegations the English court held were unsubstantiated by the evidence. But the court accepted Zambia's defense that the stipulated rate of interest under the settlement agreement was an illegal penalty, so Donegal was not entitled to enforce that rate.[8] In light of this order, the parties came to a settlement of the claim for $15 million, which represented a substantial reduction—dare I say it, substantial debt relief—relative to the $55 million claim.[9]

III
REFLECTIONS

A. Collective-Action Problems

Donegal raises a number of points relevant to past and present sovereign debt problems in low-income countries. First, the case highlights the conduct of some official creditors (in this case Romania, which sold the original debt claim to Donegal) and of some commercial creditors in eschewing international voluntary debt-relief initiatives. These initiatives have recognized that comprehensive debt relief has been necessary to address the unsustainable sovereign debt burdens that many low-income countries have faced and to free up scarce resources needed in those countries for poverty reduction and economic development. Under the HIPC Initiative, originally launched by the IMF and World Bank in 1996, expectations of creditor participation extended to multilateral, official bilateral, and commercial creditors.[10] Around thirty-five countries have been eligible, and twenty-nine of these have completed the path to comprehensive debt relief, including Zambia, which has qualified for close to $4 billion in HIPC debt relief.[11] Over $110 billion of debt relief has been delivered or committed under the HIPC Initiative, together with the Multilateral Debt Relief Initiative, which supplements the HIPC Initiative by providing one hundred percent relief of eligible debt owed to the IMF, the

7. *Id.* paras. 327, 10, 12, 17, 592, 1 Lloyd's Rep. at 452, 401, 402, 478.

8. *Id.* paras. 447, 458, 523, 1 Lloyd's Rep. at 470, 481.

9. *Zambia pays 'vulture fund' $15m*, BBC NEWS (Apr. 24, 2007), http://news.bbc.co.uk/2/hi/business/6589287.stm.

10. *Debt Relief*, *supra* note 5.

11. *IMF and World Bank Support US$3.90 Billion in Debt Service Relief for Zambia*, INT'L MONETARY FUND (Apr. 8, 2005), http://www.imf.org/external/np/sec/pr/2005/pr0580.htm.

World Bank, the African Development Bank, and the Inter-American Development Bank.[12]

Given the voluntary nature of the HIPC Initiative, its effectiveness is fraught with collective-action problems. In its design, however, the IMF's application of the HIPC framework includes a provision that would be familiar to sovereign-bond-restructuring practitioners. The IMF's provision of HIPC debt relief is subject to a minimum-participation threshold—essentially, IMF debt relief is completed only when creditors with eighty percent of the net present value of eligible debt agree to participate.[13] This minimum-participation threshold mitigates creditor-coordination problems, but like its sovereign-bond counterpart, it can strengthen the hand of sizeable minority holdouts. Even when this minimum-participation threshold is met, the effectiveness of the HIPC Initiative in bringing the debt burden of low-income countries to sustainable levels can be compromised by holdout creditors that take advantage of the fiscal space created by HIPC assistance. Majority-agreed restructuring—akin to collective-action clauses in sovereign bonds or creditor voting in bankruptcy law—has no place in the "sublegal" world of the HIPC Initiative, where enforcement tools are limited to moral suasion and "naming and shaming."

B. Litigation Assistance to Low-Income Sovereign Debtors

The second point highlighted by *Donegal* is that, in sharp contrast to the weak litigation defense commonly presented by low-income sovereign debtors, Zambia mounted a comprehensive defense. Zambia was represented by a stellar legal team including no fewer than five barristers led by Bill Blair, a leading financial lawyer in his own right and brother of then-U.K. Prime Minister Tony Blair. Zambia's legal team raised almost every conceivable legal point. Zambia's defense was also assisted by the testimony of François Gianviti, former General Counsel of the IMF, who gave evidence on the official-sector debt-relief mechanisms.[14] Donegal's success in its core claim to recognize the underlying debt underscores the reality that there is only so much litigation

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12. INT'L DEV. ASS'N & INT'L MONETARY FUND, HEAVILY INDEBTED POOR COUNTRIES (HIPC) INITIATIVE AND MULTILATERAL DEBT RELIEF INITIATIVE (MDRI)—STATUS OF IMPLEMENTATION 6 (2008), *available at* http://www.imf.org/external/np/pp/eng/2008/091208.pdf. We leave for another date a discussion of where all this money has gone and why it seems never to be enough.

13. The eighty percent minimum participation threshold has been established through IMF practice, derived from the legal trust instrument through which the IMF's participation in the HIPC Initiative is administered, requiring that any disbursements of debt relief by the IMF under the HIPC Initiative be subject to "satisfactory assurances regarding the exceptional assistance to be provided under the Initiative by the member's other creditors." *See* INT'L MONETARY FUND, ESTABLISHMENT OF A TRUST FOR SPECIAL POVERTY REDUCTION AND GROWTH OPERATIONS FOR THE HEAVILY INDEBTED POOR COUNTRIES AND INTERIM ECF SUBSIDY OPERATIONS (PRG-HIPC TRUST) § III, para. 3(f) (1997), *available at* http://www.imf.org/external/pubs/ft/sd/index.asp?decision=11436-%2897/10%29.

14. *Donegal*, paras. 53–54, 1 Lloyd's Rep. at 409–10.

counsel can do for a client that has already built a strong legal case against itself. Even the best litigation defenses are difficult in sovereign debt disputes litigated in financial centers whose laws generally favor the enforcement of creditors' rights.

This lesson should inform the many proposals and a few concluded initiatives (such as the Legal Defense Facility of the African Development Bank)[15] that seek to provide technical assistance to low-income sovereign debtors on litigation matters. Notably, when the idea was floated within the IMF to establish a "litigation trust fund" to provide IMF technical assistance to HIPCs facing creditor litigation, the IMF Executive Board recognized that such a role would be inconsistent with the IMF's duty of neutrality, which precludes the IMF from taking sides in debtor–creditor disputes. In addition, the board questioned the benefits of focusing resources on financing legal representation in light of the pro-creditor laws of major financial centers, which evidently tend to favor the enforcement of creditor rights. Instead, the IMF Executive Board discussed the idea that jurisdictions in which vulture funds tend to litigate could amend their applicable laws to provide HIPC debtors with protection from lawsuits.[16]

C. Reform in Response to *Donegal*

The idea of jurisdictions changing their laws in favor of low-income sovereign debtors has recently gained more traction—for example, with recent proposals in the United Kingdom. The discussion launched by the U.K. government in its consultation paper, *Ensuring Effective Debt Relief for Poor Countries*, illustrates the leadership the United Kingdom has taken in promoting participation in international debt-relief efforts.[17] One cannot avoid speculating that perhaps *Donegal*'s notorious outcome in the English courts may have been seen as a taint on the United Kingdom's reputation in this field, which the recent proposals may be aimed at addressing. The U.K. consultation paper strikes a highly sympathetic tone regarding the objective of legally limiting the capacity of creditors who sue low-income sovereign debtors in U.K. courts to recover beyond HIPC benchmarks.[18] Yet the design challenges, including consideration of the United Kingdom's obligations under international law (for example, in terms of the recognition of foreign judgments and arbitral awards) are not insignificant. Furthermore, one can expect that the financial-center lobby—reeling from the financial crisis—would put up a

15. *See AfDB and Member Countries Ready to Tackle Vulture Funds*, AFRICAN DEVELOPMENT BANK GROUP (May 11, 2009), http://www.afdb.org/en/news-events/article/afdb-and-member-countries-ready-to-tackle-vulture-funds-4594.

16. *See IMF Executive Board Discusses the Enhanced HIPC Initiative Creditor Participation Issues*, INT'L MONETARY FUND (Apr. 3, 2003), http://www.imf.org/external/np/sec/pn/2003/pn0344.htm.

17. *See* HM TREASURY, ENSURING EFFECTIVE DEBT RELIEF FOR POOR COUNTRIES: A CONSULTATION ON LEGISLATION (2010), *available at* http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/consult_effectivedebtrelief_200709.pdf.

18. *Id.* at 25.

spirited fight against the type of government regulation entailing the limited enforceability of certain credits.[19]

Proposals for legal reform have been influenced by attempts to grapple with the doctrine of odious debt, which also underlay some of the arguments in *Donegal*. The odious-debt doctrine—the notion that a government can disavow debts of its predecessors when creditors know that these debts were incurred without the consent, or for the benefit, of the government's citizens—has had difficulty gaining recognition in both international and domestic law contexts.[20] Within the international realm, the operational work of the IMF presents one perspective on odious debt. Unsurprising for a credit institution, the IMF's staff has been cautious about the uncharted boundaries of the odious-debt doctrine. Furthermore, the IMF's staff has noted that the potential for ex post invalidation of sovereign debt on odious grounds could increase uncertainty and borrowing costs in debt markets.[21] Caution on the broader implications of odious-debt arguments does not mean, however, that the IMF would take sides in a specific debtor–creditor dispute in which the validity of debt is challenged on odious-debt grounds. The IMF's duty of neutrality presents an appropriate constraint against the IMF becoming embroiled in the legal merits of such specific disputes. Instead, the IMF has focused on addressing the unsustainable debt situations of low-income countries through coordinated international debt-relief frameworks, such as the HIPC Initiative, thereby relieving some of the pressure points that the odious-debt debate ignites.[22]

D. Reconsideration of Romania's Conduct

Going forward, there are two seemingly minor aspects of *Donegal* that merit further thought and investigation in considering alternative ways for progress.

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19. Subsequent to these remarks, the U.K. government in April 2010 enacted the Debt Relief (Developing Countries) Act 2010 that prevents qualifying public external debts from being enforced above HIPC terms provided, inter alia, that the debtor country has made an offer to settle on debt relief terms compatible with the HIPC Initiative.

20. It is especially in the context of domestic-law analogies for the odious-debt doctrine that the 2007 article by Mitu Gulati, Lee Buchheit, and Robert Thompson has made a seminal contribution. *See* Lee C. Buchheit et al., *The Dilemma of Odious Debt*, 56 DUKE L.J. 1201 (2007).

21. *See* Sean Hagan, *The IMF's Role in a Post-Conflict Situation*, 38 CASE W. RES. J. INT'L. L. 59 (2006) (discussing uncertainty in the international financial system that could be created by the odious-debt doctrine).

22. It is important to hold together two statements of principle: (1) The IMF cares about the international credit system and therefore encourages countries to pay debts to the extent possible (or to seek debt restructuring if the debt burden is unsustainable); (2) while the IMF cares about the international credit system, it is not authorized to take sides in the legal merits of specific debt disputes. These two points are stated, for example, in the press briefing responding to a question on Ecuador's debt default: "It's longstanding [IMF] policy to encourage our members to, wherever possible, be current in servicing debt obligations and when they're economically unsustainable to enter into productive negotiations. We understand that Ecuador's decision to default on these bonds is based on a dispute about legal validity rather than debt sustainability, and of course we don't take sides on the merits." *See* Caroline Atkinson, Director, Int'l Monetary Fund External Relations Department, Regular Press Briefing (Dec. 18, 2008), *available at* http://www.imf.org/external/np/tr/2008/tr121808.htm.

The first aspect concerns the conduct of Romania. One has to be careful in judging Romania's conduct since it was not a party to the *Donegal* litigation and, as such, the direct evidence in the record on Romania's motivations is limited. Most commentators and policymakers have focused on the assignment by Romania to Donegal as starting the tale of woes. For example, as a consequence of *Donegal*, the Paris Club has admonished official creditors against assigning away the responsibility to address low-income sovereign debt claims within internationally accepted frameworks. Less attention, however, has been given to the original financing from Romania and its implications for the policy debate. Recall, the original financing in 1979 from Romania was to allow Zambia to purchase agricultural machinery from Romanian manufacturers.[23] This type of export credit, designed to subsidize domestic manufacturers, is by no means unique to this case. But this factor could provide an opportunity to recharacterize some official financing, as in substance grants rather than as loans.[24]

It is worthwhile to focus as well on the domestic policy interests that may drive some official financing. The original financing arrangement that led to *Donegal* seems to have been intended to benefit Romanian tractor manufacturers as much as anyone else, with Zambia arguably the conduit for channeling the grant or subsidy to these manufacturers. Recharacterizing financial transactions that have been subjected to legal documentation is precarious. Nevertheless, at least from a debt-management perspective, greater attention to the beneficiaries underlying the form of financial arrangements should inform low-income countries when they initially negotiate their role in such arrangements.

E. The Role of Mofed Ltd.

The second puzzling, though seemingly minor, aspect of *Donegal* was the role of Mofed Ltd.—an English company owned by the Zambia Ministry of Finance and Economic Development.[25] Like that of Romania's original financing arrangement with Zambia, the record is not very well developed on Mofed. But we do know that although Donegal had not made any substantive debt claim against Mofed, Donegal had initially been successful in persuading the English court to issue an interim freezing order against both Mofed and the government of Zambia to prevent the transfer of assets outside of England.[26] (This freezing order was lifted on the discovery that Donegal had not been forthright in its factual submissions.) What if the substantive debt claim had been against Mofed, as opposed to the government of Zambia? Would or

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23. *Donegal*, para. 6, 1 Lloyd's Rep. at 397.

24. *See* Anna Gelpern, *Odious, Not Debt*, 70 LAW & CONTEMP. PROBS. 81, 113 (Summer 2007) ("The easiest way to deal with official loans would be to call them grants and simply disregard the repayment promise, either at the time of state succession or at the time of financial distress.").

25. *Donegal*, para. 1, 1 Lloyd's Rep. at 397.

26. *Id.* para. 23, 1 Lloyd's Rep. at 404.

should *Donegal* have been decided any differently if the debtor had been a corporate entity—albeit one that was state-owned? The line between private and public debt seems to be becoming increasingly blurry.[27] The difference between restructuring debts of state-owned corporate entities through an insolvency law, as opposed to the noninsolvency-law tools applicable for other sovereign debts, is well known.[28] But the pros and cons of channeling "sovereign" debt through corporate debtor entities needs to be considered more broadly from a number of perspectives—including any differential in the cost of funding, ex ante debt management, and ex post litigation risks—in order to see whether such a strategy would tend to further the interests of low-income countries.[29]

IV

CONCLUSION

Donegal vs. Zambia deserves a reference in the modern legal history of sovereign debt not just for the range of legal issues addressed, but also for the broader policy questions it highlights for the debt problems of low-income countries. Viewing today from that broader context, it is lamentable that, notwithstanding years of aid flows and debt relief, IMF analysis has indicated that twenty-six countries, including Zambia, had become highly vulnerable to the adverse effects associated with the global financial crisis.[30] Clearly, there are no easy legal or policy solutions. But the benefit of this symposium is that it gives an opportunity for collective review of the recent history of sovereign debt, with new perspectives shaped through time and through reflection on the questions raised in the various articles. I trust that through these new perspectives, we can find more enduring solutions that would change for the better the future course of the sovereign debt problems of low-income countries.

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27. *See* Sean Hagan, *Essay: Restructuring Corporate Debt in the Context of a Systemic Crisis*, 73 LAW & CONTEMP. PROBS. 1, 4 (Fall 2010).

28. Notably, in the IMF's proposals for a sovereign debt restructuring mechanism, it was envisioned that the mechanism would not apply to public entities that are subject to a domestic statutory debt-restructuring framework. *See* INT'L MONETARY FUND, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM 23 (2003), *available at* http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf.

29. Subsequent to these remarks, the case of Dubai World has highlighted some aspects of the uncertainties of debt restructuring of quasi-sovereign entities that occupy the "middle world" between sovereign and corporate debtors.

30. INT'L MONETARY FUND, *supra* note 3, at viii.