CHAPTER 3

Lawsuits

A law is something which must have a moral basis, so that there is an inner compelling force for every citizen to obey.

Chaim Weizmann (1874–1952)

In an ideal world resolving the huge indebtedness of the HIPC countries by forgiving their outstanding debt would be the best option for avoiding litigation. But in the real world, especially with vulture fund creditors buying up sovereign distressed debt, recourse to lawsuits is the only method through which creditors can recover their money. This chapter will trace the historical evolution of vulture fund lawsuits and the legal principles on which they are based.

When the IFIs and the wealthy nations called on creditors to participate voluntarily in debt relief initiatives, not enough thought was given to the various categories of creditors operating in the borrowing and lending market. The IFIs had no difficulty forgiving or restructuring past debts, but there were many reluctant bilateral and commercial creditors who were not willing to participate in debt relief initiatives. At the same time, the market was full of potential investors who wanted to benefit from a situation where there were disappointed creditors. Failure to participate in the debt relief initiatives did not alter any of the legal rights of the creditors, or the obligations of the sovereign debtor under an existing loan agreement. Nor could the initiatives compel a dissatisfied creditor to continue to do business with a sovereign debtor which was failing in its obligations. The possibility of obtaining a return for the defaulted debt on the secondary market remained a strong option for the reluctant creditor, albeit at a much lower return than that owed by the sovereign debtor.

A secondary creditor has no alternative but to lodge a proceeding in court in order to obtain a windfall return on its investment. Lawsuits lodged by vulture funds against sovereign debtors are simply exploitation of an investment space created by the debt relief mechanisms. It has been observed that most vulture funds have been established specifically with the aim of buying distressed debts.

The tactics adopted by vulture funds during lawsuits have disempowered sovereign debtors and pose a serious threat to their ability to restructure their debt or to tackle unsustainable debt. The lawsuits have affected countries in their relationships with their business partners both on a national and international level. Countries' reputations in the international market have been tarnished. Some investors have refrained from proceeding with potential investments. Others who have already invested have themselves been targeted by vulture funds. All in all, lawsuits have increased the risk for investors. Vulture funds not only litigate against debtor countries. They also pursue claims against solvent companies who are doing business in the HIPC countries, with the sole aim of recovering their money.

This chapter illustrates the historical evolution and legal principles which form the basis of vulture fund lawsuits by looking at reported decisions. Most of the cases analysed have taken place in the London and New York courts. They highlight some of the legal principles involved and the effects they have on the economies of sovereign states.

The cases outlined in this chapter highlight:

- Legal defences that can be raised by the sovereign debtor, such as sovereign immunity, the doctrine of international comity, and champerty and maintenance principles. Court appearances and appeals are also discussed (Section 3.1);
- Legal arguments supporting vulture fund claims in court, such as *pari passu* clauses, assignment clauses and garnishee orders (Section 3.2);
- The effects of lawsuits on sovereign states and how they have affected the HIPC countries in restructuring their debts by diverting resources freed under debt relief, blocking money intended for economic development and even holding the state hostage (Section 3.3).

3.1 Legal defences available to a sovereign debtor

Sovereign immunity

The question of state immunity often arises in the workshops held by the Legal Debt Clinic. How can this legal principle help countries avoid falling into the clutches of vulture funds? How can attachment orders against the property of sovereign states which are considered immune from any suit or attachment be avoided?

This section explains the doctrine of absolute and restrictive immunity.

It explains two types of sovereign immunity arising from this doctrine:

- immunity from jurisdiction;

- immunity from enforcement.

It then explains waiver of immunity. Finally, it discusses cases which illustrate why sovereign states have been subject to lawsuits.

Absolute and restrictive immunity

What is state immunity? The saying 'The king (or queen) can do no wrong' has been incorporated into modern law through the doctrine of absolute state immunity. Based on the principle of sovereignty, traditionally state immunity was considered absolute. The sovereign is immune from civil or criminal prosecution as the state cannot commit any legal wrong. It also means that the state cannot be subjected to the jurisdiction and exercise of power of the courts of another sovereign without its consent. However, this absolute rule has been increasingly perceived as an anomaly. As government participation in business matters grew, the rule gave states and state-owned entities an unfair advantage over private sector entities. A distinction was then drawn between public and private state activities. They were labelled in Latin as: *acta jure imperii* (acts of government) and *acta jure gestionis* (acts of a commercial nature). This distinction brought in the doctrine of restrictive immunity.

Immunity from jurisdiction

Immunity from jurisdiction means that a state cannot be tried by a foreign state. Such immunity from jurisdiction is granted only for acts of government and not for commercial acts. In the 1970s, several countries passed legislation regarding the restrictive doctrine of state immunity.

In the UK, the law providing for state immunity is the UK State Immunity Act 1978.[17] In the USA, the relevant law is the US Foreign Sovereign Immunity Act 1976 (FSIA)[18]. Both laws cover the rule and the exceptions of invoking sovereign immunity, and when it can be waived or does not apply. In both UK and US law, the legislation does not provide for immunity from civil suit for any commercial transaction undertaken by the sovereign. These principles, giving rise to the restrictive doctrine of state immunity, have been applied worldwide except in China.

When two states enter into a commercial contract, immunity from legal action will usually be provided for in the contract. If the borrowing sovereign state defaults and the contract is bought by a vulture fund, the country is advised to verify the provisions regarding immunity from lawsuit in the settlement agreement.

In the case of Zambia, there was provision for mutual sovereign immunity between Zambia and Romania. When Donegal International Ltd purchased Zambia's debt from Romania, it made Zambia sign a settlement agreement which waived state

immunity. Had Zambia refused to sign the agreement, or negotiated it properly, it would still have had immunity in Donegal's lawsuit, as the debt was assigned from Romania to Donegal subject to equities. In other words, the new assignee, Donegal, would have had to accept all the terms and conditions stated for Romania.

As a rule nowadays, immunity from jurisdiction may not be invoked between commercial creditors, especially if the subject matter of the contract is in the nature of a commercial activity. It is important to note the definition of commercial activity, as it contributes to an understanding of whether immunity from jurisdiction may or may not be invoked during litigation.

A definition provided under US law which is commonly utilised in most cases is:

- **A 'commercial activity' means either a regular course of commercial conduct or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose.**
- **A 'commercial activity carried on in the USA by a foreign state' means commercial activity carried on by such state and having substantial contact with the USA.**

Immunity from enforcement

The second type of immunity relates to immunity from enforcement measures.

In UK law, Section 13 (2) and (4) of the UK State Immunity Act 1978 is important. This states that the property of a state shall not be subject to any process for the enforcement of a judgment or arbitration award or in an action *in rem* for its arrest, detention or sale. But this paragraph does not prevent the issue of any process in respect of a property which is intended to be used for commercial purposes.

Similarly, under US law, enforcement measures will only apply if the property is or was used for the commercial activity upon which the claim is based.

Enforcement measures against the property of a state may have drastic effects on a state. The conditions for the denial or grant of immunity from enforcement measures are still controversial.

A judgment creditor may find it very difficult to enforce its judgment against a sovereign state, as courts appear to be sensitive about indebted countries. In addition,

enforcing a judgment will be difficult if a state enjoys immunity from jurisdiction. The courts of the state where the enforcement measure is sought are entitled to examine the conditions surrounding immunity from jurisdiction and the purpose of the object of the execution.

Waiver of immunity

Waiver of immunity means that the state agrees to have its immunity from lawsuit lifted if the state defaults in its obligations or if another party defaults on its obligations. In other words, the state can sue and be sued. This waiver appears in most commercial contracts and especially in loan agreements. Creditors can expressly impose such a condition on the sovereign debtor. Once the state waives its immunity it can be sued before the jurisdiction under the applicable law provided in the contract. In addition, consent to waive immunity cannot be withdrawn after it is made.

In most cases, the Legal Debt Clinic has encountered, countries have wrongly agreed to settle out of court, without even examining the sovereign immunity defence. In the case of Zambia, it was clear that Zambia could have argued sovereign immunity, as the original contract was with another sovereign state.

It is important to highlight one jurisdiction which adheres to the doctrine of absolute state immunity even when involved in commercial transactions. In 2007, in *FG Hemisphere Associates, LLC v DR Congo & China Railway Groups and Ors,*[19] the judge noted that the People's Republic of China adheres to the doctrine of absolute immunity, whereas most countries have opted for restrictive immunity.

In addition, it is essential to note that central banks always enjoy immunity from enforcement measures.

Why sovereign states have been subject to lawsuits

The principle of sovereign immunity, as explained above, gives sovereign states an unfair advantage over private entities. When sovereign states started to engage in international commercial transactions, the issue of sovereign immunity had to be revised. Agreeing to waive their immunity from lawsuit was the first trade-off by sovereign states that made them vulnerable to suits from their creditors if they defaulted.

Two cases illustrate the issues surrounding loss of sovereign immunity. In the first, involving Costa Rica, the court had to interpret a clause to examine whether sovereign immunity was expressly waived.

Libra Bank Ltd v Banco Nacional de Costa Rica **1981**[20]

In 1981, Costa Rica was sued for the first time in the US courts when the Bank of Costa Rica defaulted on its debt repayments. This was also the first occasion on which a creditor bank brought a legal case against a sovereign debtor. The issue to be considered was whether Banco Nacional had explicitly waived its sovereign immunity in the contract with regard to pre-judgment attachment.

Facts of the case

A group of 16 banks had made a loan of US$40 million to the defendant, the Banco Nacional de Costa Rica, which defaulted on its payment. The defendant had a property in New York State and the lending bank moved the court to grant a pre-judgment attachment order on this property. The defendant argued that it had not explicitly waived its immunity from any pre-judgment attachment.

In the letter of agreement signed between the two banks, there was a paragraph regarding immunity from suit. The terms of the agreement were as follows:

'The Borrower can sue and be sued in its own name and does not have any right of immunity from suit with respect to the Borrower's obligations under this Letter or the Notes.'

In addition, in compliance with the terms of the letter of agreement, for every promissory note which was made in favour of each lending bank by the borrowing bank, the following conditions were provided:

'The Borrower hereby irrevocably and unconditionally waives any right or immunity from legal proceedings including suit judgment and execution on grounds of sovereignty which it or its property may now or hereafter enjoy.'

The court had to adjudicate whether these two terms constituted an 'explicit' waiver.

The Court of Appeal held that the waiver was clear and the intent of the foreign state was neither unequivocal nor ambiguous. Under this interpretation of the statute, Banco Nacional's waiver was clearly explicit.

The court ordered the pre-judgment attachment order against the property found in New York.

In this case, the issue of the act of state doctrine was also considered, in that it was argued that the court of one country must not judge the acts of another. However, this defence also failed in view of the fact that the parties had entered a commercial agreement.

In the second case, involving Argentina, the US Court of Appeal clearly established that issuing bonds was a commercial activity and therefore no sovereign immunity could be claimed in this respect by the sovereign state.

Republic of Argentina v Weltover[21]

The plaintiff, the Republic of Argentina, brought this matter before the US courts in order to adjudicate that the defendant could not sue the plaintiff as it enjoyed sovereign immunity.

Facts of the case

The plaintiff, in collaboration with its central bank, issued bonds which formed part of a stabilising plan for Argentina's currency. The bonds provided for repayment in US dollars. When the bonds started to mature, Argentina lacked sufficient foreign exchange to repay. Argentina unilaterally extended the time for payment and offered the defendant bondholders substitute instruments with a view to rescheduling the debts.

The defendant bondholders (two Panamanian corporations and a Swiss bank) refused to accept the rescheduling and insisted on repayment in New York in US dollars. Upon refusal by Argentina, the defendants sued Argentina for breach of contract.

In its defence, Argentina sought to argue that the New York court did not have jurisdiction. The Court of Appeal held that under Section 1602 of the Foreign Sovereign Immunities Act 1976, the US courts had jurisdiction over the actions of foreign states when they are in connection with a commercial activity which has a direct impact on the USA.

In *Republic of Argentina v Weltover*, both conditions were fulfilled: the bond issue was a commercial activity and the bonds were to be repaid in US dollars. On both counts, the sovereign's immunity from suit could be lifted. Argentina was hence sued before the court.

International comity defence

International comity is a judicial doctrine that allows the recognition by one nation within its territory of another nation's legislative, executive or judicial acts. As defined by the Supreme Court in the 1895 case *Hilton v Guyot*,[22] the doctrine allows one country to recognise another's laws. It refers to the notion that domestic courts should not act in a way that infringes upon the laws of another nation. This treatment is afforded as long as they are consistent with US law and policy.

In the case of *Pravin Banker Associates Ltd v Banco Popular del Peru and the Republic of Peru*,[23] Banco Popular asked for a delay to allow for the restructuring of the debt in its country (Peru). The US court granted an initial period of six months. However, granting a longer period was construed by the judge as being against the comity defence principle in the USA, especially when extending the comity would be contrary to the policies or prejudicial to the interests of the USA between commercial creditors.[24]

It should be pointed out that this defence is not a rule of law, but a rule of convenience intended to foster good relations among states.

Maintenance and champerty

These two principles may be regarded as archaic, but they are of interest in many countries. Queries about them have come up at Legal Debt Clinic seminars and it has been asked whether they can still be validly invoked in court. Note that the doctrine of champerty differs in UK and US law. The principles were invoked as recently as 1996 in the UK courts in the case of *Camdex International Ltd v Bank of Zambia*.[25]

The principle of maintenance applies if someone provides financial support for litigation when they have no legitimate interest in the claim. Unfortunately, this does not seem to happen in today's financial markets.

The law of champerty deals with an aggravated form of maintenance, i.e. maintenance and a right to obtain a share of the proceeds of a lawsuit. This definition applies in the UK and aims to stop solicitors 'trafficking' in litigation. However, under New York law the principle aims to stop creditors bringing their new claim to court if they purchased the claim with the sole aim and express intention of pursuing a legal action. In order to invoke a successful champerty defence, the vulture fund must be shown to have had an intent to obtain title for the purpose of commencing a court action.

UK courts had the opportunity to pronounce on the defence of champerty in the case of *Camdex International Ltd v Bank of Zambia*. The Bank of Zambia alleged that the assignment infringed the rules against champerty.

The next example is from the US courts. In the case of *Elliott Associates, LP v Banco de la Nacion and The Republic of Peru*,[26] the New York court concluded that in order to succeed on champerty principles in a claim, it must be shown that the buyer of the loan intended to obtain the title for the sole purpose of commencing an action in court to obtain payment. The court held that Elliott did not acquire the debt in order to bring a suit against Peru. But when the latter refused to pay Elliott, the lawsuit became merely incidental and contingent to the refusal. Hence, the court main-

Camdex International Ltd v Bank of Zambia

Facts of the case

In 1982, the Central Bank of Kuwait deposited KD15 million with the Bank of Zambia. The deposit was renewed on several occasions and a restructuring agreement was executed in 1988. In 1995, the Central Bank of Kuwait recognised that the Bank of Zambia would not repay the deposit. The Central Bank of Kuwait assigned the benefit of the deposit to Camdex International. The latter notified the Bank of Zambia of the assignment by sending it the notice of assignment and started proceedings in UK courts.

The Bank of Zambia argued that the assignment to Camdex was against champerty rules. The court dismissed this defence as the assignment was made under valid rules and the original creditor was entitled to sell his property to any person it considered fit. In spite of the fact that the Central Bank of Kuwait was to receive a portion of the proceeds obtained from the litigation by way of deferred purchase price, the deal was not champertous.

tained that Elliott did not infringe the champerty rules. The court held that:

> *... while courts have recognized that Section 489 of New York Judiciary Law is a statutory codification of the ancient doctrine of champerty – that is, maintaining a suit in return for a financial interest in the outcome – the Second Circuit stated that New York courts have interpreted the statute as proscribing something narrower than the definition would suggest. The Second Circuit examined prior case law and found that it confirmed that the mischief Section 489 was intended to remedy did not include the acquisition of debt with the motive of collecting it, even if litigation might be a necessary step in the collection process. Rather, Section 489 was intended for the narrow purpose of preventing attorneys from buying debts as an expedient means to obtain costs for bringing suit.*

Since the Elliott case, it has been repeatedly stated that the object of the statutory provision against champerty is the prevention of oppression by unnecessary litigation. Such litigation would follow from the right of an attorney to purchase a claim for the sole purpose of enforcing it in the courts and obtaining costs from the litigation.

However, it is interesting to consider the following statement made in the case of *Donegal International Ltd v Republic of Zambia & Anor.*[27] Quoting from paragraph 76 of the judgment, Michael Sheehan of Donegal International Ltd stated:

> *... our experience and that of others in this business is that you always eventually*

> *recover. You have a legal claim. Eventually if you litigate and work hard enough, you will always recover a sufficient amount to cover your costs.*

It can be argued that on this evidence, Donegal International Ltd's actions should have fallen under the doctrine of champerty. Could it be said that Donegal purchased the debt in the knowledge that litigation would almost certainly be necessary to obtain repayment? It negotiated and paid a minimum price to the original creditor with a view to obtaining the maximum amount owed with interest. It is advisable to explore this principle in any future lawsuit with further analysis so as to extend its application.

Putting a defence and appeal

The Legal Debt Clinic emphasises the importance of simply putting a defence in court and challenging any default judgment by way of appeal. These two actions are in themselves a good defence for a sovereign fund. A sovereign state that defends its case can prevent future surprises and has control over the outcome of the case. It could well be that the vulture fund's arguments are wrong. In the case of *Barbados Trust Co Ltd v Bank of Zambia*[28] (see below), Zambia successfully defended the claim in its entirety. In the case of Donegal International Ltd, Zambia did not pay US$48m – it paid instead only US$15.5m.

In addition, when an appeal is made against a decision, valid defences may be successfully raised. Many orders are not granted by the court when the sovereign defends on appeal, providing further reasons why a vulture fund should not win its claim. Several garnishee orders have been set aside on appeal. In many claims, injunction orders have not been granted or have been cancelled. Sovereigns have also successfully raised arguments using immunity defences on appeal.

Often countries that have put up a defence have benefited in several ways. Some countries that the Legal Debt Clinic has worked with have quickly entered into out of court agreements to settle the debt on the mere threat of being taken to court and have later recognised that they should not have done so.

3.2 Legal arguments supporting vulture fund claims

The *pari passu* argument

The definition of the *pari passu* clause made by a Belgian court in the case of *Elliott Associates, LP*[29] gave vulture fund operations an edge – a reason to opt out of debt restructurings and obtain windfall gains. The case succeeded because the court departed from the traditional meaning of the term *pari passu*.

This section looks first at the original case of *Elliott Associates v Republic of Peru.*

It then analyses the subsequent case lodged before the Belgian court to explain the new definition of the *pari passu* concept.

Elliott Associates had recourse to the US courts to obtain repayment of a loan when Peru called for a debt restructuring process and all other creditors were willing to participate. The case brought by Elliott Associates against Peru was a valid case under the principles of the contract.

Elliott Associates, LP v Banco de la Nacion and The Republic of Peru[30]

Facts of the case

Elliott Associates is a prominent investment fund with its offices in New York City. It was founded in 1977 by Paul Singer, who was its sole general partner (see Chapter 1). In 1996, it purchased the working capital of Nacion Banco Popular del Peru, a bankrupt Peruvian bank, for US$11.4m which was guaranteed by the Government of Peru. The real value of the debt was approximately US$20.7 million. The letter of agreement acknowledging the sale was governed by New York law.

Peru restructured its debt from January to June 1996. Peru's Brady Plan for restructuring was agreed by 180 commercial lenders and suppliers (see Chapter 1 for more on Brady Plans). Under an exchange agreement, Peruvian commercial debt would have been exchanged for Brady bonds and cash. Elliott Associates wrote to the defendants, seeking *pro rata* payment of the debt. The defendants refused to pay, arguing that Elliott Associates was not a proper holder of the debt.

On 18 October 1996, ten days before the exchange agreement was scheduled to be executed, Elliott Associates filed a lawsuit against Peru in the New York court seeking an order of pre-judgment attachment. Elliott filed a case in the District Court of New York in order to ask for repayment of the debt.[31] The debtors tried to argue the maintenance and champerty doctrine in their defence (the rules of champerty are explained above). However, on appeal the appellate court concluded that in purchasing the Peruvian debt, Elliott Associates' primary goal was to be paid in full: the intent of Elliott Associates to bring suit against the debtors was only 'incidental and contingent' to the primary goal.

The court also concluded that Banco de la Nacion had breached the Letter Agreements by failing to pay Elliott the amounts due and owing, and that Peru had breached the guarantee by not paying Elliott the amounts due and owing under the Letter Agreements following Nacion's default. The court awarded a judgment of US$55.7m in favour of Elliott Associates.

Elliott Associates successfully argued the *pari passu* clause (see Chapter 2), which was included in the debt agreement. This clause requires a debtor to treat its creditors equally when repaying its debts. In order to avoid defaulting on its restructuring process, Peru chose to settle the case by paying US$56.3m to Elliott Associates.

After obtaining judgment, Peru wanted to pay the creditors who had agreed to restructure its debt before it paid Elliott Associates. Elliott Associates sought an injunction to prevent Peru from paying the other creditors first. The repayment plan under the Brady Plan was to be conducted by Euroclear, the Belgian clearing bank. Elliott Associates brought *ex parte* proceedings in the Belgian court.[32] The court granted it an injunction restraining Euroclear from proceeding with the debt repayment. Since the deadline for the repayment was imminent, Peru settled with Elliott Associates for the full amount of the judgment and post-judgment interest, totalling US$56.3m.

The argument used by Elliott Associates in the Belgian court regarding the *pari passu* clause is explained below.

***Elliott Associates v Republic of Peru, 12 F. Supp. 2d 328* (S.D.N.Y. 1998)**

Elliott Associates argued that the *pari passu* principle allowed it to obtain payment equally and rateably with the other creditors, and that Peru could not pay the other creditors first, ahead of Elliott Associates. The Brussels court agreed with Elliott Associates.

The court held that under the *pari passu* principle the debt should be 'diminished equally towards all creditors in proportion to their claim.' Therefore no creditor could be excluded from the payment.

This judgment was a departure from the traditional understanding of the *pari passu* clause. Traditionally, under the *pari passu* clause all creditors were to be treated equally in repayment terms only in the event of bankruptcy or insolvency. The Belgian judgment enlarged its scope to include *pari passu* not just in the context of bankruptcy or insolvency but whenever a payment is made to all other outstanding creditors.

This interpretation mainly benefited the vulture fund creditors, as bankers do not opt to hold out during debt restructurings.

However, the UK courts have not adopted the interpretation[33] made by the Belgian courts. They have strong reservations about departing from the traditional meaning of the *pari passu* clause. In a vulture fund lawsuit, the sovereign debtor will gain if the UK approach is utilised.

No definite conclusion has been reached about which interpretation to adopt. It can be argued that the traditional approach is likely to be favoured in order to protect sovereign debtors from exploitation by vulture funds. It is now well established that vulture funds' operations are merely an exploitation of circumstances beyond the control of the sovereign debtor.

The garnishee orders argument

Trade within the HIPC countries is severely disrupted by vulture fund lawsuits. HIPC countries targeted by vulture funds are considered as high risk countries by investors. This is because vulture funds not only litigate against debtor countries, but have also started to pursue solvent companies who do business with these governments under the principle of garnishing. Garnishment is a *quasi in rem* proceeding (similar to a legal action brought in court) used by a creditor to reach the property of the debtor that is in the possession of a third party, known as the garnishee.

Under a garnishing order issued by the court, a creditor is allowed to take the property of a debtor even when the property is in the hands of a third party other than the debtor, for instance someone who owes the debtor money. A lawsuit is filed by the vulture fund creditor against the sovereign debtor as the 'defendant' and the property holder as 'garnishee'. Garnishment is used as a provisional remedy or when it serves to protect the creditor's interest. Under a garnishing order the property is not transferred to the creditor until the creditor wins the lawsuit. The creditor can also ask for pre-judgment garnishment if the creditor can show that the debtor is likely to lose or dispose of the property before the case is resolved in court.

The case of FG Hemisphere (see box below) illustrates the power of garnishing orders. If the order is wrongly exercised or interpreted in court, it can have damaging effects on a sovereign debtor.

This case is an example of the extent to which a vulture fund can handicap a country's economy if it decides to opt for lawsuits. There is a real risk for many investors, who can be subjected to garnishee orders through no fault on their part

Once a judgment is obtained, if the sovereign state does not take any action such as undertaking an appeal, the judgment will be implemented. An appeal acts as a stay of execution and gives the sovereign state time to act.

A sovereign immunity claim can be raised by a garnishee as well as by a sovereign state. There is no authority for the proposition that it is the sovereign's exclusive right to raise the issue of sovereign immunity under the Foreign Sovereign Immunity Act.[34]

FG Hemisphere Associates, LLC v DR Congo[35]

This dispute arose out of a loan agreement contracted by DR Congo with the plaintiff, a New York-based investment company. DR Congo defaulted in its payment and the New York court gave judgment in favour of the plaintiff. The plaintiff sought to obtain payment through a garnishing order, since DR Congo had not made any payment.

Facts of the case

In 2001, the plaintiff sued CMS Nomeco, an oil and gas company based in Texas. The case was brought by the plaintiff in order to obtain payment of royalty rights for oil from CMS Nomeco and other companies under a garnishing order, as debtors of DR Congo. These companies were making payments in kind to DR Congo. Under the garnishing order, the plaintiff asked for an attachment on the drilling of oil by Nomeco. Both DR Congo and Nomeco argued that the court did not have power to make an execution order on oil which was not located in Texas and enjoyed immunity from legal action, i.e. on property that was not located within the USA.

DR Congo, in the classic manner adopted in all loan agreements, had waived its sovereign immunity. The lower court interpreted this to mean that the waiver extended to any assets, revenues and properties belonging to DR Congo.

On appeal, it was held that the district court had wrongly determined that royalty obligations for oil based in DR Congo constituted property located in the USA as required under the US Foreign Sovereign Immunities Act 1976.

In addition, the appellate court found that the conditions under which exception to immunity from execution would apply were not satisfied. It ruled that the lower court was wrong in determining that the property utilised for a commercial activity in the matter was located in the USA.

A sovereign state only loses its immunity if, firstly, the property is located in the USA and, secondly, is utilised for a commercial activity in the USA. The absence of either of these conditions means that the immunity exception does not apply. The appellate court dismissed the garnishee orders as they were wrongly granted.

Power of assignment clauses

The power of assignment has always existed under law of contract, but litigation against a sovereign state has hardly ever happened. The reason for this is the way in which sovereign states have borrowed. When loans were made by bank syndicates,

bankers were interested in maintaining good relations with sovereign states. But when lending expanded to include investment funds, there was no need for the funds to maintain good relations with sovereign states or refrain from seeking redress through the courts.

Assignment clauses pave the way for vulture fund creditors to take over the rights of a previous creditor and aggressively pursue sovereign states for unpaid debts. States have attacked the validity of assignments on many occasions. Assignments have mainly been valid and proper except in the case of *Barbados Trust Co Ltd v Bank of Zambia*.[36]

In loan agreements that date back more than 20 years, an assignment clause was not included. If an assignment clause had been included, the sovereign debtor would have had more control and would at least have been notified when rights were transferred from an original creditor to the vulture fund creditor.

In more recent agreements, assignment clauses have been included. It is advisable to include reference to being notified without delay when an assignment is due to take place. Conditions such as a right of buy-back should be given to the sovereign debtor and must be included before an assignment can be made.

In the case of the case of *Barbados Trust Co Ltd v Bank of Zambia* (see box below) the assignment right was validly questioned and successfully argued. However, there have been many cases where the assignment has been deemed to be in accordance with the terms of the contract. In nearly all circumstances, the original creditor notifies the sovereign debtor of the assignment, but the debtor does not always take the necessary steps. This is mainly because the address for such notification is the office of the High Commissioner of the particular country in the UK, USA or France. The Legal Debt Clinic cautions sovereign debtors about the bureaucratic hurdles involved in sending documents to the appropriate ministry in the particular country. In the experience of the Clinic, some documents have taken more than six months to reach the office concerned and by that time the UK courts have already delivered a judgment.

Assignment rights are usually valid. Countries should act promptly when they receive a notification. However, it is worth analysing the formulation of the assignment clause, as it gives more control to the sovereign to choose the type of secondary owners of the debt in the event of inability to pay, with a view to avoiding damaging lawsuits.

Barbados Trust Co Ltd v Bank of Zambia[37]

Facts of the case

In 1985, the Bank of Zambia took a credit facility through a syndicated letter of credit. Article 12 of the facility agreement allowed any lending bank to assign the debt owed to it to 'any one or more banks or any other financial institutions subject to prior consent of the Borrower (such consent shall be deemed to have been given if no reply is received within 15 days)'.

The plaintiff, Barbados Trust Co Ltd, brought a case against the Bank of Zambia in an attempt to recover the amount due. The Bank of Zambia argued against the validity of the assignment and the right of Barbados Trust to bring the case.

Barbados Trust Co Ltd purchased a participation in the loan from the Bank of America. The latter had acquired its interest from a company known as Masstock. Masstock did not fall within the category of assignee, but both the Bank of Zambia and the facility agent acknowledged that it had a valid title to the debt. The dates of assignment and sale from Masstock to the Bank of America and Barbados Trust Co Ltd are essential to a discussion of the validity of the assignment.

The original sale by Masstock to the Bank of America was agreed in November 1999. Masstock notified the Bank of Zambia of its 'proposed' assignment to the Bank of America on 2 December 1999. The Bank of Zambia did not respond and on 10 December 1999 Masstock completed the assignment in favour of the Bank of America.

The court had to interpret whether the assignment, which was completed before the 15 days' notice, was valid, and whether the Bank of America had a valid title to the debt in the first case.

The court held that the assignment was in breach of Article 12 of the facility agreement. Thus Barbados Trust Co Ltd could not establish title to the debt and its claim failed.

3.3 Effects of lawsuits

A country against which a lawsuit is brought faces serious problems. First, there is the question of whether or not it should put up a defence and how to pay the legal fees. Second, even though a sovereign state can now receive help from the African Legal Support Facility (see Chapter 6, Responding to Lawsuits), it has to bear the unavoidable effects of a lawsuit alone, even after its conclusion. If the country wins the case, this is not a problem. But in cases which are not won by the sovereign state, the enforcement of judgments has brought chaotic results in most HIPC economies. These will be analysed in turn.

Diversion of resources freed under debt relief

In 2007, Donegal International Ltd, a vulture fund very similar in its culture to Elliott Associates, went to court to obtain payment upon default by the sovereign debtor, Zambia. This lawsuit is the most recent example of profiteering vulture fund activities in the UK.

The Republic of Zambia was categorised as a HIPC country and was about to receive debt relief from the international financial institutions. The owner of Donegal International Ltd, Michael Sheehan, analysed the prospect of receiving such funds in part repayment of Zambia's unpaid debt. He wrote to Romania, the original lender, with the aim of buying the distressed debt when the defaulted sovereign, Zambia, was negotiating to buy back the debt.

Letter from Donegal International Ltd to Romania, the primary lender[38]

Michael Sheehan, director of Donegal International Ltd, wrote to Romania in support of his memorandum on the repurchase of commercial debt at 11 per cent of face value and Zambia's Paris Club arrangements reflecting the Naples terms:

We understand that Zambia is not currently servicing its debt to Romania and has not made any serious attempts to reschedule these claims in many years. Furthermore, Zambia is not likely to resume servicing its obligations to Romania in the near term. Zambia's economic situation remains dire, and the country's unsustainable external debt burden makes it one of the countries likely to benefit from the HIPC initiative undertaken jointly by the World Bank, the IMF and the Group of Seven industrial countries. Under the HIPC initiative, Zambia will receive additional debt reduction from its bilateral creditors (both within and outside of the Paris Club). In particular, bilateral creditors may need to write off up to 90% of their Zambian claims and reschedule the remaining 10% over 23 years or more. It is the practice of the Paris club to require African governments to agree a minute to the effect that they will not afford any other sovereign creditor better rescheduling terms than they have afforded the Paris Club. Consequently, we believe that there is very little chance that Romania can expect to obtain more in net present value terms than we are presently offering. The net present value of the receipts from such a rescheduling, which has already been agreed in principle by the Paris Club, would be substantially less than 11% of the original principal amount.

The above letter shows the degree of persuasion used by the vulture fund to convince Romania that it was a better deal to sell the debt rather than wait for Zambia to pay it off on rescheduled terms.

The case was lodged in the UK High Court, Queen's Bench Division, in 2007. The vulture fund obtained US$15.5m for a debt which it had purchased for about $4m. The money was diverted from a country where people were living on less than a dollar a day. The Republic of Zambia, by putting up a legal defence, managed to save US$25m, as the original sum claimed by Donegal International was $40m.

Donegal International Ltd v Republic of Zambia & Anor [39]

Facts of the case

In April 1979, following a credit agreement between Zambia and Romania, the latter provided Zambia with a credit facility to the amount of US$15m to be used to acquire agricultural equipment. There was no provision regarding any governing law in the agreement. The loan was granted at a fixed 5.5 per cent annual interest on the outstanding credit balance. There was no provision for penalty interest or for any consequences if Zambia defaulted on its payments. In 1982, Zambia entered into an agreement to pay only US$5.5m by instalments over a period of eight years.

In 1985, Zambia was unable to pay the amount due and it agreed to reschedule some of the amounts owed to Romania. Under the Paris Club agreed minutes, as Zambia was committed to repaying all its debts, a debt reduction of 40 per cent was agreed between the two parties (see Chapter 8 for the Paris Club Initiative). The final resolution was signed in 1992. After further discussions, Zambia agreed to buy back its debt in November 1995 from all its commercial creditors.

In April 1998, Romania sent a *note verbale* about the outstanding debt seeking immediate payment. Zambia was given a choice of buying back at 11 per cent of the debt payable within 7 to 14 days or paying 33 per cent of the debt over 23 years with six years' grace or paying back over 33 years with no grace time. Following disagreement between Romania and Zambia about the amount owed, a deadline of 31 January 1999 was set for the final decision. Romania cautioned Zambia that it would have no other option but to sell the debt to commercial debt collectors if no agreement had been reached by that date. But unknown to Zambia, during 1998 Romania had already been approached by Donegal International Ltd regarding the assignment of the unpaid debt by Zambia. Under an agreement dated 19 January 1999, Donegal paid US$3,281,780 for the Zambian debt.

The Zambian Government subsequently acknowledged the validity of Donegal's claim and started to service the repayment. An agreement was reached whereby Zambia agreed to pay Donegal 33 per cent of the principal in 36 monthly

instalments. This would have amounted to US$14.8m. In April 2003, Donegal and Zambia concluded a settlement agreement about the discharge of the debt.

However, the Attorney General of Zambia noted some discrepancies during the repayment period and advised the government to stop payment. Donegal sued Zambia to obtain payment.

The judge considered many issues regarding elements of bribery by Donegal, but ruled that there was not enough evidence to reach a conclusion on the matter.

The judge also looked into the validity, enforceability and applicability of the settlement agreement and at the issue of whether or not the UK court had jurisdiction. In addition, the judge concluded that Zambia had agreed in writing that it should not be immune with regard to the claim which Donegal would bring.[40]

Judgment was given against Zambia for US$15.5m. There were several reasons for the award of a reduced amount, compared with the original claim. Zambia benefited from defending the matter in court.

The court made repeated references to the questionable practices that vulture funds adopt and lure others into. The case was innovative in this regard and highlighted the moral dimensions of vulture fund activities. The following quotations from the judgment illustrate these criticisms:

'... I regard the evidence of Mr Sheehan ... as so incomplete as to be deliberately misleading, and a deliberate and misleading attempt to distance ...'.[41]

'Mr Sheehan provided no credible explanation for this inconsistency and I am driven to conclude that he was misleading in his evidence at the American hearing.

'... when cross examined before me, Mr Sheehan sought to explain that he had confined his answers at the American hearing ... Mr Sheehan must have realised his responses gave a wholly false impression.'[42]

'I have already indicated that I find Donegal's account of how the Government signed the agreement inherently improbable.'[43]

This lawsuit triggered much debate among politicians, governments and NGOs and established valuable judicial precedents. The judge made strong comments criticising a director of Donegal International Ltd for the first time in a court judgment. These

comments brought to light the unscrupulous culture of vulture funds. They exposed the way their methods can frustrate the debt restructuring process in poor countries. But it is clear that even when such actions are viewed as highly immoral, they are nevertheless successful in obtaining court awards.

Blocking money for economic development

This section considers an instance where a vulture fund sought to obtain payment by suing for money which was to be disbursed by a donor country to promote economic development in the poor country.

Belgium planned to provide capital for the development of DR Congo. The vulture fund Kensington International sought to attach the money. The capital was only saved from the demands of the vulture fund creditor by the proactive action of Belgium, which decided to enact legislation to counter such moves.

Belgium's donation to DR Congo stopped by lawsuit

In 2007, Belgium planned to grant DR Congo €10.5m for a thermal power plant and €587,000 for its national television station. Before the aid had been transferred, Kensington International, a vulture fund based in the Cayman Islands, sought to attach the funds in a Belgian court in pursuance of a judgment which had already been delivered in favour of Kensington International in the UK. UK courts heard the case of *Kensington International v Republic of the Congo*.[44] The Belgian Government stopped the transfer and decided to enact a law that prohibited vulture funds from seizing Belgian monies disbursed for economic development (see Chapter 7, Legislation).

The sovereign debtor as hostage

The actions of vulture funds can hold a country hostage until the sovereign debtor surrenders to its demands. The court passes judgment according to legal principles. The recent case against DR Congo, when it was faced with a weekly fine, shows how a sovereign is unable to react once a judgment has been obtained in court.

FG Hemisphere v DR Congo[45]

Facts of the case

In 1980, DR Congo entered into a credit agreement with Energoinvest for the construction of a high voltage electric power transmission facility. The country defaulted on its payment. In 1991, the government acknowledged the debt but made no payments.

In March 2001 Energoinvest filed a motion for arbitration with the International Chamber of Commerce (ICC). Two years later, the ICC Court of Arbitration issued an award in favour of Energoinvest for US$11,725,000 plus 9 per cent interest. The sovereign debtor was also required to pay the costs of arbitration.

Subsequently, Energoinvest filed a case in the USA to have the court judgment confirmed in the USA. The US district court for the District of Columbia confirmed the arbitral award in 2004. Energoinvest then transferred its rights in the arbitration award to recover the claim to FG Hemisphere.

In 2005, when DR Congo failed to pay the amount awarded, FG Hemisphere filed a 'plaintiff's first request for production' application, in which it asked the court to order DR Congo to disclose to the court the following government assets:

- The location of any items worth more than US$10,000;
- Any documents that identified aeroplanes, boats, trucks and cars worth more than US$10,000; and
- Any gold, precious metals, works of art or jewellery.

FG Hemisphere sent the court document by courier to the Government of DR Congo. It arrived eight days after it was filed. Only two days later, the district court ruled in favour of the vulture fund company. The court gave DR Congo 30 days to comply. However, at the time of this judgment the court document was doing the bureaucratic rounds and had not yet been translated from English to French.

To date, DR Congo has not complied with the court's request, arguing that the order is a virtually impossible burden. Nevertheless, in May 2008 FG Hemisphere filed a motion in the US district court for the District of Columbia to hold DR Congo in contempt of court. The court granted the motion in March 2009.

When awarding its ruling, the court held that DR Congo had 30 days to produce the requested documents. Otherwise it would be fined a weekly amount of US$5,000

for non-compliance with the order, to be doubled every four weeks up to a maximum of US$80,000 a week. The fine would continue until the government produced all the documents sought by FG Hemisphere.

The fines are currently mounting and will total more than US$4m in one year. The judgment was delivered on 19 March 2009. (See Annex 1 for the text of the judgment.)

The cases described above are not exhaustive. There are many cases where enforcement procedures or litigation have been very damaging to HIPC countries. Liberia is the most recent. In November 2009, the UK courts granted a judgment of US$20m to the vulture funds Hamsah Investments and Wall Capital Ltd for a debt contracted in 1978. Liberia has suffered from 14 years of civil war and rescheduled its commercial debt to the World Bank in 2009 (see Chapter 8, International Initiatives).

Conclusion

This chapter has outlined key cases and reported the decisions in a number of vulture fund lawsuits. The case law highlights some of the concepts and clauses explained in Chapter 2, Loan Agreements, and how they are dealt with in practice. The lawsuits in this chapter have also highlighted legal principles which:

- No longer support the defence cases put up by sovereign states;
- Have given support to the operations of vulture funds;
- Allow vulture funds to obtain repayment of monies owed.

Such litigation causes further harm to sovereign states. All these cases show the impact that lawsuits can have on a country, and how they can make a mockery of global efforts to eradicate unsustainable debt.

The key lessons that emerge from this chapter are:

- It is essential to exercise great care and take legal advice before committing any agreement to writing.
- An active approach to defending a lawsuit brought by a vulture fund is beneficial in several ways.
- Failure to put up a defence encourages vulture funds in their harassment of sovereign states. Facilities exist that can help a sovereign to meet the legal expenses of a lawsuit (see Chapter 6, Responding to Lawsuits).

- It is important to study case law as an ongoing practice. Such study helps create new angles which the courts can use to analyse cases and may point to new legal defences and approaches in a loan agreement.
- The way in which the governments of Zambia and DR Congo have resisted being held hostage has been remarkable and has worked greatly to their advantage.
- Lawsuits can have a crippling effect on HIPC countries, especially with regard to the aggressive enforcement of judgments by vulture fund creditors.
- Sovereigns should act immediately on court notification or other notices from creditors and should always seek legal advice.

Part II will examine ways in which it may be possible to avoid lawsuits or to mitigate their effects.

Further reading

- Commonwealth Secretariat Legal Debt Clinic, http://www.thecommon wealth.*org/Internal/190714/190927/157583/legal_debt_clinic/*
- Judgments available at http://www.thecommonwealth.org/Internal/190714/ 190927/157583/180640/judgments/

PART II

Actions and Responses

Lawsuits should always be a last resort and countries should take all possible action to avoid being sued in court. Part I of this report provided the basic facts about vulture funds, loan agreements and lawsuits. Part II considers how countries can avoid lawsuits in the first place and possible ways to respond if court cases do arise.

Vulture fund litigation should not be seen simply as lawsuits. It affects the economic growth and sustainability of sovereign countries which are faced with unsustainable debt. In an ideal world, eradicating the causes that give rise to these lawsuits would be the solution: there would be no more borrowing, no more loans and hence no default on payments. However, we live in a world that is far from ideal. In reality, poverty and scarce resources make borrowing a necessity. Moreover, the unsustainable debt of sovereign states is intrinsically linked to international policies – an issue that will be explored in Part III.

The adoption of preventive measures for tackling lawsuits therefore calls for properly negotiated loan agreements to deal with the necessary evil of borrowing, and proper debt management to reduce negative impacts on economic growth.

Chapter 4, Negotiation, highlights how lawsuits can be avoided through capacity building in negotiating skills among officials in the relevant ministries.

Chapter 5, Debt Management, highlights how adopting prudent public debt management will allow a sovereign debtor to achieve better debt sustainability in the long term and avoid debt defaults ricocheting in lawsuits by vulture funds.

Chapter 6, Responding to Lawsuits, looks at the options available to sovereign debtors if they cannot avoid a lawsuit.

This part of the Handbook, like the briefings in Part I, is based on the experience of the Commonwealth Secretariat Legal Debt Clinic and the lessons learned from its seminars. It also draws on the actions undertaken by the World Bank for the development of sustainable economies, with the overarching aim of helping them achieve the Millennium Development Goals (MDGs). The seminars held by the Legal Debt

Clinic were attended both by legal officials from ministries of justice and by financial officers working in ministries of finance or government departments that deal with sovereign debt. This mixed attendance was an essential component of the deliberations during the seminars and elicited lively exchanges of views, allowing the two different functions to be properly discussed and understood. It shows that legal and financial officials in countries affected by vulture fund activities need to communicate, share an understanding of what each other's work involves and work closely together. For example, a team from a ministry of finance that is contracting a loan agreement should include officials from the ministry of justice and any other ministry involved in the project that requires the loan. Only lawyers will be able to highlight loopholes in the loan agreement and the risks involved in formulating terms and conditions which may become issues in court during a lawsuit. Debt managers should be working in accordance with public debt management as a whole, in order to reduce the country's debt vulnerability.

The aim of these chapters is to outline possible actions and responses to lawsuits which can be adopted by a sovereign state. They analyse different areas which contribute directly or indirectly to lawsuits, taking a holistic approach. They range from briefings and checklists which can be used for training and capacity building to prudent measures advocated by the World Bank. The World Bank approach has been taken up by several training organisations and regional banks such as the African Development Bank, Macroeconomic Financial Management Institute (MEFMI), West African Institute for Financial and Economic Management (WAIFEM), the Commonwealth Secretariat, Pole-Dette and the United Nations Institute for Training and Research (UNITAR).