

## POLICY POINTS

**Diplomatic solutions** must be given the opportunity before any legal actions are initiated.

**Agreements that waive sovereign immunity**

demand proper scrutiny as to the consequences on a case-by-case basis.

**Arbitration forums** should be outside of both the home country of the lender and the borrower.

**Parties should consider rejecting** non-disclosure agreements for sovereign lending, to avoid unwarranted speculations.

## China, Africa, and Debt Distress: Fact and Fiction about Asset Seizures

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IN THE PAST TWO YEARS, NEWS HEADLINES have periodically speculated that African borrowers are at risk of losing their sovereign assets to Chinese lenders. This policy brief explores what we know about the legal aspects of Chinese lending, including the waiver of sovereign immunity and the consequences thereof, and provides policy recommendations.

### THE WAVE OF CONCERNS ABOUT POSSIBLE ASSET SEIZURES

IN EARLY 2017, THE TERM “CHINESE DEBT TRAP DIPLOMACY” entered the global lexicon. Chinese lending, this view contends, was deliberately indebting borrowers so that China could gain strategic advantages, including mineral concessions and ports. When, facing a balance of payments crisis, Sri Lanka privatized 70 percent of a Chinese-financed port to a Chinese firm, most of the five loans that financed the port were still in their grace periods, so the debt burden was relatively modest. Yet some reporters described the decision as a foreclosure: “Beijing seized a strategic seaport in Sri Lanka as collateral.”<sup>1</sup>

Fears about asset seizure have spread to Africa. For example, former US National Security Advisor John Bolton warned in a 2018 speech that China “is now poised to take over Zambia’s national power and utility company in order to collect on Zambia’s financial obligations.”<sup>2</sup> The rating agency Moody’s warned that countries “rich in natural resources, like Angola, Zambia, and Republic of the Congo, or with strategically important infrastructure, like ports or railways such as Kenya, are most vulnerable to the risk of losing control over important assets in negotiations with Chinese creditors.”<sup>3</sup>

Revelations that Kenya’s Standard Gauge Railway loan contract contained a waiver of sovereign immunity added to these concerns. As we note below, waivers of sovereign immunity appear to be standard in Chinese Eximbank loan contracts. What is this likely to mean for African sovereign assets should governments default on Chinese loans?

### BACKGROUND: WAIVERS OF SOVEREIGN IMMUNITY

AT THE MOST BASIC LEVEL, AGREEMENTS between lenders and sovereign governments are contracts that enshrine the parties’ mutual promises. Contracts concluded by a sovereign state are, however, fundamentally different from those concluded by private

parties because the sovereign state would ordinarily have immunity from lawsuit.

In 1976, the US adopted a Foreign Sovereign Immunities Act that formalized, in law, foreign governments' immunity from lawsuits unless they had expressly waived this immunity.<sup>4</sup> This led to cross-border legal agreements with sovereigns typically including clauses waiving sovereign immunity for the borrowing government and its properties.<sup>5</sup> As a 1998 study on globalization noted, "In order to be able to attract loans, it is rational for countries to commit themselves to promises that are perceived to be credible, so they often willingly waive their rights to sovereign immunity in loan contracts."<sup>6</sup>

The waiver of sovereign immunity allows a sovereign state to be sued in a foreign court or submit to international arbitration. However, once a judgment has been made, and a borrower is found liable for damages, there is the question of enforcement. Waiver of immunity from *enforcement* is different from the initial waiver for purposes of lawsuit or arbitration and is accompanied by serious technical legal difficulties pertaining to the sovereign immunity laws of the involved jurisdictions. Sovereign assets that are not used for commercial purposes (diplomatic missions, for example) are almost invariably protected. The extent of immunity protection enjoyed by sovereign assets used for commercial purposes would depend on each national jurisdiction's laws.

### CHINESE LOAN CONTRACTS: SOVEREIGN IMMUNITY AND ARBITRATION

WE REVIEWED A NUMBER OF CHINESE loan contracts and found that most include language on the waiver of sovereign immunity with regard to arbitration *and* enforcement. This sentence from a Benin water project is typical, "The Borrower hereby irrevocably waives any immunity on the grounds of sovereign or otherwise for itself or its property in connection with any arbitration proceeding [...] or with the enforcement of any arbitral award."<sup>7</sup>

All the agreements state that disputes should be solved through "friendly consultation," but that, should this fail, the dispute will be submitted to binding arbitration. The venue for arbitration is always specified in the contract. Sometimes it is the International Court of Arbitration of the International Chamber of Commerce (ICC) in Paris, the London Court of International Arbitration in the UK, or the Hong Kong International Arbitration Center. However, most often it is the China International Economic and Trade Arbitration Commission in Beijing (CIETAC – established in 1956). Most of the agreements we have seen

specify that in general, the contract is governed by Chinese law, although this is not a requirement of CIETAC arbitration, which allows the application of international conventions and foreign law in individual cases.<sup>8</sup>

### THE KENYA STANDARD GAUGE RAILWAY AND MOMBASA PORT

IN LATE 2018, RUMORS FLOWED THAT KENYA had put up Mombasa Port as collateral for the Standard Gauge Railway (SGR).<sup>9</sup> In December 2018, a Kenyan Auditor General audit for the Kenya Port Authority (KPA) came to light, which noted that KPA should have listed its role as part of the financial guarantee for the SGR loan repayment as a potential risk to its assets, should the Kenya Railways Corporation default on the loan.<sup>10</sup>

As explained to Kenya's Parliament in 2014, the SGR loan repayment is backed by general revenues from the railway but the loan contract provides two further guarantees.

- First, the state-owned KPA signed a "take-or-pay" agreement in which it agreed to guarantee a minimum amount of cargo to be transported to Nairobi by rail.
- Second, KPA was tasked with imposing a 1.5 percent Railway Development levy on all imports to help Kenya finance the railway (in 2018 the Railway Development levy would have provided US\$ 261 million).<sup>11</sup>

These revenues were to be deposited in an escrow account from which the loan would be serviced; this account is the collateral for the loan.<sup>12</sup> Furthermore, Kenya was required to take out an insurance policy with China's export credit insurer, Sinosure, priced at 6.93 percent of the commercial loan value. All of these guarantees suggest that China Eximbank wanted to insure loan repayment, rather than that they were keen to obtain the Mombasa port.

A Kenyan reporter who obtained a copy of the loan contract admitted that it had "no specific reference to the port" as collateral.<sup>13</sup> However, he argued, since Kenya had agreed to waive its sovereign immunity from lawsuits, any commercial asset of the government could be at risk of attachment should the lender sue for non-payment. "*What that basically means is that everything will go in case of default,*" he argued [emphasis added].<sup>14</sup>

If Kenya runs into difficulties with repayment of the SGR loan, the most likely outcome is an extension of the repayment period through a "friendly consultation."<sup>15</sup> If Kenya is required to pay and still could not pay, it appears that Sinosure would possibly cover the payments to China Eximbank, as per the insurance policy. However, then Kenya may have to indemnify

Sinosure depending on the terms of the insurance. We have not yet seen cases in Africa where China Eximbank or Sinosure have used courts to arbitrate sovereign loan defaults, but this is not unprecedented in international development banking.

In 2004, for example, it was reported that Germany's Kreditanstalt für Wiederaufbau (KfW) export credit agency successfully submitted a dispute to the ICC in Paris regarding the Zimbabwe Steel Corporation (ZISCO)'s nonpayment of three loans amounting to US\$ 59 million. The ruling allowed KfW to try to attach commercial properties outside of Zimbabwe. In 2010, KfW obtained a legal order to seize six properties in South Africa owned by the Zimbabwe government, but this was set aside by a South African court that ruled that the properties were protected by diplomatic immunity.<sup>16</sup> By 2018, the debt, still unpaid, had ballooned to US\$ 225 million with penalties and interest arrears.<sup>17</sup>

This suggests the difficulties a government bank faces in enforcing a favorable arbitration award. The SGR loan contract specifies arbitration in Beijing. The Kenyan Auditor General's 2018 letter argued that this "biased" the agreement, as the Beijing location meant that "fairness in resolving the disagreement may not be guaranteed." If the Chinese lender took the case to arbitration and obtained a judgment against Kenya Railways Corporation, they could then (as KfW did) try to attach Kenyan government commercial properties in or outside of Kenya. Their ability to do this would depend on the jurisdictional rules of the place where the execution of the judgment is sought.

The ever-increasing application of foreign court judgment and arbitral award enforcement treaties make the possibility of transnational execution more likely now than ever before. For example, the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, commonly known as the New York Convention, now has 156 member states including Kenya and China. What this means is that an arbitral award given in any one of these states could be enforced in each one of the 156 countries. Given these transnational legal possibilities, waiver of immunity from lawsuit and execution, whether through arbitration agreements or otherwise, are not merely theoretical. The risks of unpleasant legal confrontations are real and must be managed, carefully taking the interests of both the creditor and the debtor into account.

However, in practical terms, should the railway loan go into default despite these revenue guarantees, and should arbitration go against Kenya, it is still hard to make the case that China Eximbank could (or would) ask a Kenyan court to force Kenya to hand over Kenyan state assets like the port of Mombasa. After all,

as a group of experts on sovereign debt restructuring pointed out in 2018, "it is relatively easy for creditors to get court judgments against a defaulting sovereign but relatively difficult for creditors to enforce those judgments."<sup>18</sup>

## POLICY RECOMMENDATIONS

THE SINGLE MOST IMPORTANT CONSIDERATION is the fairness of the legal process devised to manage situations of default. A process perceived as one-sided, unfair, and inequitable does not produce an acceptable and enforceable result. It only exasperates a relationship that had already become precarious because of default and escalation to the legal realm. Formulations for the management of default situations could benefit from the following policy recommendations.

1. Diplomatic solutions must always be given adequate opportunity before any legal actions are initiated.
2. Agreements that waive sovereign immunity must not be entered into without proper scrutiny as to the consequences on a case-by-case basis. When such waivers become necessary for the protection of the legitimate interests of the creditor, the scope of the waiver must be carefully circumscribed to achieve the particular legitimate interest.
3. Arbitral agreements should be properly negotiated in each individual case and avoid any real and perceived lack of neutrality and independence of the decision-makers and administering institutions. The fairness of the applicable rules and the acceptability of the final outcome to both parties must be guaranteed. We recommend that borrowers choose arbitration forums outside of both the home country of the lender and the borrower.
4. With the exception of narrow matters legitimately requiring confidentiality, parties should consider rejecting non-disclosure agreements for sovereign lending, to avoid unwarranted speculations that undermine public trust and unnecessarily complicate matters. ★

## ENDNOTES

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