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# A Law-and-Economics Analysis of Odious Debts:

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This paper seeks to reflect the core of my PhD dissertation project devoted to the law-and-economics analysis of odious debts. It identifies the major issues in the field, existing proposals, potential soutions as well as remaining gaps and areas which require future research. It is an on-going project which is still under development.

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**Introduction**

Odious debt is an obligation incurred in the name of a sovereign nation by a despotic or illegitimate government, the proceeds of which only enrich the despot, or fund the repression of his subjects.[1] Some governments take up these types of debts, only to leave it to the people and the successor government to repay them once they are out of office or overturned. The concept of odious debts dates back to the writings of Aristotle[2] and was revived and formalized by Alexander Nahum Sack in an early 20th Century doctrine[3]. Although its impact has been negligible, the doctrine and the problem of odious debt have sparked ongoing interest in academia and debt restructuring debates. This interest has reemerged with striking momentum as a result of the Iraq war and again more recently upon Norway's public cancellation of debts owed to it on the grounds that they loans were originally illegitimate loans on its part.[4]

Post-Saddam Hussein's debt sparked an international debate over the odious character of the debt he left his people behind with. However, the problem of odious debts has existed throughout the history of international finance. A history characterized by much reckless lending, irresponsible borrowing and mismanagement of money.

The international law of state succession requires for the continuity of rights and obligations, including the obligations to assume debts, when there is a change in government. This rule has both a legal and an economic rationale. The former is based on notions of the continuity of state identity and personality as well as on classical theories of benefit and burden. Most importantly, the sanctity of contracts and duly acquired rights of creditors justify the rule. The economic rationale stems from the fact that continuity of obligations fosters international exchange by providing credible commitments. Given that international finance is a repeated game with a small number of players, reputation plays a major role in sustaining continuing creditor-debtor relationships.

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[1] Feibelman, A, "Contract, Priority and Odious Debt" (Forthcoming Duke L. & Contemp. Probs. 2007) at 2
[2] See Cheng, Tai-Heng. "Renegotiating the Odious Debt Doctrine" (Forthcoming Duke L. & Contemp. Probs. 2007)
[3] Sack, A.
[4] "Norway Takes Historic Step" (2006) www.odiousdebts.org available at: http://www.odiousdebts.org/odiousdebts/index.cfm?DSP=content&ContentID=16405

Despite the legal and economic rationales for the succession of public debts, there are instances when it seems that such a rule is morally repugnant. When debts which were incurred by a previous government have been used against the general interest of the population, have violated human rights, caused environmental damage and been subject to corruption, forcing the population which has suffered as a result of these debts to pay them back seems to go against basic moral principles.

It is the moral dimension of the problem of odious debt which has received the most attention. Many scholars, public officials and activists alike seem to believe that there is a need for certain debt relief on purely moral grounds, which is to be treated separately from debt relief due to economic necessity.[5] While the problem is indeed a moral one, it has many faces. It is a political economy problem which has to do with the shortsightedness of governments and the high discount value they have in the long run interest of the people they owe a fiduciary duty to. Odious debt is also a result of market failure. The externalities imposed on developing country populations as a result of irresponsible borrowing, irresponsible lending and bad or negligent advice by international financial institutions (IFIs) are not internalized. At the same time, information asymmetries between parties in the debt market as well as an overall lack of transparency in the system aggravate the problem of odious debt.

The organization of my research is as follows: The first chapter will look back at the history of debt and the rule of succession of state obligations. It will highlight how some of the new questions about debt obligations which have resurfaced in conjunction with the odious debt debate can be traced back as far as the 13th century. The legal and economic rationale for the succession of debts can be found in history and state practice. These rationales are not only still applicable today, but arguably even more relevant in the context of modern day globalization. The existing exceptions to the rule of state succession of debts will be evaluated, namely the cases of war debts and hostile debts. A

[5] See Gelpern, A. "Odious, Not Debt" (forthcoming Duke L. & Contemp. Probs. 2007) where she argues that odious debt debate should focus on its moral dimension because countries have many options available to deal with the economic necessity and debt overhang issues. Using odious debts as a vehicle to address economic necessity is more trouble than its worth. See Davis, A. Paper presented at the "Odious Debt and State Corruption Conference" Duke School of Law. January 26th, 2007 , where she discussed the analogy of odious debts and black reparations for U.S. slavery, focusing on the need to address historic injustices and human rights abuses in the context of debt. See Adams, P. *Odious Debts*, 1991 and her website www.odiousdebt.org .

preliminary law-and-economics analysis will be applied to them, in order to provide some insight as to why, in contrast, a workable "odious debt" qualification has not developed until now and would not prove efficient. The section will conclude with

The second chapter will critique the doctrine of odious debts from an institutional perspective, looking at the obstacles impeding it from acquiring a place in international law. Economists Kremer and Jayachandran propose that the odious debt doctrine be converted from an ex-post rule to a quasi ex-ante rule. They develop a model in which an international body such as the United Nations Security Council has the power to impose loan sanctions on odious regimes.[6] Some light on this proposition is shed using Shavell's economic analysis of ex-post versus ex-ante regulation. Their model is also analyzed taking into consideration issues of practical and political feasibility. Finally, theirs and other scholars' assumption that a functioning odious debt doctrine would increase public welfare is questioned using the work of Choi and Posner on the subject.

The third chapter looks at private domestic law analogies and solutions to odious debt. In agency law, the risk of non performance is traditionally borne by the principal. However, there are exceptions to the rule and instances where this risk is shifted to the third party. These include cases of a runaway agent, or collusion between the agent and the third party. Such examples are also found in corporate law. The aim is to look at how these examples provide a domestic law backdrop dealing with similar issues existent in the problem of odious debt. The possibility of using existing national legal doctrines to support an odious debt repudiation in the municipal courts of either New York or London is also explored. These include the doctrine of fraud, unclean hands and unjust enrichment.

The fourth chapter shifts the focus to the creditors. Different types of creditors are guided by different incentives and consequently it is important to analyze them separately.[7] Private sovereign creditors' are motivated by profit maximization. Intuitively, this motivation is not at odds with tackling odious debt. In fact, some authors argue that in many circumstances, the interests of non-odious creditors will be aligned with the interests of sovereign debtors.[8] Bona fide creditors benefit

[6] Kremer, M. and Jayachandran, S. "Odious Debt" American Economic Review. 2006
[7] As important as the distinction is, it is more and more difficult to achieve, given the flow and size of the secondary market for debt. This issue will also be discussed in this section.
[8] See Feibelman, A. "Contract, Priority and Odious Debt." (forthcoming Duke L. & Contemp. Probs. 2007)

most clearly when their sovereign debtor avoids obligations that are not valuable to the debtor, increasing the value of non odious debt. Accordingly, several debt priority and equitable subordination ideas will be proposed in this context. Public creditors, on the other hand, are not primarily motivated by profit maximization and in many cases do not have a uniform interest in getting paid back. Instead, they are motivated by the potential for policy influence in the sovereign debtor country.[9] Their range of different political and strategic interests is large, and therefore aligning them with tackling odious debts is a challenging task. Finally, IFIs have particular interests themselves, as reflected by the conditionality requirements they often impose on their loans. Some proposals concerning holding IFIs liable for bad economic advice and aligning their interests to the Gross Domestic Product (GDP) of the sovereign debtor are discussed. A recurrent theme throughout this chapter is the issue of information and the ability of creditors to either directly or indirectly provide it, monitor and control it. The law can induce creditors to use their informational advantages and skills through liability. The market can also bring this about through the use of financial instruments.

## 1 Succession of Sovereign Debts

### 1.1 Succession of Sovereign Debts

Looking back at history allows one to trace the legal and economic rationale for what has developed into the present international doctrine of state succession of obligations.[10] Because the concept of odious debts basically challenges this doctrine, understanding where it comes from is an enlightening starting point.

#### 1.1.1. Legal Rationale

The concept of "sovereign debts" and the notion of state were developed in the classical writings of Grotius and Pofendorf. They molded what is known today as the 'rule of succession in debt obligations' in international law. Their writings were in part shaped by the Roman law of inheritance and generally accepted rule of universal succession of obligations.[11] Their theories brought forth legal rationales for such a rule which are still valid today. Before Grotius, the maintenance of public debts referred to debts of individual rulers and princes, as opposed to debts of nations, and had not been based on the conception of the modern state.[12] He developed the notion of state identity and argued that the state remains identical despite the immigration or emigration of its nationals and changes in the form of its government.[13] A change which is merely political does not affect the identity of the state and its fiscal liabilities as debtor.[14]

Pufendorf later brought forth the 'Permanence of Burden' and 'Benefit' theories to support the rule of succession.[15] The former holds that the debtor state did not acquire debts in its capacity as such,

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[10] The leading treaties are Ernst Feilchenfeld, *Public Debts and State Succession* (1931) (hereinafter, Feilchenfeld), Daniel Patrick O'Connell, *State Succession in Municipal Law and International Law,* Vol I (1967) (hereinafter O'Connell) and most recently, Tai-Heng Cheng, *State Succession and Commercial Obligations* (2006)

[11] The concept of inheritance in civil law is a derivative of Roman law and states that the *heres* (appointed successor) acquires not only the single *res* but also the aggregate rights and liabilities *ius universitas.* See Craven, M. *The Problem of State Succession and the Identity of States under International Law*, 1998

[12] Feilchenfeld, Ernst. *Public Debts and State Succession* 5. at 30

[13] Feilchenfeld, Ernst. *Public Debts and State Sucesssion* at 27

[14] This theory was later developed by O'Connell who considered the state as having two forms of personalities; political and social. The argument is similar, as it holds that when there is a government or state succession, only the political personality is affected, and therefore the social personality (legal condition of the people) remains intact. See O'Connell, *State Succession in Municipal Law and International Law*1967, volume I, at 11

[15] Feilchenfeld Ernst. *Public Debts and State Succession* at 30. See Pufendorf, S. 1967 Treatise, "Natural Law and the Law of Nations."

but the debts have their foundation in the fact that the debtor possessed certain assets. It follows then, that the debts must logically be passed on to each subsequent possessor of the assets.[16] The benefit theory, in turn, argues that a state remains permanently liable for all the money which has been used for the benefit of the population.[17]

Both Grotius' and Pufendorf's theories were considered as arguments which supported the continuity of obligations upon state succession, rather than exclusive rationales to it. They explicitly adhered to the sanctity of contracts and duly acquired rights of the creditors. They believed that countries ought to respect their debt contracts because creditors should not lose the duly acquired rights which they acquired from a lawful ruler.[18] The argument continues, even if some contracts may have been subject to moral objections, this does not affect their legal validity.[19]

### 1.1.2 State versus Government Succession

At this point, some clarification of the terminology may be necessary. The classical writings on state succession shed light as to the legal rationale for the continuity of international obligations in general. They did not at the time distinguish between the notions of state and government. Today, positivists define the two differently. Cheng explains that state succession involves a change in the territory or international legal personality of the state. In contrast, governmental succession involves a change in government and does not change the state's legal personality.[20]

At present, there are no clear customary rules or multilateral treaties in force governing whether and when a successor state is responsible for the debts of its predecessor state.[21] Scholars and

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[16] *Id.*
[17] *Id.* In a recent paper, Buchheit et al. Explains how the US. Property and Inheritance Laws also reflect these burden/benefit theories and they have a foundation in common sense. (On note with author, unpublished) "The Dilemma of Odious Debts" 2006. See also RESTATEMENT OF PROPERTY § 537 for discussion on relationship between benefits and burdens.
[18] Ernst. *Public Debts and State Succession* at 30.
[19] *Id.*
[20] Tai-Heng Cheng., "Renegotiating the Odious Debt Doctrine" forthcoming Duke J. Contemp. Probs. 2007 (draft 2006) available at ssrn: http://ssrn.com/abstract=948704
[21] Tai-Heng Cheng, "Renegotiating the Odious Debt Doctrine" forthcoming in Duke J. Contemp. Probs.2007 available at: http://ssrn.com/abstract=948704 (hereinafter Cheng, "Renegotiating the Odious Debt Doctrine) at 10-11

jurists are divided on whether the 'clean slate' approach or the 'universal succession' approach is applicable.[22] State practice has also been inconsistent.[23]

However, while the issue of state succession is more contested, public international law today is particularly strict in requiring successor governments to take up the debt obligations of their predecessors.[24] Under positivistic international law rules, a successor government is always responsible for the debts of its predecessor government.[25] Buchheit et al. describe governmental debts in the sovereign context as 'congenital'and 'adhesive' in the sense that each generation of citizen inherits a responsibility to contribute toward repayment of the old debts merely by being born in the state.[26] They go on to argue that sovereign debts are also 'ineradicable' and it is these three factors considered together which makes for intergenerational conflict.[27]

Cheng has argued that although positivists explicitly make the distinction between state and government succession, in practice the definitions have been blurred.[28] There is a wide and complex range of different types of successions including independence from colonial rule, fall of Soviet-style regimes and acquisition among many others and it is difficult to come up with a clear distinction. Cheng argues that both government and state succession should be justified or criticized on the same grounds and rationales. As the next section will show, the economic rationale for continuity of obligations is indeed applicable to both. For the rest of this paper, unless specifically distinguished, state succession will refer to both government and state succession.

### 1.1.3 Economic Rationale

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[22] *Id.* The 'clean slate' approach argues that the new state is never boudn by the obligations of the predecessor state. The 'universal successio' approach, on the other hand, argues that the successor state is generally bound by the obligations of its predecessor state.
[23] _insert reference
[24] The leading treatises are *Supra* note 2, Ernst Feilchenfeld, *Public Debts and State Succession* (1931) and O'Connell, State Succession in International Law and Municipal Law, Vol. I (1967)
[25] For an elaboration on the distinction between state and government succession see Cheng, "Renegotiating the Odious Debt Doctrine"
[26] Buchheit, Lee C., Gulati, G. Mitu and Thompson, Robert B., "The Dilemma of Odious Debts" (Draft 2006) Duke Law School Legal Studies Paper No. 127 Available at SSRN: http://ssrn.com/abstract=932916 (hereinafter Buchheit et al., "The Dilemma of Odious Debts")
[27] *Id.* They take this from Watson, G.*The Law of State Succession in Contemporary Practice of Public International Law*.
[28] See Cheng. *State Succession and Commercial Obligations*

The doctrine of state succession of obligations is also justified economically. There has been much analysis regarding what sustains the current equilibrium between creditors and debtors in international finance. The economics of sovereign debt builds on the following axiom: Unless default imposes costs on the debtor, not only will the debtor not pay the debt, the lender will not make the loan in the first place.[29] Accordingly, economists have suggested two explanations to sovereign debt; the reputation theory and the enforcement theory.

The reputation theory reflects the dominant view that the primary cost of default to the sovereign is exclusion from future borrowing.[30] The theory is based on the assumption that national economies are cyclical and that people prefer to consume evenly across the cycles. Countries then decide to borrow on the downward cycle to fund consumption and repay the loans with returns generated on the upward cycle.[31] If a country defaults on its debt during its upward cycle, it will come at a cost of being shut out of the credit markets and associated consumption constraints on the next downward cycle.[32] Therefore, only countries that never want to borrow again will default under this theory.

The enforcement theory, in turn, argues that even if a sovereign still needs a future source of finance it might still rationally repudiate its debts.[33] The model looks at the choices a sovereign has at the end of an upward cycle, after having incurred debt in its previous downward cycle. It can either pay the debt, or it can default and invest the capital. If an investment opportunity is available, it would prove rational for the sovereign to default and obtain the higher return available from saving and investing than that which is available from borrowing and repaying.[34]

The intuition behind this theory is that sovereign debt cannot be sustained on reputational enforcement alone. Bulow and Rogoff develop this argument and provide a model in which they show that it is not the threat of exclusion from financial markets, but the creditor's ability to seize a debtor's

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[29] See Bratton, W. William and Gulati, G. Mitu. "Sovereign Debt Reform and the Best Interests of Creditors." (2003) (hereinafter Bratton and Gulati, "Sovereign Debt Reform and the Best Interests of Creditors")
[30] Bratton,and Gulati. "Sovereign Debt Reform and the Best Interest of Creditors" at 14
[31] *Id.*
[32] *Id.*
[33] *Id.* at 15
[34] *Id.*

foreign assets in case of non repayment, which sustains creditor-debtor relations.[35] They do admit that the ability of creditors to seize foreign assets is limited and that sovereigns in default do not leave any obvious assets around for creditors to grab. However, they argue that the exercise of international creditor evasion carries indirect costs. Even if these are small in relation to GNP, are still large enough compared to the defaulted interest and consequently render repudiation undesirable.[36]

The evidence behind both theories suggests that both have a place in the dynamics of sovereign creditor-debtor relations. Moreover, they show that the continuity of state obligations upon succession is efficient by arguing that the costs of default for the sovereign are greater than the benefits and this allows the lender to make loans in the first place. Not only debtors, but also creditors have an interest in avoiding the consequences associated with default and sustaining an ongoing relationship. This is primarily because after the loan is made there is a surplus to be gained from restructuring for both parties as compared with a "double negative" situation upon default. The costs of default to the sovereign do not result in gains to the creditors, as they consequently have to incur enforcement costs. Furthermore, the creditors' unpaid bonds trade at discounts as a result.[37] Ideally, creditors prefer restructuring the debt prior to default but even after default has occurred, creditors prefer restructuring relative to more disruptive options such as suing the debtors in court.[38] In conclusion, the international doctrine of state succession of obligations reflects the general interests of the parties to sovereign debt in maintaining continuous relations.

Finally, it is important to emphasize that the interest in continous relations by international parties is ever increasing with globalization, as are the repercussions for breaking them. Cheng argues that sovereign debt cannot be looked at in isolation but must be analyzed as part of the greater context of international and interdependent commercial obligations. Accordingly, when considering obstructing the continuity in debt relations, one must take into consideration any other commercial

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[35] Bulow, J.. and Rogoff, K. "Sovereign Debt: Is to Forgive to Forget?" 79 Amer. Econ. Rev. 43 (1989) See also Bulow, J. and Rogoff K. "A Constant Recontracting Model Model of Sovereign Debt" 97 J. of Pol. Econ. (1989)

[36] Explanation of Bulow and Rogoff's model in Bratton and Gulati, "Sovereign Debt Reform and the Best Interest of Creditors" at 16.

[37] Bratton and Gulati, "Sovereign Debt Reform and the Best Interest of Creditors" at 24

[38] In fact, creditors almost never sue sovereign borrowers for delays in repayment. In national courts, no official or multilateral creditor has ever brought forward cases against Southern governments for delays in debt repayment and only very few private banks have done so. See Ashfaq Khalfan. "Sites and Strategic Legal Options for Addressing Illegitimate Debt." in *Advancing the Odious Debt Doctrine* (2003)

relations which will be interrupted or affected as a result.[39] Cheng argues that taking a broader view of the obligations and parties involved will balance the weighs in favour of maintaining continuity of many obligations upon state succession.[40] Other economists have also emphasized the relevance of reputation spillovers in the international context. [41]

### 1.1.4. Law-and-economics rationale

If the core of the dynamics between international creditors and debtors is largely based on reputation and continuous relations, is law relevant in this context? Ginsburg and Ulen bring forth a theory where clear international rules of state succession relate to democracy.[42] They emphasize the role that international law has in providing states the ability to make credible commitments and therefore facilitates international exchange and domestic state building.[43] A doctrine of state succession facilitates international cooperation by making the promises of all states more believable to other states.[44] The authors argue that this function of state succession is more important for democracies than for dictatorships. This is because dictatorships have a relatively longer time horizon than democracies, which by definition, have governments which come and go.[45] They conclude that without a doctrine of state succession, democracies would be at a relative disadvantage in the international sphere, because counterparties would be less willing to trust that the successor government would uphold the obligation.[46] In other words, a doctrine of state succession removes the transactions costs, which are a result of uncertainty and incomplete information of parties, to long term

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[39] *Id.*
[40] Cheng. *State Succession and Commercial Obligations*
[41] See Cole, L. Harold and Patrick Kehoe. (1996) "Reputation Spillovers Across Relationships: Reviving Reputation Models of Debt" Federal Reserve Bank of Minneapolis. Research Department Staff Report 209 (March)
model of reputation spillovers in the international context which explains that in today's globalized world, countries have many relationships with one another and there can be reputationa effects which have spillover effects across different arenas.[41] A sovereign's reputation in the debt arena, can have spillover effects into other areas such as investment and can be viewed as a sign of how much a country respects property rights.
[42] Tom Ginsburg and Thomas S. Ulen. "Odious Debt, Odious Credit, Economic Development, and Democratization." Forthcoming in Duke J. Contemp. Probs. 2007 (hereinafter Ginsburg and Ulen, "Odious Debt, Odious Credit, Economic Development and Democratization.")
[43] *Id.* at 11
[44] Ginsburg and Ulen. "Odious Debt, Odious Credit, Economic Development and Democratization."at 11
[45] *Id.* They give the example of the Chinese Communist Party being able to make sufficiently credible promises to attract foreign investment even in the absence of an independent legal system.
[46] *Id.*

international contracts. These transactions costs are relatively bigger for democracies than for authoritarian regimes which by nature have longer time horizons. The transaction costs may be especially relevant for newly emerging democracies.

### 1.2. Qualifications to the rule of state succession

Every rule has an exception. Public international law has identified two types of debts which may qualify as exceptions to the general rule about state succession, namely, war debts and hostile debts.

#### 1.2.1 War Debts

War debts are those incurred by a government to finance the conduct of hostilities against a force, foreign or domestic, that eventually succeeds in overthrowing the contracting government.[47] In other words, they are debts that were contracted during a war, by the party who ultimately lost it. The argument says that the winning side cannot be compelled to repay such debts.[48] The doctrine can be traced back to the British annexation of the Boer Republics in 1900. The British, after having won, announced that they would take up the debts of the South African Republics which were contracted before the hostilities had begun, but refused to take up those debts which followed after the Boer War had begun.[49] Another example is that of the peace treaties negotiations after the First World War, where the Allies excluded war debts from distribution against the ceded territories. They insisted that the debts were to be borne by Germany, Austria and Hungary.[50] Also, the Fourteenth Amendment of the Constitution of the United States applied the same policy to the debts incurred by the rebellious Confederate States of America.[51]

The war debts qualification to the rule of state succession was regarded by Feilchenfeld as a reflection of the inherent consideration of 'justice' by the British and American state practice in this

[47] "If the rebels get inside the presidential palace, they are not obliged to honour loans incurred by the prior occupants to purchase bullets employed in the effort to dissuade the rebels from their recent enterprise." *Supra* note 13 at 9

[48] See King, J. "The Doctrine of Odious Debt under International Law : Definition: Evidence and Issues Concerning Application" in *Advancing the Odious Debt Doctrine* 2003, p.18

[49] Pufendorf, S. 1967 Treatise, "Natural Law and the Law of Nations." at 10. See also Felichenfeld, Ernst. *Public Debts and State Succession* at 393-395

[50] A compromise agreement was reached with Austria and Hungary since the entire burden would have resulted in complete bankruptcy.

[51] Pufendorf, S. 1967 Treatise, "Natural Law and the Law of Nations." at 10

area. Others, such as O'Connell, have justified it on the grounds that the creditors enter the war voluntarily on a particular side.[52] Fischer reinterprets this argument as an "all or nothing" bet by the creditors on the outcome of the war.[53] Therefore, the war debts exception does not question the validity of the debts per se, but shifts the focus to the reasonable expectations of the creditor when extending the loans.

#### 1.2.2 Hostile Debts

The second qualification to the strict doctrine of state succession has also been articulated through state practice. The most noted example goes back to the Spanish American War of 1898. The United States won the war, and Spain ceded to it its sovereignty over Cuba, the Philippines, Puerto Rico and other territories. Spain argued that the United States was bound to repay the debts of the territories being transferred.[54] With regards to certain loans that the Spanish Crown had incurred and pledged Cuban revenue streams for, the United States were reluctant to honor these loans and put forth several justifications.[55] One of the main arguments emphasized the role of reasonable risk assessment on the part of creditors. It argued that in the context of sovereign lending, reasonable expectations are not always based on the borrower's ability and willingness to pay, but sometimes they are based on the probability that the incumbent regime will remain in power long enough to repay the debt.

What is interesting is that the United States combined economic arguments with moral ones. Aside from stressing the role of creditors, they also stressed the "hostile" nature of the loans. This was completely different from the war debts qualification. The Americans did not claim that the proceeds from the loan helped finance Spain's war against the United States. Rather, they had been used for the suppression of the independence movement of Cuba and were therefore purposely harmful to the Cuban citizens.[56]

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[52] Felichenfeld, Ernst. *Public Debts and State Succession* at 46

[53] J Pufendorf, S. 1967 Treatise, "Natural Law and the Law of Nations." at 11. John Fisher's argument is discussed: "A creditor who advances money to a belligerent during a war to some extent adventures his money on the faith of the borrower's success."

[54] Pufendorf, S. 1967 Treatise, "Natural Law and the Law of Nations." at 11

[55] For discussion see Feilchenfeld

[56] O'Connell also gives the example of the Treaty of Versailles exception of Poland in 1919 from the repayment of debts incurred for the purposes of the Prussian and German colonization of Poland. It was argued that the debts were an active campaign against the interests of the nation.

In his Treaty, "State Succession in Municipal Law and International Law", O'Connell cited a second example of hostile debts. In 1919, the Treaty of Versailles exempted Poland from the repayment of debts which were incurred to contribute to the German and Prussian colonization of Poland. Again, it was the notion that the debts were aggressive or 'hostile' to the interests of the nation.[57]

One can gather that the intuition behind this qualification is that, under certain circumstances, debts are personal to the regime or the rulers in power.[58] Creditors who lend out money during these circumstances cannot reasonably expect to be paid back if the regime changes.

### 1.2.3. Law-and-Economics Rationale

Buchheit, Gulati and Thompson have qualified war debts, hostile debts as well as odious debts under the umbrella of 'profligate debts' – they convey little or no benefit to the people which are expected to repay those debts.[59] However, in contrast to odious debts, it may be efficient to have war and hostile debts as exceptions to the general rule of continuity.

The economic analysis of contract law can help determine under what circumstances creditors should have to bear the risk of non repayment The problem is essentially that the primary 'wrongdoer' responsible for either war debts or hostile debts is no longer in the picture when the debts need to be paid back. Neither the creditors nor the successor government are primarily at fault for either losing a war or having engaged in overtly hostile activities. So in the languages of the economics of contract law, neither emerges as the 'cheapest cost avoider' because neither was in a particularly good position to influence the risks.

The question is then whether one of them is better able to bear the risk. Which party is the 'best risk bearer' is dependent upon which party was in a better position to detect the risk in the first place.[60] Under normal circumstances, and for the reasons explained in the first section, it is efficient

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[57] *Id.*
[58] The debts can be paid out of state funds if the politicians remain in power long enough but otherwise the debts terminate when the rulers depart.
[59] Buchheit et al. "The Dilemma of Odious Debts" at 9
[60] Hans-Bernd Schäfer and Claus Ott. *The Economic Analysis of Civil Law.* (2004) at 273-295 discussed the "welfare economic checklist" of questions to ask to determine the efficient allocation of contractual risk.

for successor governments to bear the risk and inherit the obligations of the previous government. However, activities such as wars and independence movements are not normal circumstances. They are unique events which are easily observable at low cost. Creditors lending at that time knew, or should have known, of these circumstances and accordingly priced the risk in the contract.

This logic also makes sense when looking at the incentives of the parties involved. In the case of war debts, for example, if the victor were to take on the debts of the defeated nation, this would reduce the cost of credit for future enemies because creditors would feel confident that they would get repaid regardless of whether the debtor wins the war. The victor has no reason for giving creditors this incentive.

As the next section will discuss, in contrast to war and overtly hostile activities, odiousness is much more vague and occult. Therefore its risk is not detectable by creditors and this prevents them from pricing it efficiently. Consequently, the creditors are not necessarily the best risk bearers for odious debts.

### 1.3. Odious Debts

One of the reasons odious activities are difficult to detect and efficiently price in contracts is because there is no clear and workable definition of what odiousness actually is. This section briefly goes over the purported doctrine of odious debt. Given its limitations, lack of place in international law and its failure to clarify what odious debts are, the doctrine is more trouble than its worth. However, the problem of odious debts itself is arguably still worth tackling.

#### 1.3.1. Definitional issues and (lack of) doctrine

The ‘odious’ label has been attributed to activities related to the looting of international funds in many forms. From ill advised investment projects, Swiss bank accounts of heads of state, the financing of inefficient and corrupt projects, to the use of the loan proceeds for the oppression of the citizens of the debtor country. Interestingly, however, the doctrine from where the concept of odious debt is taken from applies to only a relatively small portion of debts within the large category which

has emerged in this debate.[61] The doctrine of odious debt was formalized by Alexander Nahum Sack in the early 19th Century and it requires that public inherited debts fulfill three criteria in order to qualify as odious and consequently should not be paid back: 1. the debts were incurred without the consent of the people of the state 2. The money owed was used against the general interest of the people of the state and 3. The creditors who made the loans were aware that the money was used for illegitimate purposes.[62]

Buchheit et al. stress the fact that the three criteria are linked with connectives.[63] As a result, only debts which were incurred by a dictator, without the consent of the people and against their interest can be qualified as odious under the doctrine. These criteria are difficult to observe and verify by third parties. Buchheit et al. suggest that aside from being theoretically attractive, as soon as one tries to apply the criteria in practice, the doctrine's "limits as a diagnostic tool" become obvious.[64] For example, the standard of having every cent of the debt be used "against the interest of the people" is virtually impossible to fulfill even with modern day corruption.[65] There is typically some effort, however marginal, for social benefit.

The proponents of the doctrine passionately advocate its potential to remedy gross injustices imposed on the debtor nation's population and identify its normative basis as a question of human rights.[66] Interestingly, Cheng notes that the terms in the doctrine inadequately support such a cause. He argues that the doctrine is both over and under-inclusive.[67] It is over-inclusive because it would interfere with creditor's rights, when such interference would destabilize global markets and this in turn would cause harm to millions of people dependent on those markets for their livelihoods.[68] At the

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[61] *Supra* note 11 at 21, 22
[62] Sack, N. Alexander. *Les Effets des Transformations des Etats sur leurs Dettes Publiques et Autres Obligations Financieres* (Recueil Sirey 1927)
[63] "...the debt must be incurred by a despot (that is without the consent of the population) and it must not benefit the state as a whole and the lender must be aware of these facts. Like a Las Vegas slot machine, all three cherries must simultaneously come into alignment before the Sackian odious debt bell starts to ring." At 16
[64] *Supra* note 11 at 17
[65] Chander, A. "Odious Securitization" forthcoming in Emory Law Journal available at SSRN.com
[66] www.odiousdebts.org, Jubilee Iraq, www.cadtm.org
[67] Cheng. "Renegotiating the Odious Debt Doctrine." at 3
[68] *Id.*

same time, it is also under-inclusive because it does not address non-debt commercial obligations which could just as likely impose harm on the successor government.[69]

Most advocates of the odious debt doctrine turn to a 1923 arbitration involving Great Britain and Costa Rica as precedent. Mr. Tinoco overthrew the Costa Rican government in 1917 and became a dictator. Right before he left after two years, however, Mr. Tinoco borrowed money from the Royal Bank of Canada. The entire proceeds from this loan left the country at the same time as Mr. Tinoco did.[70] The subsequent arbitration involved William Howard Taft of the United States as the sole arbitrator. While he adhered to the rule of state succession, Mr. Taft refused to order Costa Rica to repay the Tinoco loans on the basis that transactions were not of "an ordinary nature" but were full of irregularities [71] He added that the bank knew that this money was to be used by the retiring president, Mr. Tinoco.[72]

What is particular about this case is the fact that Mr. Tinoco appropriated the entire amount of the debts for his personal use. For this reason, the exception may be justified on the same law-and-economics grounds as war and hostile debts, being that the event was readily observable at low cost and the creditors should have known. Again, the point that arises is that most cases of 'odiousness', in contrast, are not so blatantly obvious today. Governments are not 100% odious all of the time and the money they borrow is not entirely used for odious purposes. On the contrary, Choi and Posner note that most dictators generally become wealthy by taking kickbacks on public contracts and similar forms of corruption.[73] They build roads, airports, dams and other projects, from which they take some of the profits, but the resulting infrastructure benefits the public in some way. In this sense, the Tinoco arbitration fails to enlighten how the odious debt concept can be applied to modern day corruption in international finance in the same way that Sack's doctrine failed.

### 1.3.2 More issues

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[69] *Id.*
[70] Arbitration between Great Britain and Costa Rica (1923) U.N. Rep. Int´l. Arb. Awards 369 from *Supra* note 18
[71] *Supra* note 11 at 14
[72] Arbitration between Great Britain and Costa Rica (1923) 1 UN REP. INT´L ARB AWARDS 369
[73] Albert H. Choi and Eric A. Posner ."A Critique of the Odious Debt Doctrine" (draft 2006) available at http://ssrn.com/abstract=957346

Other scholars since Sack have tried to advance the doctrine by attempting to better define the terms in it.[74] Despite their efforts, a workable definition is yet to be found. Without it, the doctrine cannot serve as a tool which clearly determines when and under which circumstances debts should be considered odious. Unfortunately for the adamant activists groups pushing it, the doctrine of odious debt has more than definitional problems, it has severe institutional ones too.

The sources of international law are principally treaties, customary law as determined by widespread state practice and *opinion juris* (a belief in the existence of the rules), general principles, and *jus congenus* (premptory norms).[75] Although an exception to continuity for odious debts was included in a draft article of the Vienna Convention on Succession of States in Respect of State Property, Archives and Debts, it was ultimately omitted in the final version of 1983.[76] As for the doctrine being considered of as of part customary law, state practice is at best inconsistent and rather non existent. While there are precedents where the doctrine has been referenced[77], by and large there has been a widespread reluctance of new regimes to invoke it. Stephan notes that the last thirty years has seen the collapse of authoritarian or Soviet-style governments across the continents which were all frought with human rights abuses and political injustices, yet none of the successor regimes sought debt relied by adhering to the doctrine of odious debt.[78]

Others point out that the context in which the doctrine wants to have influence is not primarily governed by legal rules.[79] Cheng explains the intense political dimension of successions. Outcomes are often reached through negotiations involving claims and counterclaims. He states that the influence of such claims on outcomes does not depend on the inherent compliance pull of rules, but rather on

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[74] _insert references
[75] See Statute of the International Court of Justice, art 38. in Cheng, "Renegotiating the Odious Debt Doctrine" at 7
[76] See Cheng, "Renegotiating the Odious Debt Doctrine" at 24,25
[77] See Jackson v. People Republic of China in Paul Stephan, "The Institutional Implications of an Odious Debt Doctrine" Draft presented at the European Association of Law and Economics, Madrid (2006) at 11
[78] Stephan, "The Institutionalist Implications of the Odious Debt Doctrine." At 11. In his paper, Stephan also entertains the idea that the 'invisible college' could bring forth the doctrine to have a place in customary international law. The invisible college conception argues that expert opinion provides better evidence of an esiting international consensus than do the observations of non experts. He concludes that even under this conception the doctrine would not find a place in custom, as academic and expert opinion is from a consensus on the subject.
[79] Cheng, "Renegotiating the Odious Debt Doctrine" at 7-8

power, authority and the interests that underlie those claims.[80] If looking at the doctrine from a strict positivist angle, it argues for the cancellation of oppressive debts *ipso jure* upon succession and does not refer to a non legal claim that may be made during post succession negotiations.[81]

### 1.3.3 Forget the doctrine – now what?

In a recent conference on odious debt held at Duke University this year, something which is rare in the academic world occured: everyone was in agreement....at least on the point that advancing the odious debt doctrine is undesirable. This opinion is shared by others in the field, as reflected from the recent odious debt literature in the past years, which has shifted from attempting to justify or advance the doctrine of odious debt, to addressing the problem of odious debt itself. If we can assume that the doctrine of odious debt is more trouble than its worth, the question then becomes whether the problem of odious debt is still worth analyzing. This section briefly goes over the most compelling arguments in favor of addressing odious debt.

The debt relief movement rests on two main arguments: that debt further impoverished poor countries and that loans were often illegitimate in the first place.[82] There is a lack of a mechanism in international finance to fight mismanagement, oppression and looting. Accordingly, there is a need for debt relief on purely moral and political grounds. It has been acknowledged by some economists that odious debt is more detrimental to a country's development and economy than the problem of debt overhang, which has received relatively more attention.[83] The intersection between odiousness and development is an important one. Other economists argue that debt relief on the basis of odiousness should be separated from debt relief based on economic necessity and unsustainability.[84] In part, this is because there already exists a range of options and solutions for the sovereign whose debt has become

[80] *Id.*
[81] *Id.*
[82] Jayachandran and Kremer. "Odious Debt" at 91
[83] Kremer and Jayachandran, "Odious Debt" American Economic Review
[84] Anna Gelpern noted this at the Conference on Odious Debt and State Corruption Conference held at Duke University on January 26th, 2007. See Anna Gelpern, "Odious, Not Debt" forthcoming Duke J. Contemp. Probs. 2007

unsustainable.[85] The odious debt argument might not be the most efficient vehicle if what is really being dealt with is economic necessity. Odious debts should be treated separately in order to efficiently tackle the moral and political dimension of the problem.

Odious debt has been a problem throughout the history of international finance. Arguably, however, it may be a bigger and more relative global concern today for two reasons. One is the changing nature of the parties involved. From the commonplace syndicated loans which were common in the 1980's, have emerged a much larger and more dispersed category of bondholder creditors. The expansion of the secondary market for sovereign debt brings with it new challenges as well as solutions with respect to information asymetries, creditor coordination and bargaining dynamics. Both creditors and debtors benefit in the long run from a clearer and more transparent system of international finance.

Secondly, given the frequency of successions and the magnitude of debt that could be at stake, there should be an international response to the problem of odious debt. Important successions have occurred in the last part of the 20th Century, including the fall of Soviet-style regimes across the world. The United States' war against terrorism has led to a change in regime in Afghanistan, Iraq and possibly other countries in the future. These successions, along with many others, have consequences which are of global magnitude. Accordingly, the consequences of odious debts are also of global concern and can include corruption, economic repression and isolation from international attention. Kremer and Jayachandran have argued that these are the characteristics of breeding grounds for terrorist networks.[86] This suggests that the interest of global security could be at stake if odious debts and corruption in international finance go unaddressed. Finally, some have highlighted the link between the fight against odious debt as an overall policy goal of democratization.[87]

[85] Gelpern, "What Iraq and Argentina might learn from each other" explaining the many options both Argentina and Iraq had at their disposal to deal with their unsustainable debt. While both countries at some point contemplated using the odious debt argument, it proved relatively less attractive to other options.

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[87] See Ginsburg and Ulen. "Odious Debt, Odious Credit, Economic Development and Democratization"

## 2. Challenges in tackling odious debts

There seems to be large support for the notion that sovereigns should not incur odious debt and that successor regimes should not be required to repay truly odious debt.[88] But tackling odious debt is a challenging task. This chapter is devoted to emphasizing the legal, economic and political

[88] Adam Feibelman, "Contract, Priority and Odious Debt" forthcoming in Duke J. Contemp. Probs. 2007 at 24

obstacles which currrently stand in the way of an efficient solution. The 'loan sanction' proposal by economists Kremer and Jayachandran will be discussed in this context. Their proposal was one of the first in the field.[89] While there have been other proposals brought forth by the literature coming from academics, non-governmental organizations and activist groups, Kremer and Jayachandran´s has been the most commented on.[90] It has been much critizised on institutional and practical grounds as well as, more recently, on the perverse incentives it gives to dictators. It also spurred a debate over whether an ex-ante or an ex-post approach to deal with odious debt is most efficient. The proposal and its critique provide a helpful platform from which to highlight the challenges in addressing odious debt.

### 2.1 Loan Sanctions

Kremer and Jayachandran propose an on-going international institution, such as the United Nations Security Council, which would have the power to designate particular regimes as odious.[91] The authors envisage an odious label being applied only to "the most egrerious violators of legitimate conduct."[92] They propose imposing legal sanctions on odious regimes, by instituting legal changes that prevent the seizure of countries´ assets for non repayment of debt incurred after the regime was designated as odious.[93] In essence, loan sanctions would prevent creditors from seizing the foreign assets of a debtor country which are located in the creditors' countries. The loan sanction eliminates the penalty to a country from repudiating odious debt, and anticipating this, most creditors would presumably avoid lending to sanctioned regimes, or at least charge a much higher interest rate to do so.[94]

The authors emphasize why they think that loan sanctions should only apply to debts which are incurred after the specific regime is designated as odious, as opposed to all the debts of the regime.

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[89]. Kremer and Jayachandran were the first the introduce the concept of odious debt to international financial organizations at an IMF Conference in 2002
And were the first to offer an economic model of odious debt. See Michael Kremer and Seema Jayachandran, "Odious Debt" American Economic Review (2006)

[90] Before Kremer and Jayachandran, non-governmental had proposed the idea of an odious debt tribunal See Jubile Iraq, *Preliminary and Procedural Aspects of Iraq Debt Tribunal* http://www.jubileeiraq.org/tribunal.htm. See also Feibelman, "Contract, Priority and Odious Debt" at 19 (citing the proposal). See also Patricia Adams' odious debt website with other ideas, www.odiousdebt.org

[91] Kremer and Jayachandran, "Odious Debt"

[92] Kremer and Jayachandran, "Odious Debt" at 19

[93] *Id.*

[94] *Id.*

They assume that an ex-ante mechanism is most efficient. They argue that the current movement to nullify some debts on the grounds of odiousness is hindered by the inability for creditors to anticipate which loans will be considered odious in the future. If odiousness is declared in advance, creditors will have to find alternative borrowers, but would not risk large losses from a successful ex post campaign that nullifies some of their existing outstanding loans.[95] Also, they assume that the risk of bias by the international institution would be smaller than if the declaration of odiousness would be ex post, when interested parties have redistribution at stake.[96]

Therefore, under their assumptions, Kremer and Jayachandran´s model improves the welfare of the affected population in mainly two ways. It relieves the successor government and its people from repaying any inherited debt from a previously odious regime. Secondly, the mechanism leads to multiple equilibria where creditors lend to non-odious regimes but do not lend to odious regimes. The borrowing restrictions reduce the utility a dictator would obtain form being in power and therefore lower the probability of a dictator taking power in the first place.[97] On the potential of their proposal Gelpern notes that it would, "remove some reputational damage to a country from repudiating odious debt, would shield the country from lawsuits and would enable meaningful risk assessment by creditors."[98]

## 2.2 Limits of the proposal

Despite these advantages, the proposal faces important obstacles pertaining to its implementation. Even if it could be transferred into practice, it might have some undesirable consequences.

### 2.2.1 Toward judging regimes?

[95] See Robert K. Rasmussen, "Integrating a Theory of the State into Sovereign Debt Restructuring" Emory Law Journal (2004)
[96] *Id.*
[97] Kremer and Jayachandran, "Odious Debt"
[98] Gelpern, "What Iraq and Argentina might learn from each other" as cited in Feibelman, "Contract, Priority and Odious Debt" at 21.

The loan sanction proposal takes a significant leap from assessing debts, to assessing entire regimes. The stakes are high, as are the potential disruptive impacts on the functionings of international finance. Feibelman notes that the political pressure will be high because the international community will be asked to create an ongoing institution with a broad ranging mandate.[99] Because the consequences of being labeled as odious are so great, the political pressure will be present despite the ex ante nature of loan sanctions. Therefore, contrary to what the authors argue, bias and political influence can be a relevant obstacle for an institution with the power to judge regimes. Moreover, the danger of ad-hoc labeling and judging of countries is well recognized by lawyers and is inherent to the non interventionist principles in international law.[100]

There seems to be no obvious reason as to why judging regimes would be easier that judging debts. Without a clear definition of odiousness, both exercises prove equally challenging. And given that no country can ensure that it will never be targeted by such an institution, it could prove difficult to find the necessary support for it. The United Nations Security Council already exists and has the power to impose trade sanctions so this may suggest that imposing loan sanctions may not be out of its reach. However, this venue would require different nations being able to agree on which countries are odious and what constitutes odiousness. Jayachandran et al. recognize the difficulty of achieving consensus at the level of the United Nations, unless the nations involved had sufficiently similar worldviews.[101] They argue that despite this problem, in some important historical cases such as apartheid-South Africa, it would have been possible to gather international consensus for action.[102]

Some scholars argue that if this mechanism were to substantiate, it would likely develop a very clear definition of odious regimes because the institution would be significantly scrutinized on having clear and consistent application. Feibelman argues that a strict definition would be adopted

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[99] Feibelman, "Contract, Priority and Odious Debt" at 22

[100] The 'non intervention in national affairs' principles derive from the Peace of Augsburg in 1555 and were later developed at the Peace of Westphalia in 1648. It is also well established by the international law concept of 'sovereign immunity' which has been adopted by most Northern courts. Common law makes a distinction between commercial (jure gestionis) and state commercial (jure impreii) and permits sovereign immunity only for the latter.

[101] Seema Jayachandran, Michael Kremer and Jonathan Shafter. "Applying the Odious Debt Doctrine while Preserving Legitimate Lending" (draft 2006)

[102] *Id.* At 23

which would only be applicable only to extreme cases.[103] While this may solve the definitional problem, having a rarely applicable definition of odious debts risks diluting the deterrent effects for future dictators and corrupt governments.

### 2.2.2 Vested Interests of Creditor Countries

Even if countries could in theory agree on obvious cases of odiousness, self interest may prevent them from doing so. This has many features of the classical prisoner's dilemma problem. All countries as a group would benefit from a well functioning mechanism where odious regimes are singled out, risks are able to be efficiently priced and the international finance system as a whole is more clear and transparent. Individually, however, countries benefit (at least in the short term) from engaging and doing business with odious regimes. Creditors benefit either financially or in the form of greater policy influence in the debtor country, among other interests.[104]

Secondly, Kremer and Jayachandran presume that it is always in the global interest not to support oppressive regimes.[105] But there are many circumstances in which it is necessary to work together with corrupt governments and dictators to achieve specific goals. These goals can include global security for example and is relevant today in the context of terrorism. Choi and Posner give the example of a government imposing sanctions on Syria because of its terrorist ties, but at the same time, its cooperation is needed to solve the situation in Iraq.[106] Likewise, Cheng argues that if an oppressive regime with nuclear or chemical weapons required financial assistance to avoid its implosion, refusing to extend new loans may cause its regime to make irrational decisions and possibly lose its armaments to insurgents or terrorists.[107]

### 2.2.3 Timing

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[103] Feibelman, "Contract, Priority and Odious Debt"
[104] Different types of creditors and creditor incentives will be discussed in chapter 4.
[105] This was noted by Cheng, "Renegotiating the Odious Debt Doctrine" at 29
[106] Choi and Posner "A Critique of the Odious Debt Doctrine" at 2 (citing Iraq Study Group, The Way Forward: A New Approach 2006)
[107] Cheng, "Renegotiating the Odious Debt Doctrine" at 29

Assuming that a mechanism such as that ensivaged by Jayachandran and Kremer was feasible, other concerns still arise. An interesting question is whether designating a regime as odious can have different consequences at different times. There are different factors which might determine the optimal timing of such a declaration.

#### 2.2.3.1 Multilateral Agreement

The chances of obtaining a multilateral agreement on labeling a regime as odious may increase as more time is elapsed by the regime. The more time a corrupt government has been in power, the more obvious it might become for member countries in the UNSC that it is odious and make consensus easier. The odious activities of the regime may become more observable to outside parties in general, including NGO's, the media and other bodies which can exert pressure on the empowered institution to take action.

#### 2.2.3.2 Minimising Odious Damage

In terms of minimising the amount of odious debt that is inherited by successor governments and its citizens, it is more efficient declare an odious regime as such as soon as possible. The earlier the declaration is made, the earlier creditors will be aware that a loan sanction has been imposed against the regime and their incentives to lend to it will be curtailed. The sooner the odious ruler's access to international credit is hindered, the less proceeds from loans he has to loot. This minimises both the direct cost of odious debt as well as the indirect cost from any human rights violations, repression and other negative externalities imposed on the population.

#### 2.2.3.3 Deterrent Effects

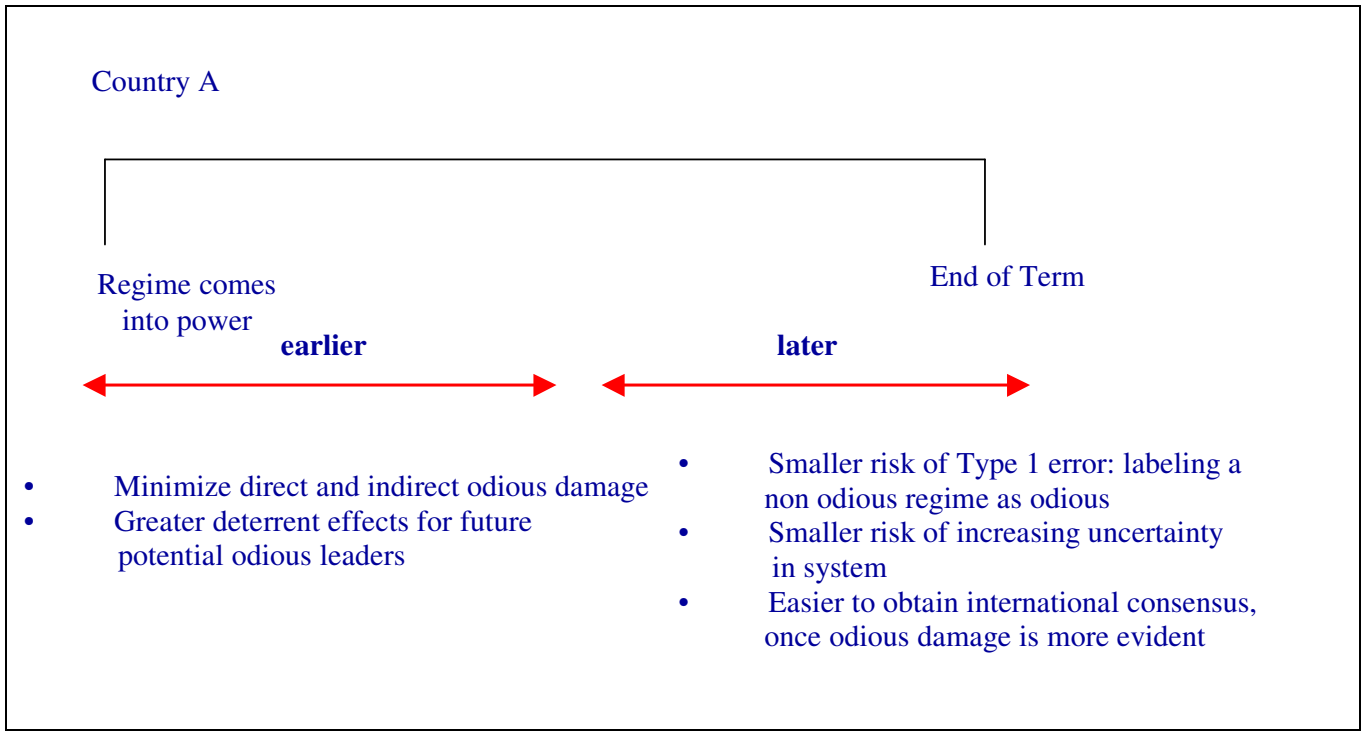
If potential odious rulers are to be deterred from taking power in the first place, their expected spoils from being in office must be minimised.[108] This is the case the earlier an odious declaration is made. If they expect to be imposed with an odious label early in their term, this affects their incentives to take power to a greater extent than if they expect it later in time.

#### 2.2.3.4 Risk of Error

[108] Jayachandran and Kremer also argue that curtailing potential benefits of dictators would reduce the probability of coups.

Jayachandran and Kremer have identified that a potential peril in their proposals is the risk of applying sanctions to a non-odious government.[109] The probability of this is greater the earlier a regime is labeled as odious. Waiting will reduce the risk of mislabeling a regime, as more information on odiousness becomes available. A related issue is that of governments, for the most part, not being a 100% odious 100% of the time. Many rulers only become odious towards the end of their term, when they have less time in office to suffer the consequences of any odious actions. Very few regimes are born odious or reveal their odiousness at an early age.[110] There is also the problem of regime behavior shifting over time and this complicates the timing analysis.

**Figure 1: When is it more efficient for an institution to designate a regime as odious?**

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### 2.2.4 Note on Choi and Posner

Interestingly, Choi and Posner argue that any odious designation at any time can give rise to perverse incentives for an odious ruler who is already in power and plans to stay in power for a long

[109] Jayachandran and Kremer, " "Odious Debt" at 89
[110] Ginsburg and Ulen, "Odious Debt, Odious Credit, Economic Development and Democratization" at 7 (citing Gulati).

period.[111] Their model shows that, ironically, the existence of an odious debt mechanism has the effect of making the dictator in power short-sighted. This is due to the fact that it makes the probability of the population overthrowing the government greater.[112] The expected gains for the population from overthrowing the dictator are increased because they will not have to repay the regime's past odious debts. Given that the probability of being ousted is greater, the dictator will have less incentives to invest and more incentives to loot, use the existing loans for his own consumption, or impose a negative externality on the population, which gives him a certain utility.[113] Also, if the dictator invests in the future, this will further increase the expected benefit of populations overthrowing him, as they would not only avoid past debts but now also enjoy a public benefit form investment as well as interest. Without an odious debt mechanism, it can be in the dictator's self interest to invest in public goods if the expected return in the future is high enough. In terms of public welfare, therefore, it is not necessarily the case that designating regimes as odious would be beneficial.[114]

It is not clear whether this would be the effect of a Jayachandran-Kremer style proposal. Choi and Posner assume complete information, where the population as well as the dictator know that the current regime will be considered odious and that a successor government will therefore not have to repay any of the its past odious debts. In the loan sanction model, on the other hand, there is asymmetric information and neither the dictator nor its population knows whether the regime will be designated as odious by the UNSC. One could argue that the fact that the UNSC has been empowered to label regimes as odious could have the same short sighted and perverse incentives on the dictators as Choi and Posner suggest. The incentives could also go the other way. The risk of being labeled as odious could induce the dictator to invest more in public goods to reduce that risk. Investing would still increase the expected benefit for the population of overthrowing him, even without an odious debt mechanism. So the dictator would invest as long as doing so will decrease his chances of being labeled odious more than it increases his likelihood of getting overthrown. If, as Feibelman argues, the UNSC develops a very strict definition of odiousness only applicable to very extreme cases, then a

[111] See Choi and Posner,"A Critique of the Odious Debt Doctrine"
[112] *Id.*
[113] *Id.*
[114] *Id.*

dictator need only invest in the public a little bit for it to be out of risk of a loan sanction. A future part of my dissertation could follow up on this section and model the effects of an odious debt label by the UNSC with asymmetric information.

Choi and Posner's model raise important factors which had previously been neglected in the literature; the incentives and motives of dictators and how these are affected by the different odious debt solutions which have been proposed. They also highlight the fact that dictators have a choice between investing in the future or spending for personal consumption. Most corrupt governments do both and they enrich themselves by obtaining kickbacks from public projects which are of benefit to the population.

### 2.3 Ex-post versus ex-ante debate

The loan sanction model essentially shifts Sacks´s ex-post doctrine from an ex-post rule, to a quasi ex-ante rule. It is not necessarily the case that this is more efficient. One point of divergence in the odious debt literature is whether and ex-post or an ex-ante solution to odious debts would be optimal. Steven Shavell's economic analysis of regulation versus liability can provide insight into this debate.[115]

Using economic analysis, Shavell compares the effects of liability rules and direct regulation and evaluates them on a utilitarian basis, given the assumption that individual actors can normally be expected to act in their own interest.[116] He sets out a measure of social welfare that it is equal to the benefits parties derive from engaging in their activities, minus the sum of the costs of precautions, the harms done, and the administrative expenses associated with the means of social control.[117] Applied to the ex-ante versus ex-

post debate, the formal problem is to derive the means of minimizing odious debts which maximizes this measure of welfare.

Shavell brings forth four determinants that influence the solution to the maximizing problem. These will be discussed in light of the problem of odious debts.

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[115] See Steven Shavell. *Foundations of the Economic Analysis of Law.* (2004)
[116] *Id.* at 358
[117] Shavell. *Foundations of the Economic Analysis of Law*. at 358.

### 2.3.1 Difference in knowledge about risky activities

Private parties have different degrees of information and knowledge as to risky activities than a regulatory authority does. In the context of sovereign debt, the relevant private parties to the contract are the borrowing government and the private creditor. Examples of a regulatory authority can be the EU or the United Nations.[118] In cases where it is the parties themselves who possess the superior information about the risks of harm, an ex post mechanism like strict liability would be the most efficient given that it motivates the parties to balance the true costs of reducing risks against the expected savings in losses caused.[119]

But who has superior knowledge about the use of sovereign loans? It is safe to say that the government has better information about what it will use the proceeds for. It is in a naturally superior position to estimate the benefits, the nature of risks of harm from its activities as well as the costs of prevention. This is because the information is an ordinary byproduct of the government's activities. For the United Nations or another regulatory authority to obtain comparable information would be a practical impossibility. This is in part to due to the difficulty in verifying such information which can be very costly for a third party.

The case for creditors' knowledge is less clear. Looking at private creditors, banks may in a good position to monitor and control the misbehavior of an odious ruler.[120] Lee Buchheit notes that most major private banks have branches or representative offices in the debtor countries and are thus in a favourable position to assess first hand certain types of information.[121] Ben-Shahar and Gulati argue that banks are able to detect blatantly easy cases of odiousness. For example, if the despot asks a foreign bank to deposit funds borrowed in the name of the state into the personal Swiss bank account then the creditors knew or should have known that stealing was occurring.[122]

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[119] *Id.*

[120] See Omri Ben-Shahar and Mitu Gulati. "Partially Odious Debts? A Framework for an Optimal Liability Regime" (Draft 08.02.2007) forthcoming J. Law & Contemp. Probs (2007) (hereinafter Ben-Shahar and Gulati, "Partially Odious Debt? A Framework for an Optimal Liability Regime")

[121] Lee C. Buchheit. "Cross Border Lending : What's Different This Time? Nw. Journal of Int'l. Law and Business" (1995) at 48

[122] Ben-Shahar and Gulati. "Partiall Odious Debt? A Framework for an Optimal Liability Regime" at 4, 31

On the other hand, a large portion of sovereign debt today is in the form of bonds. These are liquid instruments and the individual holders are atomistic and don't even know what bond they are holding in their portfolios at any given point in time.[123] The number of bondholders can be in the hundreds or thousands and incredibly dispersed. These creditors are unlikely to know about the behavior of the governments they are lending to. That said, most despotic borrowing is not in the form of bonds. Saddam's $130 billion debt, for example, had no bond debt in it at all.[124]

However it is not always the case that a regulatory authority has an informational disadvantage relative to the parties. Shavell suggests that a regulatory authority may have better access to a superior ability to evaluate information.[125] This may be especially true with regards to the United Nations, given that it has many specialized agencies and has the ability to develop working groups on specific subjects as well as work together with other NGO's. The lack of knowledge on the part of the government may come from a lack of expertise or lack of access to such knowledge.

### 2.3.2 Incapability of paying for the full magnitude of the harm done.

The second determinant of the relative desirability of ex ante regulation versus ex post liability is that private parties might be incapable of paying for the full magnitude of harm done.[126] Shavell argues that when this is the case, ex post liability would not bring about adequate incentives to control risk. He discussed the context of safety, where private parties would treat losses caused that exceed their assets as imposing liabilities only equal to their assets.[127] Two factors influence whether liability can lead to efficient incentives. One is the size of the parties' assets in relation to the probability distribution of the magnitude of harm. The other is whether the actual harm can be calculated. [128] The second factor is the most relevant for odious debts, since it is difficult to be able to put a value on harms incurred in the forms of human rights violation, suppression of citizens and environmental damage. This poses two problems. Whether creditors or debtors lose in a liability suit, the amount of

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[123] *Id.*at 32
[124] *Id.*
[125] Shavell, *Foundations of the Economic Analysis of Law*. at 368
[126] *Id.* at 360
[127] *Id.*
[128] Shavell. *Foundations of the Economic Analysis of Law* at 361

money at stake is the amount of the debt (plus whatever interest has accumulated) without including the amount of harm caused by the debt. Deterrent effects from a suit will therefore be inadequate. Secondly, in terms of social welfare and analyzing efficient breach, it is necessary to be able to calculate whether the third party negative effects to a contract are greater than the surplus value created by the contract. This becomes a difficult problem when the third party effects are incalculable.

Furthermore, incentives to take precaution on the part of sovereigns are diminished by the incapability to pay. This incapability does not come from a lack of assets, but by the fact that the head of state who borrowed the money is no longer in office when the debts are to be repaid and probably not even in the country by the time the indirect costs of the debts substantiate. One of the main reasons why sovereign borrowers do not take into consideration the negative impact of their borrowing activities is because they suffer from shortsightedness. Heads of state have high discount values. Under ex ante regulation, however, the incapability to pay for the harm done would be irrelevant according to Shavell, assuming that parties would be made to take steps to reduce risk as a precondition for engaging in their activities.[129]

### 2.3.3 Parties would not face the threat of suit for harm done

The third determinant refers to instances where parties do not face the threat of suit for harm done. It resembles the second determinant in the sense that, in such cases, the incentives to reduce risk created by liability are diluted. Again, this has no impact on the efficacy of ex ante regulation.

If there is a long passage of time before the harm manifests itself, this will make accountability by the party who engaged in the harmful activity less likely.[130] Again, this reflects the problem of holding governments accountable who will no longer be in office once the odiousness of their borrowing activities becomes evident.

Shavell identifies two other factors which diminish the probability of suit. One is if there are many dispersed victims affected by the harm, and the other is if it is difficult to trace the injurers.[131] Both appear to be present when looking at odious debts. When many dispersed third parties are

[129] *Id.*
[130] *Id.*
[131] Shavell. *Foundations of the Economic Analysis of Law.* at 361

harmed, it can be unattractive for any victim to individually take action. Accordingly, it is difficult to attribute harm to the parties responsible for producing it.

Debts are very difficult to trace and very easy to camouflage. Hanlon highlights the difficulty of distinguishing between legitimate and illegitimate loans due to existence of large secondary markets for debt as well as the continuous rolling over of loans.[132]

### 2.3.4 Administrative costs

The final determinant brought forth by Shavell, which influences the choice between regulation and liability, is the magnitude of administrative costs incurred by the parties and by the regulatory authority.[133] In the case of ex post liability, he broadly defines the costs to include the time, effort and legal expenses borne by the parties in the course of litigation or coming to settlements, as well as the expenses related to conducting trials etc. The administrative costs of regulation include the expenses of maintaining the regulatory establishment as well as the costs of compliance by the parties.

Shavell argues that it can normally be assumed that ex post liability will be less costly than ex ante regulation. This is because the costs associated with liability only occur if harm actually occurs, whereas those of regulation are incurred regardless.[134] This may not be so clear cut in the odious debt context, since many of the relevant costs associated with a solution depend on whether the mechanism used is already in place and how much it will disrupt the functionings of international finance as well as how much it will contribute to a more clear and transparent system.

Shavell also argues that in the absence of special knowledge about parties behaviour and categories of risk (whether governments or banks are prone to odious activities or not), there is no tendency for the administrative costs of a regulatory authority to be borne only by those most likely to cause harm. If the harmful activity does not occur often and only affects a few, it is not efficient for

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[132] An illustrative example is that of Congo, who found itself in arrears with the IMF because it was not repaying debt from the old,Mobutu regime. As a result, France, Belgium, South Africa and Sweden gave Congo bridging loans of 543 million US dollars to repay the IMF. The IMF, then, in turn, gave congo a new loan of 543 of which 522 went back to the pay the countries for the bridging loan. “corrupt and foolish loans were washed away and converted into new good loans” See Hanlon, J. “Defining Illegitimate Debt and Asking when Creditors should be Liable for Improper Loans.” *Third World Quarterly*, 2002 at 22

[133] Shavell. *Foundations of the Economic Analysis of Law.* at 363

[134] *Id.*

many people to bear the public costs of regulation. However, given that odious debts impose widespread and long term costs on many people, any administrative costs of regulation may be justified.

Another argument has to do with costs of enforcement by a regulatory authority. Enforcement is easier and less costly when lack of compliance is hard to conceal and easily verifiable. Shavell suggests that "second order choices" may be the most practical in certain instances, when for example, high administrative costs of regulation are combined with poor information about the behavior of parties and risk, but regulation is still considered more efficient than liability. The example given is that of regulating the use of sprinklers and smoke alarms to prevent fire, instead of trying to control the actual causes of fire which are often difficult to regulate, such as storing flammable goods near a heating pipe.[135] Because good or non-odious behaviour is difficult to verify, a second order proxy for good behaviour may be more efficient to regulate, although this remains a difficult task.

### 3. Private Domestic Law Analogies and Solutions

It is a bit of a puzzle why the debate and literature on odious debts automatically adopted a macro/universal approach, given that most international debt contracts explicitly choose national venues and national law to deal with disputes.[136] Perhaps it is because Sack initially envisioned an international body to deal with odious debts.[137] Jayachandran and Kremer. shifted the literature and the international debate from a universal approach which assesses odious debts, to one which assesses odious regimes. While this occurred rather innocuously, some recent legal contributions have

[135] Shavell. *Foundations of the Economic Analysis of Law* .at 371
[136] *Supra* note13 at 67
[137] *Supra* note 48

consciously turned back to a more micro, loan by loan, approach.[138] Accordingly, this new trend is being accompanied with an adherence to existing national tools and solutions which can contribute to the repudiation of odious debts in one of the venues usually chosen by the contracting parties themselves. Which direction will lead the way in the literature is still an open question.

The last chapter highlighted the many challenges and obstacles to addressing odious debt. The rest of the dissertation, as a response, is devoted to finding and exploring different solutions. This chapter draws from a rich private law tradition of dealing with issues inherent to the problem of odious debt in the national context.

New York and London are the two jurisdictions most often chosen in sovereign loan contracts. Most of these contracts are comprehensive in nature. They normally include a waiver of sovereign immunity and the act of state doctrine as well as a choice of forum and of law clauses.[139] There do exist, however, several rules in national that call for the non enforcement of the obligation in spite of the contractual agreement. The following sub-sections will go over some of the elements of the odious debt doctrine which have counterparts in such rules of national law.

### 3.1 Fraud and Unclean Hands

A creditor that colludes with a corrupt government in concealing the circumstances of a transaction, such as by paying a bribe to place a loan, can be argued to have committed fraud.[140] The common law doctrine of fraud could be applied to many abuses associated with odiousness, including corruption and secrecy, and might invalidate some loans. Furthermore, contracts that are tainted with bribery or any other illegal activity can be subject to the defense of "unclean hands."[141] This doctrine can limit the ability of a lender to enforce a debt contracted under irregular circumstances. The US Supreme Court explains its application:

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[138] See *Supra* note 11, Buchheit, Gulati and Thompson. Also, Paul Stephan, „The Institutionalist Implications of an Odious Debt Doctrine" 2006
[139] *Supra* note 102 at 15
[140] *Supra* note 102 at 16
[141] McClintock, L. Henry. (1948) *Handbook of the Principles of Equity* 52

> *This maxim...is a self imposed ordinance that closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief, however improper may have been the behavior of the defendant*.[142]

The odious debt problem definitely finds a counterpart in the defense of "unclean hands" as both consider the bad faith of the creditor who demands repayment, if he contributed to the corrupt activitiy of the borrower. The doctrine was applied in *Adler v. Federal Republic of Nigeria*, which denied the plaintiff wh paid more than 5 million dollars in bribes to Nigerian officials, from recovering from them once the proceeds from their corrupt deal never substantiated.[143] The rationale behind this doctrine is to not only deter fraud, but also deter any incentives to contribute to fraud.

### 3.2 Unjust Enrichment

Some legal scholars have referred to the common law of unjust enrichment as a useful analogy to the problem of odious debt when the creditor has been unjustly enriched as a result of repayment it received for odious loans which caused harm to the debtor's population.[144] There is an interesting twist to the equivalent to unjust enrichment in German law[145] which would arrive at a different conclusion in the scenario of odious debt. Like in common law, German law holds that one party should not be unjustly enriched at the expense of another if it acted in bad faith or if it knowingly engaged in an unlawful activitity. However, the law differs if both parties were in bad faith and knowingly knew about the unlawful activtity they were engaging in. Even though the unlwaful contract should technically be void, if the adressor has already paid the adressee, then he is unable to recuparate on his money and this overrides the unjust enrichment of the adressee which no longer applies. Essentially, what the law does is to punish the addressor for having knowingly initiated an unlawful contract.[146] The rationale is that if the addressor initally intended to circumvent the law, it cannot later recur to it

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[142] *Precision Instrument Manufacturing Co. V. Automotive Maintenance Machinery Co.,* (1984) 324 U.S. 806, 814

[143] 219 F. 3d , 9th Cir. 2000 at 869-873

[144] _insert reference

[145] BGB §817, "Verstoss gegen Gesetz oder gute Sitten"

[146] The rationale has been much contested in German law as it is difficult to see why one party (the adresee) should benefit from having knowingly engages in an unlawful activitiy.

when the law is in its favour.[147] This qualification to the unjust enrichment law is less favourable to the debtor in an odious debt situation. Unjust enrichment would be a correct analogy if only the creditor was in bad faith. If both the debtor and the creditor knowinglynd engaged in an activitiy which was unlawful or in bad faith, arguably like when apartheid South Africa borrowed money from creditors to finance its abusive regime, then if these debts are paid back the debtor cannot recuperate on them even if later it is actually proven they were odious.

The analogy and rationale might be complicated if one argues that it was one government who incurred the odious debt in bad faith and used it for odious purposes, but it was another government who has to repay it. This was again the case of South Africa when the democratically elected government of Nelson Mandela paid back the debts of its apartheid regime predecessor.

### 3.3 Contributory Negligence and Comparative Benefit

The problem of allocating liability among secondary contributors is familiar in the law. Ben-Shahar and Gulati show that this problem applies to the odious debt scenario.[148] They note that there is a paradox in punishing either the creditor or the populace for the odious debt since both are innately victims of the despot who stole from them.[149] They argues that fault, then should be understood as a relative judgment and what is left for the law to determine is the relative culpability of the disputing parties, the populace and the creditor.[150] Accordingly, the comparative benefit of the respective parties should be taken into consideration, such as the population benefitting from the use of some of the odious loan proceeds.[151] The combination of these two tools would effectively break the binary, "all or nothing" approach of previous proposals to deal with odious debt.[152]

### 3.4 Agency

[147] Münchener Kommentar zum BGB. BGB § 817 Verstoss gegen Gesetz oder gute Sitten.1. Normzweck
[148] See Ben-Shahar and Gulati. "Partially Odious Debts? A Framework for an Optimal Liability Regime" at 14-28
[149] *Id.*at 14
[150] Ben-Shahar and Gulati. "Partially Odious Debts? A Framework for an Optimal Liablity Regime" at 15
[151] *Id.* at 21
[152] *Id.*

The problem of odious debts is a principal-agent problem. The agent, the government who incurs loans and uses the proceeds for odious purposes, breaches its fiduciary duty to the principal, the country and its population over time. Agency law can be applied in a municipal court.[153] The creditors rely on the government agent to fulfill its fiduciary duty. Except for very overt cases, most of the time this is something that the third party creditors cannot verify or observe. As a result, the risk is borne by the Principal. This goes back to both the concept of efficient risk bearing and the economic rationale of the rule of state succession of obligations.

When looking for tools to back the odious debt concept in national law, it is interesting to look at the instances where agency law shifts the risk bearing from the principal to the third parties. This could help understand when a court might move from the usual rule of state succession to shifting the risk to the third party creditor.

One instance is when a corporate officer signs a guaranty for a debt for which the corporation is not receiving any benefit.[154] Another instance is reflected in the Second Restatement of the Law of Agency of the United States, which brings argues that if the circumstances of the transaction raise reasonable doubts about whether the agents is abusing his fiduciary duty to the principal, the third party is under a duty to investigate.[155] The reason why the risk is shifted has to do with the fact that suspicious behaviour on the part of the agent is visible at low cost. In such cases, it is efficient for the burden of verifying the agent's fidelity to be borne by the creditors.

Buchheit, Gulati and Thompson also point to the instances of the 'runaway agent' and the case of the principal lacking authority or lacking the necessary funds, as other relevant analogies of when the fiduciary duty is shifted away from the agent. [156] These could prove helpful when analyzing agency relations in odious debt.

### 3.5 Misuse of Separate Identity Status

[153] *Supra* note 11 at 38
[154] *Supra* note 11 at 39 discussing *Strip Clean Floor Refinishing v. New York District Council no. 9,* 333 F. Supp. 385, 396 (E.D.N.Y. 1971)
[155] Restatement (Second) of Agency (1958) § 312 comment d
[156] Buchheit, Gulati and Thompson. "The Dilemma of Odious Debt"

Lastly, some scholars have made an interesting comparison between the legal analysis of a soveriegn state and that of a corporation.[157] They note that both are artificial persons recognized by law as separate persons from their constituent members.[158] To make it clear, a government has its citizens and a corporation has shareholders. A government and a corporation is managed by officers and directors. Third parties such as creditors or other contractual counterparties are present in both cases.

The rights and obligations of the corporation do not change when individual stakeholders change and instead remain as those of the continuing legal fiction.[159] This is a perfect anaolgy to the rule of state succession, where obligations of the state remain regardless of the governements that come and go. Once again, it is the exceptions to the rule that provide the most insight. American law considers that if innocent parties are being injured as a result of respecting the continuing legal fiction, an exception may be justifiable.[160]

Such an exception in corporate law is that of the doctrine of "piercing the corporate veil" (PVC). Creditors of a corporation will seek a court's permission to pierce the limited liability of the corporation. Their aim is to recover the claims from a controlling shareholder that abused the corporate form. A court will disregard the separate entity and pierce the veil so that the creditor can recover directly form the controlling shareholder, if it believes that the shareholder and the corporation have abused the limited liability of the corporation to harm a third party. [161]

What arguments can be derived from the PVC which could help advance an odious debt claim in a national court? Buchheit et al. argue that the underlying rationale of the PVC is applicable to the odious debt situation. This would be the misuse of the separate identity status. In other words, the misuse of the continuity of obligations inherent in the rule of state succession. The authors argue that the relevant argument is that of two of the three parties, being the agent, the principal and the third party, colliding to use the separate identity to the detriment of the third.[162] With regards to odious

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[157] Buchheit, Gulati and Thompson. "The Dilemma of Odious Debt" at 44
[158] *Id.*
[159] *Id* at 45
[160] *Id.*
[161] Buchheit, Gulati anf Thompson, "The Dilemma of Odious Debt"
[162] *Id* at 46

debts, this would entail the third party creditor and the government agent taking advantage of an innocent principal.

### 3.6 Some Limits

The list of national tools available to back an odious debt claim is not exhaustive and requires further research into different areas and countries from where analogies can be drawn. However, they highlight the fact that the innate elements to the odious debt problem are not so intangible and have a place in national law.

It might be the case, however, that these national law analogies are at best, just analogies. DeMott argues, for example, that it might be problematic to apply the agency doctrine to an odious debt scenario.[163] The agency doctrine focuses on representation and is premised on the notion that the principal is consensual. The consensual character of the relationship between the despot and its population is not evident. Identifying the principal is also not self evident. The population of a country is a fluid principle and the question might arise as to which population should be referred to. The population over time? The population as a whole? Some scholars emphasize the complicit role that some or all of the population plays in a country with a repressive and despotic regime.[164] This further complicates the analysis.

There are also some obstacles to applying such arguments in the municipal courts of either New York or London. These include collective action problems on the part of municipal courts. Gooch and Klein argue that the courts in New York and England have an institutional interest in being perceived as as providing a fair forum to borrowers and lenders. Accordingly, they are concerned with remaining the principal centers for international lending.[165] It is debatable whether any of the two would be keen on being perceived as encouraging defaults, in fear of undermining the bargaining

[163] Deborah DeMott commenting at a panel discussion at the Duke Conference on Odious Debt and State Corruption. January 26th, 2007.
[164] *Id.* See also David Gray, "Devilry, Complicity and Greed: Transitional Justice and Odious Debt" J.L. & Contemp. Prob. (forthcoming 2007) emphasizing the point that despots, rarely, if ever, act in isolation; usually, they have at least a portion of the local populace and the international community that supports them.
[165] Gooch A. et al "Annotated Sample Loan Agreement" (1986) at 354

powers of creditors and scare away international finance to the competing forum.[166] Recently, Ben-Shahar and Gulati have provided a counterargument, stating that creditors switching from one forum to another may be perceived as a signal that it is concerned about legitimacy issues.[167] Also, for political reasons, neither New York nor London will want to be the court that attracts the borrowing business of odious debtors/creditors.[168]

Another important obstacle is the fact that there remains one element of odious debts which does not seem to have a counterpart in national law, for good reason. This has to do with national law not allowing for breach of contract when a loan was unwise, or the use of the proceeds foolish. If most creditors do not pay bribes or engage in overt fraud, there are not many remaining defenses to bring forth by the debtor governments.

Finally, some have noted that such arguments may not get their day in court given that debtors will only have a chance to use them if their creditors decide to sue them, which up until now has been a rare practice. [169] The nature of sovereign finance changed in the 1970's, when sovereigns were able to get their immunity stripped in the commercial context, this opened the possibility for creditors to obtain a judgment against a sovereign debtor in either the U.K. or the U.S.[170] Still then, creditors did not overwhelmingly opt for this option because aside from being able to obtain a judgment, they had little means to enforce it.[171] This has changed substantially in the recent years as enforcement has become more feasible and creditor coordination problems have also diminished as a result of new developments in the sovereign debt market.[172] This means that in the current era, creditors suing debtors may be more commonplace and is likely to increase.

### 3.7 Cases and other domestic forums and tools

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[167] Ben-Shahar and Gulati. "Partially Odious? A Framework for an Optimal Liability Regime" at 40
[168] Ben-Shahar and Gulati,. "Partially Odious? A Framework for an Optimal Liability Regime" at 40
[169] Peter Behrens pointed this out to me when I presented these arguments at the Graduiertenkolleg seminar held on November 16th, 2006.
[170] Sovereigns also explictly waive their immunity. Ben-Shahar and Gulati. "Partially Odious? A Framework for an Optimal Liability Regime" at 12
[171] *Id.*
[172] These developments, their impact on inter-creditor relations and their connection to odious deb twill be analyzed in the next chapters.

On the other hand, recurrence to domestic tools and doctrines of law to treat elements of the odious debt doctrine does not have to be a mere analogy exercise. There are examples of domestic jurisdictions employing domestic tools to sanction fraudulent behaviour of banks as well as to treat the complicity of businesses in international human rights abuses.

The Alien Tort Claims act dates back to 1789.[173] Its enactment is intended to give federal district courts jurisdiction to hear claims by aliens (foreigners) for torts in violation of law of nations (international law) or treaties of the United States.[174] Under this Act, a claim was brough forth against companies which conducted business with South Africa during the apartheid regime. The claim is that of aiding and embetting the apartheid regime through lending activitiy.[175]

This is just one of many litigations of the sort. Many Swiss banks have been sued for their collaboration to Nazi atrocities during the Second World War and their role as "fences" which are repositories and places where Nazis could hide or convert their "ill gotten and blood tainted" gains.[176] Another well known example is that of the government of the Philippines together with numerous private citizens, seeking assets from the Estate of Ferdinand Marcos under this Act.[177] Ginsburg and Ulen argue that making looted assets aborad recoverable from the looters is arguably easy under the boundaries of existing tort law. They note that in the *Marcos* litigation, the Philippine government relied on the traditional tort of conversion to seek recovery of Marcos' estate that had been obtained with government funds.

Ramasastry emphasizes the emerging movement among various domestic jurisdictions for judges to use domestic tools from criminal and civil law to sanction banks.[178] Further research in this section will be devoted to analyzing such cases where domestic jurisdictions found banks liable for

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[173] See Alien Tort Claims Act available at: http://www.usaengage.org/MBR0088-USAEngage/default/priority%20issues/ats.htm. See also Florence Gerber, "L'Alien Tort Claims Act: une possibilité intéressante mais ménacee.(2005) available at http://www.business-humanrights.org/Categories/Lawlawsuits/Lawsuitsregulatoryaction/AlienTortClaimsActUSA?&batch_start=51

[174] *Id.*

[175] Anita Ramasastry. "Should Swiss Banks be Liable for Lending to South Africa's Apartheid Government?" (2002) available at FindLaw at http://writ.news.findlaw.com/ramasastry/20020703.html

[176] *Id.*

[177] *Philippines v. Marcos*, 978 f.2d 344 (2d Cir. 1986) cited in Gisburg and Ulen. "Odious Debt, Odious Credit, Economic Development and Democratization" at 22

concealment, aiding and embetting and laundering of money related to the activities of corrupt heads of state.

## 4. Inter-Creditor Relationships, Incentives and Information

This chapter shifts the focus towards the sovereign creditors. Differents types of creditors are guided by different incentives and therefore it is important to analyze them separately. Some ideas regarding the role that creditors can play to address odious debt are discussed. A primary theme throughout the analysis is the need and potential to increase information in the sovereign debt market.

The ability and leverage of creditors to observe, monitor and divulge information through direct and indirect means suggests that they may be the "cheapest cost avoiders" of odious debt.

## 4.1 Private Creditors

### 4.1.1 Incentives

Markets tend to be very shortsighted. They seldom incorporate the long term implications of debt. Private creditors are motivated by profit maximization. Therefore, their incentives to cooperate in an odious debt solution must be aligned with this motivation. As this section will try and show, financial interest is not necessarily at odds with tackling odious debt.

### 4.1.2 Bondholders and the relevance of the CAC – SDRM debate

The secondary market for debt started to develop during the 1970's. Several banks sought to reduce their exposure to foreign sovereigns by selling off parts of their loans at a discount and writing off the difference as a loss. At the same time, under the Brady Plan, commercial banks agreed to repackage the remaining loans into bonds offered to the public and freely tradable on secondary markets.[179] The rise of the secondary market and the Brady Plan led to a fundamental change in the nature of creditors in the sovereign context. The change was one from major bank creditors to a much larger category of hundreds and thousands of creditor bondholders.[180] This change had fundamental impacts on the dynamics of debt restructuring as well as inter-creditor relationships. One of the problems which emerged as a result was that of complex bargaining dynamics, information asymmetries and creditor coordination.[181] As a response, two proposals came to light: the IMF's Sovereign Debt Restructuring Mechanism (SDRM) and the Collective Action Clauses proposal (CAC).[182] The two proposals are a reflection of the debate between an institutional approach and a

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[179] See Pierre-Hugues Verdier. "Credit Derivatives and the Sovereign Debt Restructuring Process" (2004) International Finance Seminar, Harvard Law School

[180] *Id.*

[181] Jerome Sgard. "IMF in Theory: Sovereign Debts, Judicialisation and Multilateralism" (2004) No 2004 – 21 CEPII

[182] The SDRM is a sort of international bankruptcy mechanism for sovereigns. It would be in the form of a quasi-judicial body which would have first administered debt renegotiation and legally asanctioned the restructuring agreements. See*ID.*. Verdier and See also: Anne Krueger, "A New Approach to Sovereign Debt Restructuring" (2001) available at: http://www.imf.org/external/np/speeches/2001/122001.htm

market based-contractual approach. In turn, this debate parallels the debate in the odious debt literature between an ex-ante/bottom up approach and an ex-post/top down approach to the problem. Ultimately, the CACs have gained broader support and Mexico they were pioneered by Mexico in 2003 and have since become standard in emerging market sovereign bonds.[183]

What the debate as a whole reflects is that creditors can no longer regard themselves as intense competitors, as banks did before. The changes in the sovereign debt restructuring process have prevented creditors from negotiating adjustments of their own credit exposure individually and separately from other fellow creditors.[184] As a result, and with some pressure from the official sector, they have increasingly embraced creditor coordination as an effective means to restructure sovereign debt instruments.[185] The increased potential of creditor coordination has implications within the odious debt scenario, as will be discussed in the next subsection.

#### 4.1.2.1 Equitable subordination

As a consequence of greater need for creditor coordination and the general preference for the contractual approach of CACs, this may have helped the market be more receptive to other contract-based sovereign debt developments such as one brought forth by Feibelman.[186] He proposes a contractual odious debt arrangement which takes advantage of this new potential for creditors to work together. Under such an approach, a majority or super-majority of a sovereign's creditors would have the power to identify odious obligations of the sovereign, and the sovereign would then be obligated to repudiate these debts.[187] Non odious creditors should have good incentives to employ this arrangement and monitor each other, because they have an interest in keeping their non odious loans with priority for repayment. They have incentives to prevent their own claims from being devalued by the foolish and corrupt use of funds that odious loans can lead to.

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[183] Anna Gelpern. "After Argentina" (2005) Policy Briefs in International Economics. No. PB05-2
[184] See Lee C. Buchheit and Ralph Reisner. "The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships" (1998) U. Ill. L. Rev. 493
[185] Feibelman. "Contract, Priority and Odious Debt" at 10
[186] *Id.*
[187] *Id.*

Feibelman's proposal highlights the fact that the interests of non-odious creditors can be aligned with the interests of the citizens of sovereign debtors.[188] One complication may be the fact that, just as debtors are not 100% odious or non odious, neither are creditors. However, the potential of priority schemes applied to odious debt in the sovereign context seems promising.

#### 4.1.2.2 Financial Instruments and the Potential of the Secondary Market

One type of risk faced by holders of debt instruments is credit risk. Credit risk is that a debtor will default on its obligations by reason of a deterioration in its creditworthiness.[189] Credit derivatives are designed to transfer credit risk between counterparties. They are traded in New York or London and constitute a significant segment of the market.[190] The simplest form of credit derivatives are credit default swaps (CDS). CDSs provide valuable information to the market, as they create a mechanism by which the credit risk of an asset if priced separately from its other features. Verdier argues that the spread of CDSs referenced to a particular entity may foretell future financial difficulties or default.[191] This market based source of information can be of use to investors, as well as domestic and international policymakers. It may also prove useful in providing information about odious activities which affect credit risk.

The existence of an active and liquid bond market has the potential to reveal relevant information necessary to tackle odious debts. Ben-Shahar and Gulati argue that if the market is active and recognizes that certain types for debts are less likely to be repaid, because there was corruption involved or the population did not benefit from the debt, then the market will incorporate that information into the price. If odious debts are paid back less often, this could affect the threat of liability for the underwriter, and consequently this will affect disclosure.[192] Other scholars have proposed a creditor liability scheme for odious debts.[193] The threat of liability for creditors or their intermediaries will make the information regarding odiousness important for pricing, and this will

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[188] *Id.*
[189] Verdier. "Credit Derivatives and the Sovereign Debt Restructuring Process"
[190] *Id.* at 2
[191] *Id.* at 42
[192] This was pointed out to me by Trachtman
[193] Ben-Shahar and Gulati. "Partially Odious Debts? A Framework for an Optimal Liability Regime" at 33

provide incentives for institutions to emerge to provide insurance for this particular type of risk. Credit derivatives, as mentioned above, could fill this institutional gap and provide a mechanism by which odious debt liability is exchanged. The advantage of this is that creditors would not have to do any of the monitoring of debtors themselves. They rely on market institutions like underwriters and rating agencies to collect the necessary information and sell it to them.[194]

In future chapters of this dissertation, there is room to look at existing rating and reporting agencies in search of relevant proxies which could be used in a potential odious rating project as well as other sources where verifiable information on odiousness could be found such as election observers, the ICC or other international courts and the Human Rights Council and Human Rights Committees. Also, some experts have noted the existence of bondholders who are protected against credit risk, increases the likelihood of default for a debtor nation.[195] It would be interesting to analyze if any such unintended effects could be brought about by the existence of many bondholders protected against odious debt liability risk.

#### 4.1.2.3 New Forums

Besides contractual approaches and financial instruments, other platforms may prove increasingly relevant in sovereign debt market and within the fight against odious debt. One such forum is the International Center for Settlement of Investment Disputes (ICSID). Some proponents argue that a recent decision on a case involving a Canadian businessman who had paid a $ 2 million dollar cash donation to former Kenyan president Daniel Arap Moi to secure a contract, reflects a modern day application of the odious debt doctrine. The businessman was denied recovery on his claim, including that under a restitution theory.[196] Also, following the Argentinian default, holders of Argentinian debt took to the ICSID on grounds of expropriation. While it is not clear whether this

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[194] *Id.*

[195] Verdier explains that the protected bondholder had no incentive to agree to voluntary exchange offers by the debtor, or other restructuring mechanism or any other restructuring mechanism because the bondholder is entitled to the full value of the old bonds from the protection seller. The non participation of protected bondholders increases the likelihood that the exchange offer will not reach the required threshold and the sovereign will be prevented from succesfully restrcuturing its bonds and reducing its debt load. in "Credit Derivatives and the Sovereign Debt Restructuring Process"

[196] Report available at http://www.odiousdebts.org/odiousdebts/index.cfm?DSP=content&ContentID=16728. (cited in Ben-Shahar and Gulati. "Partially Odious Debts? A Framework for an Optimal Liability Regime" at 43

forum is more adequate than the municipal courts of either New York or London, it suggests the possibility of dealing with debt issues, including odious debt, in the ICSID.

### 4.1.3 Banks

#### 4.1.3.1 Culprits

The implication of banks in international finance is not only as lenders, but also as repositories. Both of these roles are equally important and relevant to odious debt. As has been discussed in a previous chapter, banks have taken an active role in aiding and collaborating with despots, helping them take money out of their countries and concealing or laundering them in foreign banks.[197]

#### 4.1.3.2 Security Issues

With security and terrorism now a global priority, there has been increased pressure and scrutiny on the activities of banks. Ramasastry notes that one example is the U.S. Patriot Act. As a result of it, banks need to exercise high due diligence when engaging with a category of politically exposed persons.[198] The banks' potential to monitor or prevent the financing of corrupt activities may play an increasing role in the fight against terrorism. In order to induce them to take the precautionary actions at their disposal it might, again, be necessary to hold banks liable.

This might indicate a fundamental change in the way the law regards the resposibilities and functions of banks. After the Second World War, the Chairman of Dresdner Bank was tried and acquitted by the United States Military Tribunal in Nuremberg of charges that he had played a role in financing the construction of Auschwitz.[199] The Tribunal justified its decision:

*Does [Rasche] stand in any different position than one who sells supplies or raw materials to a builder building a house, knowing that the structure will be used for an unlawful purpose? A bank sells money or credit in the same manner as the merchandiser of any other commodity. It does not become a partner in enterprise, and the interest charged is merely the gross profit, which the bank*

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[197] See Chapter 3 Section 3.5
[198] Anita Ramasastry in a discussion at Duke Conference on Odious Debt and State Corruption. January 26th, 2007.
[199] Ramasastry. "Should Swiss Banks be Liable for Lending to South Africa's Apartheid Government"

*realizes from the transaction, out of which it must deduct its business costs, and from which it hopes to realize a net profit. Loans or sale of commodities to be used in an unlawful enterprise may well be condemned from a moral standpoint and reflect no credit on the part of the lender or seller in either case, but the transaction can hardly be said to be a crime.*[200]

Today, the decision may have been different, considering for example, that the United States has cracked down on corporate entities and charities that are alleged to have financed terrorist activities.

#### 4.1.3.3 Reporting and Disclosure

There is increasing international pressure and interest in exploiting the abilities of banks to monitor and control activities as well as disclose and report information. Within the corporate context, reporting practices and mechanisms are well developed and it could prove a fruitful framework from which to draw insight. Also, the possibility of developing new covenants within this context should be explored.

Banks already engage in some types of disclosure as to their lending activities. For example, the major English banks abide by the EIRIS Guide to Responsible Banking, which includes reports of the different lending policies adopted by banks. Among these are policies in relation to lending to companies involved in controversial activities or behaviour, such as arms, environmental degradation and interestingly, "operating or dealing with countries with oppressive regimes."[201]

On the same note, there are many initiatives at the international level, such as the United Nations Global Compact, whose normative argument and cause is that businesses should avoid being complicit in human rights abuses. They are committed in finding ways to work together, share information and best practices with private companies on these issues. Linking how the increase attention to corporate complicity and the emerging movement of corporate social responsibiliy and reponsible investment could play a role in the odious debt problem may also be considered for further research.

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[200] *Id.*
[201] Ethical Investment Research Service, Guide to Responsible Banking (2003) at 6

## 4.2 Bilateral/Public Creditors

### 4.2.1 Incentives

The incentives of public creditors differ from those of private creditors. They do not all have a uniform and primary interest in profit maximization. On the contrary, often they are not concerned with getting repaid but rather are in pursuit of longer term, non-financial interests. This section will briefly go over what motivates countries to lend money to other countries.

#### 4.2.1.1 Geopolitical and Economic Influence

Providing financial assistance can provide creditors with the ability to exert policy influence in the debtor country. The range of policy interests of different creditor countries is vast and can be benign or odious. Sometimes countries seek to obtain privileged positions with regards to natural raw materials such as diamonds and oil in return for financial assistance. Other policies can include the promotion of export credits or imports. Often incentives are combined with geopolitical ones.

Some scholars have expressed concern over what they call the "rogue creditor" country.[202] These are countries that have deep pockets and are unconcerned about the characters of regimes that they deal with. Ginsburg and Ulen provide China as an example.[203] China is the biggest supporter of the Sudanese government, which is enabling genocide in Darfur.[204] It also recently hosted a summit of every leader on the African continent, including Robert Mugabe.[205] This highlights the danger of singling out odious regimes and isolating them, as it puts rogue creditors like China in a particular favorable position to extend credits to these regimes.[206]

#### 4.2.1.2 Inadequate Incentives of Governments

Domestic political interests of states may get in the way of incentives to fight odious debt internationally. Public choice theory argues that those in power in democratic governments want to maximmize votes and win elections and therefore seek to maximize the welfare of their own

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[202] Ginsburg and Ulen. "Odious Debt, Odious Credit, Economic Development and Democratization" SectionVI. The Problem of the Odious Creditor
[203] *Id.*
[204] *Id.*at 17
[205] *Id.* at 17
[206] Ginsburg and Ulen. "Odious Debt, Odious Credit, Economic Development and Democratization." at 17

inhabitants. Ben-Shahar and Gulati note that the maximizing the domestic welfare of a democratic states's inhabitants is often not going to be aligned with policing odiousness elsewhere.[207]

Again, in certai contexts such as terrorism, global security and the enirvonment, policing the consequences of odious debt are in the long term interest of the citizens of every country. But the shortsightedness of governments is also another political economy problem relevant to odious debt. Furthermore, if governments are going to steal, it is at least, politically easier to steal from international funds than to take from other pools such as the population's tax base.

#### 4.2.2 Challenges

Finding solutions for odious debt may prove more challenging in a context where political issues dominate rather than more predictable incentives like profit maximization. Information gathering is also more complicated, given that debt negotiations and issues usually take place behind closed doors at the Paris Club. There is a risk that the odious debt cause will only be advanced when it is in the interests of powerful nations to do so. This was arguably the case when the United States first began to use the odious argument in the context of Iraq. Interestingly, after Iraq received one of the largest write-offs in the Paris Club ever (80%) the American interest in the odious debt caused quickly diminished.[208] On the other hand, some scholars such as Buchheit have argued that the Paris Club relies and seeks to obtain clear rules and precedents to work wit because they acnknowledge the danger of being perceived as customizing remedies.[209] This may suggest that there is room for guidelines to tackle odious debts efficiently and consistently and may be embraced by such forums. If one odious case succeeds within the Paris Club, even if its behind closed doors, it can serve as precedent for future cases of the same nature. At the very least, this can improve the bargaining power of debtors at the negotiation table.

### 4.3 International Financial Institutions

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[207] Ben-Shahar and Gulati. "Partially Odious Debts? A Framework for an Optimal Liability Regime" at 7
[208] Gelpern. "What Iraq and Argentina might learn from each other"
[209] Lee Buchheit made this comment at the Duke Conference on Odious Debt and State Corruption. January 26th, 2007.

#### 4.3.1 Incentives

International financial institutions are yet another category of sovereign creditors with separate incentives. Often, these incentives involve getting debtor countries to agree to certain macroeconomic programmes, policy courses and debt restructuring agreements. The role of the International Monetary Fund (IMF) is an intermediary one as a facilitator of finance between lenders and a sovereign borrowers through its conditionality mechanism.[210] However, as Sgard explains, IMF conditionality is built on a model of interaction wholly different from that of a private bank engaged in credit intermediation. Lending by the Fund includes conditionality clauses which are instruments that commit the borrower to a specific policy course but recognizes that the sovereign might derail and behave in a realistically opportunistic way.

#### 4.3.2 Bad Advice

While the Fund's incentives may be benevolent and seek to promote development in debtor countries,[211] its advice is sometimes wrong. The policy route embedded in its loan conditionality clauses can turn out to be an inappropriate policy mix and lead to disastrous economic consequences for the debtor country. Unfortunately there are many examples in history.[212] It would be interesting to question who is responsible for bad advice and how this issue fits in the overall discussion of odious debt.

#### 4.3.3 Aligning incentives

Risk sharing might be a potential answer. As explained in previous sections, the law can bring risk sharing about through liability and the market can induce it through financial instruments. In the case of creditors whose incentives are more long-term, one idea could be to have IMF owed debt in the form of GDP linked bonds. The IMF would only get paid back if the GDP of the borrowing

[210] See Jerome Sgard. "IMF in Theory: Sovereign Debts, Judicialisation and Multilateralism" (2004) CEPII no 2004-21

[211] There is much debate about the Fund's function and incentives and whether they are committed to the well being of developing countries or to the policy interest of its members , particularly the United States.

[212] See examples of bad policy advice by the IMF in Patricia Adams. *Odious Debts.* (1991)

country increases as a result of its policy advice. In this way, the interests of the creditors are tied to the interests of the debtor. Such bonds can be attractive even to private creditors who wish to diversify their portfolios. Overall, the role that financial instruments can play in risk sharing and information with all types of creditors is worth further research.

#### 4.3.4 The World Bank and the Case of Chad

The World Bank provides an example of innovative mechanism where it works together with the government of the debtor country in designing ex-ante the use of loan proceeds and they collectively engage with other domestic agencies in reporting and monitoring throughout the life of the loan. The World Bank agreed to back a large pipeline building project in Chad which would carry Chad's petroleum to the Atlantic coast for export.[213] Before it could become involved, the Bank wanted assurances that the revenues would be used to lift Chadians out of deprivation. The joint project between the World Bank and Chad included, among other things, that 10% of Chad's direct oil revenues are placed in trust for future generations and that 80% are devoted to priority sectors such as education, health and social services.[214]

There are many obstacles in the way of its efficient implementation. One is the issue of Chad having no incentives to abide by the agreed conditions once it has been granted the loan. The reporting mechanisms put in place and the fact that the project is consistent on continuing loans by the World Bank curbs Chad's incentives to defect. Actually, the World Bank did at one point during the on-going project suspend loans to Chad on grounds that the African country's government had breached the agreement over oil revenue controls.[215] Overall, this example is worth further analysis as it is an interesting experiment of trying to share the risks and responsibilities as well as share skills and attempt to align the incentives of the parties involved.

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[213] The World Bank. "Chad-Cameroon Pipeline" available at: http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/AFRICAEXT/EXTREGINI/EXTCHADCAMPIPELINE/0,,contentMDK:20532054~menuPK:1329410~pagePK:64168445~piPK:64168309~theSitePK:843238,00.html

[214] *Id.*

[215] BBC News. "World Bank suspends loans to Chad" (2006) available at: http://news.bbc.co.uk/go/pr/fr/-/business/4588412.stm

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