



JOHN M. OLIN CENTER FOR LAW & ECONOMICS

WORKING PAPER No. 07-007

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A FRAMEWORK FOR AN OPTIMAL LIABILITY REGIME**

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*FORTHCOMING: JOURNAL OF LAW & CONTEMPORARY PROBLEMS, 2007*

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## *ARTICLE*

# Partially Odious Debts? A Framework for an Optimal Liability Regime

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### Abstract

This article argues that the cost of odious debt ought to be borne by the party who is best positioned to prevent the accumulation of such debt. Creditors should bear odious debt liability—be barred from recovering the debt—to the extent that they could have taken measures to reduce the risk of forfeiture or to monitor the use of the money. Such liability would induce better care in funding decisions. At the same time, the magnitude of creditors' liability should reflect only the true social harm of odious debt. Even despotic regimes direct some of the funds to benefit the populace. Accordingly, creditors' liability ought to extend only to the fraction of the debt that served odious purposes. Effectively, liability for odious debt would be shared by the creditors and populace, with the relative shares depending on comparative blameworthiness, assessed from an economic, incentive-oriented perspective. After developing this principle, the paper explores ways in which it can be implemented.

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## I. INTRODUCTION

The despotic ruler of a poor nation borrows extensively from foreign creditors. He spends some of those funds on building statues of himself, others on buying arms for his brutal secret police, and places the remainder in his personal bank accounts in Switzerland. The longer the despot stays in power, the poorer the nation becomes. Although the secret police are able to keep pro-democracy protests subdued by force of arms for many years, eventually there is a popular revolt. The despot flees the scene with a few billion dollars of his ill gotten gains. The populist regime that replaces the despot now has to pay the debts to the foreign creditors of the old regime. In effect, the populace suffers the costs of a despotic rule twice. Once, when the despot was in power, depleting the resources of the nation and reducing the populace to penury. Second, when the creditors whose funding sustained the despot collect payment for the debts of the despot.

The foregoing scenario will strike some as unfair. Others might be less sympathetic, invoking the need for the populace to bear collective responsibility for the contractual obligations incurred by the state. The legal rule here, a creature of public international law, is an unforgiving one that supports the notion of strict collective responsibility for state contractual obligations. Governments inherit the debts of prior governments, regardless of their differing characters, philosophies, or populist bona fides.<sup>1</sup> So, the ANC-led government in South Africa inherits the debts of the predecessor apartheid regime. Corazon Aquino's populist government in the Philippines inherited the debts of the Marcos dictatorship. The Islamic Revolutionary government in Iran inherited the debts of the Shah. And so on and so forth. Unwilling to pierce

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<sup>1</sup> See Ernst Feilchenfeld, *Public Debts and State Succession* (1931); M.H. Hoefflich, *Through a Glass Darkly: Reflections Upon the History of International Public Debt in Connection with State Succession*, 1982 U. Ill. L. Rev, 39. For a contemporary overview, see Lee C. Buchheit et al., *The Dilemma of Odious Debts*, \_\_ Duke L. J. \_\_ (forthcoming 2007).

the veil of the state entity and to separate the state from its government, sovereign debt law views the state as strictly liable for debts accumulated by its prior despotic rulers.

This situation poses a dilemma for international law that private law has been tackling in a variety of settings: who among the innocent parties should bear the loss created by a culprit that can no longer be held accountable. Surely, neither the creditors nor the populace are the primary “wrongdoers”—they did not steal any money nor commit any violation. Still, the greater blameworthiness of the ex-dictator’s intentional actions should not blur the different shades of fault of the two more innocent parties. If their relative fault can be compared, it might provide a formula for dividing liability among them.<sup>2</sup> Thus, the purpose of this article is to borrow from a rich private law tradition and to explore the treatment of odious debt as a problem analogous to allocation of liability in private law.

The framework that this paper adopts is economic. Drawing on the economic analysis of private law, it develops insights as to the structure of an optimal liability regime. Under the economic approach, liability is imposed not on the basis of some intrinsic judgment as to the parties’ relative blameworthiness, but rather in a forward-looking fashion, on parties who are best suited to take actions to prevent the loss. Under this approach, in addition, liability is imposed in a magnitude that is tailored to induce optimal, rather than too little or too much, precautionary measures.

According to this approach, the question whether the people of a nation should bear responsibility for the debts of their despotic leaders, even where they have no control over those

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<sup>2</sup>Although we have not found analysis of this comparative fault perspective among contemporary commentators on the odious debt subject, there appears to have been consideration of it over a century ago in the context of the repudiation of debts by the various American states. See William Amia Scott, *The Repudiation of State Debts* (1902). The state debts that Scott was analyzing had often been incurred by corrupt legislatures and governors, sometimes in violation of the state’s own laws. The question then was that of how to allocate liability between the “State and the innocent bondholders”, once the corrupt legislature or governor was gone. *Id.* at 201. And part of the answer to the question was framed in negligence terms; that is, whether the bondholders had inadequately investigated the legal legitimacy of the bond issuance in question. *Id.* at 202.

leaders and their borrowing decisions, cannot be resolved merely by invoking presumptions regarding collective responsibility and the legal entity of the state. From an economic perspective, a basic question is whether the people of a nation have cost-effective means to prevent the accumulation of insolvent odious debt. Are they better positioned than the creditors to take such harm prevention measures? And if both sides—the people of the nation *and* the creditors—could have taken some steps to reduce the harm, how should liability be tailored to induce them to do so?

One of the first observations we make in this article is that creditors should ordinarily bear at least some of the costs of insolvent odious debt. Because these creditors are going to be better situated than the populace to protect against the harm, and because it is their behavior that an imposition of legal liability could potentially change, at least some of the liability should be borne by them.<sup>3</sup> By contrast, the imposition of liability on the populace for the ill deeds of a despot is often utterly useless in terms of providing prevention incentives; because the very definition of the despot is one who has taken away power from the populace. Thus, at a first cut, and a very rough one, the rule that accords the creditors unconditional right to recover seems undesirable.

To illustrate, take the circumstance of the despotic dictator seeking to supplement his offshore bank account. Creditors will often be in a better position than the populace to monitor and control the misbehavior of this individual. If, for example, the despot asks a foreign bank to deposit funds borrowed in the name of the state into the personal Swiss bank account, the bank

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<sup>3</sup> Although not always articulated in these terms, the insight that creditors are often in a better position to prevent the harm in question, appears to drive many of the calls for increased creditor liability for odious debts. See, e.g., Joseph Hanlon, *Defining Illegitimate Debt and Linking Its Cancellation to Economic Justice* (draft dated June 2002) (available at [www.globalfairtrade.ca](http://www.globalfairtrade.ca)) (discussing creditor responsibility on account of their negligence in the making of many of these loans); Kunibert Raffer, *Risks of Lending and Liability of Lenders* (forthcoming *Ethics and International Affairs*, 2006) (making a similar point about the inefficiency of a system that does not require creditors in the sovereign lending context to exercise due care).

can simply refuse to issue the loan on the ground that this looks like a case of the despot stealing from his people (and after all, the client borrowing the money is the people; the despot is only the agent). It might not be as straightforward to determine where the funds are diverted. But the point of our liability regime is to induce the creditor to seek ways to make the necessary determinations so as to prevent the potential harm. Making the creditor liable can provide such an incentive.

The article explores in some detail the types of precautionary action that creditors can take and that liability would induce them to take. It shows that even when creditors lack the ability to conduct meaningful monitoring, they have indirect means that could make it more difficult for the despotic regime to use the funds in ways that do not benefit the populace. For example, creditors can make information regarding loans and the lack of accountability public, empowering domestic and international watchdog groups and according the populace or the international community some leverage to prevent the wasteful use of the debt. Effectively then, placing the liability on creditors, while increasing the risk that they face in the event that funds do disappear, can at the same time reduce despotic behavior and, paradoxically, increase the funds available for repayment ex-post.

This comparative fault calculus suggests that creditors should bear liability for the loss. But should their liability extend to the *entire* loss? Should they forfeit their entire right to recovery of the loan? The second component of the framework developed in this article focuses on an additional factor: the extent to which the populace *benefited* from the loan. The point here is, again, simple: credit that was used in ways that did benefit the populace—in ways that would be regarded as legitimate if used by a democratic regime—should not be forfeited. The creditors “fault” extends only to allowing funds to be exploited in a despotic fashion, but does not extend

to legitimate uses of the funds. Thus, our framework provides enough flexibility to tailor the relief for the populace in accordance with the magnitude of the exploitation it suffered. The larger the fraction of the debt that used to build hospitals and bridges, the more it should be paid back. Even the Saddams, the Abachas, and the Mobutus, when they borrow money, tend to steal but a portion of the debts they incur. It is only this portion that justifies a regime that would place a special prevention burden on creditors.

Thus, putting together the prevention and the relative benefit factors leads to a liability regime that would generally divide the loss between the creditors and the populace. The populace continues to be strictly liable for the national debt, but it now has a defense of contributory negligence against the creditors. If the successor government can show that the creditors were at fault, the component of the debt that served ill purposes is discharged. The more the populace benefited from the debt, the more they have to pay back.

Note that “creditor liability” is perhaps a misnomer, an overstatement. We do not suggest that the debtor state should have an affirmative tort claim for “wrongful lending practices” or for “reckless financing” of the despotic regime. Nor do we argue that the creditors ought to be liable as accomplices for financing the crimes of the dictator. The sole issue at stake, in the analysis here, is the debt; and the normal context in which it arises is in a claim by the creditor to collect it. Thus, it is a *defense* accorded specifically to the populace and can only be asserted by its representative successor government. It is possible that some of the arguments we raise may be invoked in support a more ambitious proposal of holding creditors tortiously liable and subjecting them, not only to the loss of the debt, but also to add-on damages. We believe that this is a more difficult case to make, with significantly narrower applicability. This is not the case we intend to advance.

The Article proceeds as follows. Part II provides background on the problem. It sets out: (a) how the fact of the state being the debtor complicates the analysis; (b) the relevance of historical experience in attempting to address the problem; and (c) the relevance of the contractual nature of the contemporary problem. Part III is the core of the analysis, which sets out the proposed partial liability scheme. Part IV works through practical factors that might complicate the operation of the partial liability scheme. Part V concludes.

## **II. BACKGROUND**

### **A. Complicating Factors when the State is the Debtor**

The problem of the agents, such as corporate managers, taking control from the purported principals, such as the shareholders, and seeking to abuse their position by engaging in self-dealing, is a familiar one. Agency law, and by extension, corporate law, seeks to deal with this abuse problem by giving shareholders the right to sue in circumstances where they can demonstrate to a court that some self-dealing despotic CEO is seeking to fill his own pockets at the expense of his investors. Other bodies of law, such as the securities laws, supplement corporate law in requiring truthful disclosure about the activities of the collective and by regulating the processes by which shareholders are allowed to challenge existing leadership. Various rules and regulations place additional obligations on actors that collaborate with, or facilitate, the managers' wrongdoing. With the misbehaving leader of a state, however, things get more complicated for at least three reasons.

*No Domestic Rule of Law* -- First, with a despot in power, the state itself has no incentive to police the misbehavior of the leader.<sup>4</sup> The central problem is that the despot has taken

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<sup>4</sup> See Paul D. Carrington, *Law and Transnational Corruption: Globalizing Lincoln's Law*, \_\_ J. L. & Contemp. Prob. \_\_ (forthcoming 2007).



control of the state. The people of the state, because they are a dispersed collective and fear the coercive powers of the state's police or military machinery, are unlikely to be able to do much. Enforcement, if it is going to happen, has to occur from the outside. At the least, the solution to the collective action problem among the populace has to occur from the outside. And that leads to the second problem.

*Inadequate Incentives to Police on the Outside* -- Outside states, and the international community at large, do not have enough of an incentive to police domestic despotism. These states, even when their internal processes are working, have an incentive to maximize the welfare of their own inhabitants because those in power want to win the next elections. But history has shown that maximizing the welfare of a democratic state's inhabitants is often not going to be aligned with policing odiousness elsewhere. Indeed, democratic regimes (taken as a proxy for non-odiousness) have supported over the years many dictatorial states, in order to further their geopolitical interests.<sup>5</sup> For example, it may be in the interests of a non-despotic state that is seeking to obtain oil at a cheap price to make a side deal with a despotic leader elsewhere to support his despotism as long as he keeps up the supply of cheap oil.<sup>6</sup> On the flip side, it is also likely that a despotic state with no geopolitical importance or special natural resources will simply get ignored by the world community.

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<sup>5</sup> Among the articles in this symposium that emphasize the foregoing point are Tom Ginsburg & Thomas S. Ulen, *Odious Debt, Odious Credit, Economic Development and Democratization*, \_\_ J. L. & Contemp. Prob. \_\_ (forthcoming 2007); Albert H. Choi & Eric A. Posner, *A Critique of the Odious Debt Doctrine*, \_\_ J. L. & Contemp. Prob. \_\_ (forthcoming 2007); Anna Gelpern, *Odious, Not Debt*, \_\_ J. L. & Contemp. Prob. \_\_ (forthcoming 2007).

<sup>6</sup> The recent decision by the UK government to shut down its corruption probe of an arms deal between a UK company and the Saudi government in response to the threat by the Saudi government to scuttle a potential arms deal illustrates the general point being made in the text. See *Saudi Defense Deal Probe Ditched*, BBC News, December 15, 2006 (available at <http://news.bbc.co.uk/1/hi/business/6180945.stm>) (where Lord Goldsmith, the AG, justifies the dropping of the probe as a matter of balancing domestic public interests (presumably the arms contracts that would produce domestic jobs) versus the rule of law).

*Timing* -- Third, and this derives from problems one and two, enforcement and policing are likely to occur only after the dictator has been overthrown. But at that point, it is most likely that the bad guy is counting his ill-gotten gains in some undisclosed location, and disgorgement of his wealth is only partially possible. So, unlike the classic agent-expropriation problem, the law here has to determine who among the secondary players should suffer the burden of the lost funds. Moreover, while in other areas agents can be deterred from stealing by the threat of ex-post liability, and may even be discouraged from taking positions of power if such positions no longer enable them to steal, in the sovereign context it is quite unlikely that the liability for odious debt would deter despotic leaders from assuming power.

Thus, traditional notions of agency and fiduciary law, which operate well in disciplining officers of organizations, do not provide the same adequate framework for state agents, particularly when these are despotic leaders who leave little room for the citizens to engage in monitoring. In the absence of a meaningful agency relationship, a legal regime that holds the citizenry liable for the debts of its despotic leader is problematic. The presumption of strict governmental succession and of the citizens' collective responsibility for loan repayment is lacking in foundation.

## **B. Historical Attempts to Tackle the Problem and Contemporary Context**

*Odious Debt Analysis in Historical Context* -- The question of collective responsibility of a people for the misbehavior of their government, and specifically its debts, has been one of philosophic and legal inquiry through the ages.<sup>7</sup> Aristotle, Hume and Jefferson are among those

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<sup>7</sup> The intellectual history of this topic has been described in detail by a number of articles (including many in this symposium) and we will not reinvent the wheel by including citations for every historical fact. Interested readers who want citations for the factual assertions made in the subsection can look to Buchheit et al., *supra* note \_\_; Ashfaq Khalfan et al., *Advancing the Odious Debt Doctrine* (2002) (available at [www.cisd.org](http://www.cisd.org)); James Feinerman,

who discussed it. But the narrower question of a legal doctrine of odious debts had its heyday (that is, until now) in the period roughly 1890-1930. This was a period that saw substantial amounts of lending by creditors in richer western countries to less developed nations. Notably, these debtor sovereigns were not subject to formal sanctions in any court; the doctrine of sovereign immunity protected them. Sanctions for default and other debtor misbehavior were exclusively of the informal variety. And even on the informal sanction front, there was no IMF or other multilateral body to perform intermediary functions. Among the informal or extra-legal sanctions of this era, the most well known is “gunboat diplomacy”, which was essentially self help, in that creditors from a debtor nation might persuade their government to send in the troops to teach the offending nation fiscal responsibility.<sup>8</sup> Within this context, the leading international law scholars of the time suggested that there might be a narrow exception to the rule of strict governmental succession. When the creditors knowingly lent to a regime that was ruling without the consent of the governed and was not using the proceeds of those funds in the interests of its populace, debts might be suspect.

A Russian jurist of the time, Alexander Sack, characterized debts satisfying the three foregoing conditions as “Odious” (he also characterized the regimes in question as “despotic”). When jurists such as Sack purported to be describing the state of international law at the time, they did not mean that these odious debts were uncollectible as a function of some legal proceeding.<sup>9</sup> There was no meaningful legal proceeding to be had. Sack himself was proposing

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Odious Debts: Old and New, \_\_ J. L. & Contemp. Prob. \_\_ (forthcoming 2007); Tai-Heng Cheng, Renegotiating the Odious Debt Regime, J. L. & Contemp. Prob. \_\_ (forthcoming 2007)..

<sup>8</sup> See Kris James Mitchener & Marc Weidenmier, Supersanctions and Sovereign Debt Repayment, (draft dated July 2005) (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=760165](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=760165)). (describing the importance of “gunboat diplomacy” as a sanctioning mechanism in the 1870-1913 period).

<sup>9</sup> Although contemporary writers in the Odious Debt literature have not plumbed Sack’s own motives, they are perhaps worth investigating given his contemporary revolutionary status among at least some of those who are urging the adoption of a Sackian doctrine. Examining Sack’s motives might cast suspicion on the value of the version of the doctrine he had proposed. Sack was a Russian émigré to France at the time that he articulated his

that there be an arbitral forum to resolve these matters. Instead, the characterization of these debts as suspect by scholars such as Charles Cheney Hyde (who was closely connected with the U.S. government) was in effect telling creditors that if they engaged in such problematic lending, their home governments, when it came to applying informal sanctions such as sending in the gunboats, might be less willing to do so.<sup>10</sup>

For the remainder of the twentieth century, the topic of odious debts remained largely dormant, except for occasionally surfacing in particular situations, as when the Iranian Revolutionary Government sought to avoid payment on the Shah's debts, the Chinese government was sued on unpaid bonds issued by the Imperial government in the early 1900s, or academic assertions that poor nations in Africa and elsewhere should not be liable for debts foisted on them by creditors such as the World Bank who were aware of the corrupt nature of the regimes doing the borrowing. These claims went nowhere.

The U.S. incursion into Iraq in 2001 changed everything. Iraq, under Saddam Hussein, had managed to incur well over \$100 billion in debt. And the U.S. government, the new power in Iraq, was not inclined to present that bill for over \$100 billion to its taxpayers (the Iraqi taxpayers were certainly not in any position to repay anything). The Bush administration thus turned to a different strategy: making public assertions regarding the Odiousness of Saddam's debt. Those assertions – which for many in the human rights community signaled an avenue

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Odious Debt doctrine; he had fled the communist regime, having been closely tied to the Tsarist regime. In France at the time, there was a financial crisis because the communist regime that took over Russia was refusing to pay the Tsar's debts. A large portion of the lending to the Tsar had come from the bond purchases of the French public. And the French public was incensed at the refusal of the communist regime to pay the Tsar's debts. Viewed in this light, one might ask the question of whether Sack's articulation of a highly narrow Odious Debt Doctrine (Sack's writings confirm that he was no friend of the communist overthrow of the Tsar) was done with the goal of ensuring that none of the Tsarist bonds held by Sack's French hosts could be deemed uncollectible under an Odious Debt doctrine. Cf. Gunter Frankenberg & Rolf Knieper, Legal Problems of the Overindebtedness of Developing Countries: The Current Relevance of the Doctrine of Odious Debts, 12 Int'l J. of Sociology of Law 415 (1984) (noting that the French commentators of the 1920s, notably Jeze (1921) and Sack (1926), were at the extreme end of the spectrum of commentators in terms of their eagerness to protect creditor claims).

<sup>10</sup> See Charley Cheney Hyde, The Negotiation of External Loans With Foreign Governments 16 Am. J. Int'l L. 523, 531 (1922).

through which much of the debt of poor nations in Africa and elsewhere could be reduced – spurred new interest in the topic. Since then, Iraq’s debt has largely been renegotiated; Iraq received one of the largest write offs (80%) in the Paris Club ever.<sup>11</sup> And with that resolution, the U.S. administration’s interest in asserting the existence of a doctrine of odious debt waned. But not before the genie was out of the bottle; there exists today, with or without the support of the U.S. government, a robust debate about what place the doctrine of odious debt (and query as to whether it could even be characterized as a doctrine) has in the modern context.<sup>12</sup> This renewed interest was further heightened when, in October 2006, Norway publicly disavowed the debts owed to it by five sovereigns on the grounds that those loans were made improperly by the Norwegian government.<sup>13</sup> Finally, as of this writing in February 2007, Ecuador is threatening to repudiate a subset of its prior debts on the grounds these were illegitimate debts made to a prior military regime.<sup>14</sup>

The differences between the modern world of sovereign finance and the one that existed in the 1890-1930 period are relevant to the extent that a century-old doctrine is invoked in current debates. As noted, that prior regime was one of informal or “soft” law. Assertions that some debt or the other was odious were at best starting points in a bargaining among the involved states. In the current era, much is different. Ever since the early 1970s, sovereigns engaging in commercial activities have had their sovereign immunity stripped with regards to transactions in the United States and the United Kingdom. In addition, sovereigns themselves,

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<sup>11</sup> See Andy Metzger, A Mission Accomplished, *Legal Times*, April 10, 2006 (available at <http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1144672790115>).

<sup>12</sup> For a fuller discussion of the odious debt doctrine and its modern reincarnation in the context of Iraq, see Jai Damle, *The Odious Debt Doctrine After Iraq*, \_\_ J. L. & Contemp. Probl. \_\_ (forthcoming 2007); see also Anna Gelpern, *What Iraq and Argentina Might Learn From Each Other*, 6 *Chi. J. Int’l L.* 391 (2005).

<sup>13</sup> See Kunibert Raffer, *Odious, Illegitimate, Illegal or Legal Debts: What Difference Does it Make for International Chapter 11 Arbitration*, \_\_ J. L. & Contemp. Probl. \_\_ (forthcoming 2007) (discussing the Norwegian initiative).

<sup>14</sup> See Lester Pientel & Jeb Blount, *Ecuador Calls Foreign Debt “Illegitimate”, May Default on 60%*, *Januar 19, 2007*, *Bloomberg News* (Bloomberg.com) (available at <http://www.gata.org/node/4722>).

who do the overwhelming majority of their borrowing in these two jurisdictions, explicitly waive their immunity. Of course, obtaining a judgment against a sovereign is only one half of the trick; one still needs to be able to enforce it. Enforcement too, though, has become more feasible in recent years. In addition, multilateral institutions such as the IMF exercise oversight of the market and seek to solve coordination problems when they occur. Finally, developments in technology and globalization mean that creditors and creditor-support institutions (such as credit rating agencies) are far more capable of monitoring sovereign behavior than they were a century ago, where creditors sometimes found themselves issuing loans to fictitious sovereigns. Thus, in the modern era, enforcement of debt is no longer restricted to soft mechanisms such as reputation and bargaining, but rather operates through formal channels in municipal courts.<sup>15</sup> And when these formal enforcement venues are available, creditors are able to gain full recovery. In effect, then, the existence of rigorous enforcement highlights a basic feature of current law: if the debt is recoverable (and not subject to the odious debt doctrine), it is recoverable in full: this is the zero-one, all-or-nothing nature of the recovery rule.

### **C. Novel Approaches to the Odious Debt Problem.**

Recognizing that under current rules creditors often get too much protection, new proposals have been put forth. The most prominent of these proposals favors an *ex ante* solution, where sovereigns are in effect licensed ahead of time in terms of odiousness. Here, if they insist, creditors have an opportunity to know in advance whether the debts that are being incurred are potentially suspect under the odiousness doctrine or not (and can either refrain from lending or

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<sup>15</sup> See Buchheit et al., *supra* note \_\_\_\_.

charge a higher interest rate).<sup>16</sup> In a modification of the foregoing proposal, creditors who wish to lend to regimes that have been pre-designated as odious can do so and still have their debts valid if they perform “due diligence” in terms of determining credibly that the proceeds of their loans are going toward non-odious purposes.<sup>17</sup>

This approach calls for a collective international body to make the odiousness determination. How should that body be designed? One area of importance involves the political versus legal nature of this body. Will it be a multilateral organization like the United Nations, which enjoys broad legitimacy but is nevertheless political? Or should it be a court that can predict fairly well how ex-post courts would decide on the odiousness issue? If it is a professional legal tribunal (as opposed to a political body), is there the need for the creation of a new Sovereign Bankruptcy regime or will existing municipal courts suffice? Another aspect implicated by the ex-ante approach is how centralized the decision making body ought to be. Some proposals call for a single centralized non-market decisionmaker (either a UN type licensor or a specialized sovereign bankruptcy court). Other proposals advocate a decentralized system where disputes conceivably could be resolved in a variety of jurisdictions, perhaps even the jurisdictions that the parties choose in their contracts.

A licensing system would provide creditors with much needed predictability. With greater predictability, non-odious debt would be cheaper and odious debt would be costlier, both desirable effects. The problem with an ex-ante licensing system is on a practical level. Can we expect an agreement by the majority of states over the creation of some international body that will be authorized to designate odiousness? Indeed, the Security Council already has the power

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<sup>16</sup> See Kremer & Jayachandran, *supra* note \_\_; see also Patrick Bolton & David Skeel, A Critique of the Odious Debt Doctrine, \_\_ J. L. & Contemp. Prob. \_\_ (forthcoming 2007) (attempting to propose a workable definition of what an odious regime might be).

<sup>17</sup> Jonathan Shafter, Applying the Odious Debts Doctrine While Preserving Legitimate Lending (draft dated December 2005) (forthcoming in *Ethics and International Affairs* (2006)).

to make such designations and chooses not to do so. Can this body have proper information about the odiousness of a particular debt or regime? If one believes that the primary problem in setting up such a legal regime is the detection of wrongdoing, then it may be that an ex ante determination is not just difficult to make, but highly error prone. And finally, can such determinations be made without excessive political bias especially when the odious regime is still in place and has the ability to make deals with other states with political power?<sup>18</sup>

It is not our purpose here to explore the different sides of the ex-ante licensing regime. Others have done it in their comparisons of ex ante versus ex post solutions.<sup>19</sup> We are skeptical about the practical viability of the ex ante licensing approach. Still, the interest that such a novel solution created is an indication of the need for a different regime than the existing one. In Section III to follow, we set out a framework that relies on ex-post adjudication—a more traditional approach—but one that addresses the concerns that the ex-ante regime tackled.

### **III. THE PARTIAL LIABILITY REGIME**

The analysis in this section, the core of the paper, seeks to answer two questions. First, who should bear the liability for the lost debt—the creditor or the populace? Second, to the extent that the creditors should bear some liability, what should be the magnitude of this burden?

#### **A. Comparative Fault**

There is a paradox in blaming either the creditor or the populace for the lost debt—for the fact that the despotic dictator stole from them. Both the populace and the creditors are *victims* of the wrongdoing by the dictator, not the perpetrators of the harm. Why should the victims be

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<sup>18</sup> The numerous institutional barriers to the setting up of an international regime to govern and police odious debts are discussed in Paul Stephan, *The Institutional Implications of an Odious Debt Doctrine*, J.L. & Contemp. Prob. \_\_\_ (forthcoming 2007).

<sup>19</sup> See Bolton & Skeel, *supra* note \_\_; see also Stephania Bonilla, *A Law and Economics Analysis of Odious Debts*, (draft dated 2006) (available on [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=946111](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=946111)).



blamed? Fault, under our analysis must be understood, then, as a relative judgment. Surely, the overthrown dictator is the ultimate blameworthy actor. But his disappearance makes this fact functionally irrelevant. What is left for the law to determine is the relative culpability of the disputing parties, the populace versus the creditors. Since the loss must fall somewhere, absent a third-party willing to provide a subsidy, one of these two parties must end up bearing it. It is between these two parties that relative fault matters. Who is more at fault for letting the dictator misuse the money or run away with it?

This problem, of allocating liability among secondary contributors is familiar in the law. Does the innocent buyer of stolen art work get to keep it, after the thief/seller disappeared with his money, or can the innocent original owner recover her painting? Does a person whose identity or checkbook were stolen have to pay for the purchases made by the thief, or do the banks or vendors bear this loss? Does a person who was the victim of defamatory materials that were wrongfully and anonymously posted on a website bear the loss, or should the operator of the website who allowed users to post content be held liable? In these situations, and many others, the purpose of the law is to identify the party who is comparatively more blameworthy and place liability on that party. It is usually the party who could have done more, *ex ante*, to prevent, detect, or insure against the loss.

Who, then, is more responsible for the dictator's opportunities to steal, the populace or the creditors? In an important set of circumstances, the creditors are more at fault because they have greater means to prevent this loss. They are the cheaper loss-avoiders. External creditors who make loans to sovereigns are often able, we argue, to exercise at least a minimal level of monitoring and control.<sup>20</sup> This monitoring and control can occur in several ways.

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<sup>20</sup> On the methods by which banks might be able to protect against odious debts, see Anita Ramasastry, *Directors, Banks and Odious Debts*, J.L. & Contemp. Prob. \_\_ forthcoming (2007).

*Observation and Exit:* Creditors are often able to observe the despot's intended use of the funds, as a byproduct of the credit transaction itself. For example, in a situation where the borrower insists on secrecy and asks for funds that are supposedly being borrowed on behalf of a sovereign to be deposited in a despot's personal offshore account, the creditor is likely able to observe the misbehavior at little or no cost. Control by the creditor can then be exercised, for example, by refusing to lend the funds, or by mandating a different deposit venue. Given that, in the scenario sketched out above, the creditors can at a low cost both observe signs of misbehavior and protect against it, it makes sense for them to be required to do so. Restricting the ability of creditors to recover on their loans under such conditions would incentivize creditors to exercise scrutiny and control; and it should be borne in mind that creditors are typically in the business of exercising precisely this type of scrutiny and control in the context of their non-sovereign lending.

*Disclosure and Empowerment:* Creditors can also exercise control via third parties; specifically, third parties who do not have access to information, but might act (or threaten action) if provided with that information. The most relevant third-party here is the populace of the sovereign debtor. Creditors could make public disclosures of the fact of the loans being made and of the purported reasons for the borrowing. Those disclosures would be made using information that the creditors would demand from the debtor as a condition of making the loan; information that the government might not be otherwise be providing the populace.<sup>21</sup> When loans involve disbursements over an extended period of time, creditors can require periodic disclosures as to the results of the investments that were made. If, say, loans were taken out in

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<sup>21</sup> This appears to be the basic idea behind the Publish What You Pay ("PWYP") initiative. Under the PYWP, a group of thirty NGOs have requested companies doing business in resource-rich developing countries to disclose publicly what they are paying for resources such as oil, gas and minerals. The idea being that the sovereigns will be less likely to misbehave if they are more accountable. For details, see <http://www.publishwhatyoupay.org/english/>

order to build chicken farms, periodic public disclosure of the number of eggs produced could be required so that the public would be able to evaluate the efficacy of expenditures supposedly made in its interest. Public disclosure – especially when it can effect coordination among the disaffected members of a populace – can be a cheap and effective means of empowerment. And from the perspective of the creditors, requiring disclosure is not only going to be a cheap matter, but to the extent it produces constraint and better behavior on the part of the sovereign borrower -- despotic tendencies might be reduced if the public is watching -- it might be value-enhancing.

*Governance:* The third set of actions creditors can take fall into the governance category. As corporate finance scholars observe, creditors engage not only in exit but also in voice.<sup>22</sup> And these rights to exercise voice come in the form of a combination of covenants and events of default. The presence of these rights to exercise voice is important because the lending relationship is rarely going to be a zero-one (good-bad) proposition. In any sovereign lending relationship, when money is about to be lent, the borrower will likely strive to show himself to be pure of heart and intending to invest the funds to serve the populace and increase economic growth.<sup>23</sup> Signs of trouble typically appear subsequently, when funds begin to move from the creditor to the debtor. Initial signs will not tell the full story; trouble may be brewing, but will likely not have emerged full blown. Creditors can negotiate, ex ante, for control rights to kick in when these initial indications show themselves – indications that funds may be being diverted to ill uses – for heightened involvement or control of the project. For example, debtors can be required to engage external expert monitors to evaluate whether specified milestones for the project are met. If those milestones are not met, either additional control rights for the creditor

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<sup>22</sup> See, e.g., George G. Triantis & Ronald J. Daniels, The Role of Debt in Interactive Corporate Governance, 83 Cal. L. Rev. 1073 (1995).

<sup>23</sup> That is, unless the lender is explicitly colluding with the despot to enable the stealing from the populace. But this is the extreme case where the creditor's fault in the matter is readily apparent.

kick in or else the debt gets accelerated. And, if one debtor accelerates, typically every other debtor will accelerate as well. The result is that creditors have a rather big stick with which to reign in misbehavior when initial signs of bad behavior show up.<sup>24</sup>

*Demand Adequate Assurances.* Even if not engraved into the initial debt contract, creditors can often be in a position to demand from the debtor adequate assurances that the funds are used in a legitimate manner. Similar to the right of parties to a sale contract to seek adequate assurances of performance any time they have reasonable grounds for insecurity,<sup>25</sup> creditors can request their sovereign debtor to issue proof as to the manner in which funds are being used, and to make these statements public. Thus, to solidify a doctrine that would place some liability on creditors, it might be sensible for the Official Sector (that is, institutions such as the IMF and the World Bank) to supplement private credit agreements with a generalized requirement that that, perhaps as a condition of IMF or World Bank membership, grants creditors various rights to seek information and assurances in the course of the relationship, anytime prior to the full repayment of the debt, as long as some grounds for insecurity exist.

These actions are only a partial list of the monitoring measures available to creditors. In addition, external creditors are likely better able than the populace to diversify the risk of a misbehaving despot. This, to be sure, suggests that the added liability would be factored into the cost of credit, making it selectively more costly and less affordable to regimes that pose a greater risk of invoking the proposed defense ex post (we will discuss this effect in more detail below.)

We are careful, however, not to make an empirical claim about the prevalence of such

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<sup>24</sup> Actions that creditors could take, in terms of contract-based governance are discussed in Adam Feibelman, *Contract, Priority and Odious Debts*, \_\_ N.C. L. Rev. \_\_ (forthcoming 2007). Feibelman differs from us in that he is optimistic that creditors are likely to, on their own or with the assistance of the official sector, make these contractual reforms to police odious debt even in the absence of a legal regime that pushes them to coordinate such a reform. *Id.*

<sup>25</sup> Uniform Commercial Code 2-609

monitoring opportunities. It is not our claim that effective measures always exist. Rather, the claim is that *to the extent that it can be shown ex-post that such effective measures did exist and yet were not taken, courts adjudicating the debt claim should not ignore that information.*

Measuring the creditors' negligence though is only one side of the equation. Creditors' fault eventually has to be compared to the fault of the other party to the current litigation, the populace. Generally, however, the populace does not have effective ways to scrutinize or make a fuss over the use of the funds (unless the disclosure of certain information results in the populace coordinating to conduct an overthrow). The dictator has taken away the ability of the populace to acquire information about the use of the money, and more importantly to do anything about it. The populace might suspect—in fact, it might know for sure—that their leader is stealing money borrowed from creditors. But absent some coordinating mechanism, there is nothing individual members of the populace can do.

A few more general comments are in order. First, the problem of placing liability on the cheaper loss avoider or insurer is not restricted to only two candidates, the populace versus the creditors. There are other actors who either help the despot cause the harm, or can be instrumental in avoiding it. Despots do not usually act alone in enacting their oppression. They need the support from some actors among the populace who participate in odious transactions (e.g., sell arms that are then used to suppress a peaceful pro-democracy protest); they need for states to recognize the despotic regime and cooperate with it; they need for international groups to fail to note the brutality of the regime; and so on.<sup>26</sup> If creditors can supposedly monitor and control some aspect of the behavior of the despotic regime, is it not the case that other groups

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<sup>26</sup> See 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).

and entities can also engage in some monitoring, and ought to be incentivized by the threat of liability?

Indeed, some of the actors that interact with the odious regime may be able to take better care and avoid contributing to the harm inflicted by the regime. Creditors, in this sense, are not different than, say, weapons manufacturers, consultants, and the like. It may well be that a cause of action ought to lie against such contributory actors, shifting the cost of the harm done with their contribution or complacency from the populace that suffered it to them. To the extent that cheap prevention and precautionary actions can be taken, the same argument that we develop here would justify liability on these actors.

Second, creditors' liability, under this framework, operates merely as a defense against their claim to recover the debt. For one, it is not an independent tort for which the populace can affirmatively recover.<sup>27</sup> It merely applies, at most, to the debt the creditors are seeking to recover. Moreover, as a defense to the otherwise strict liability of the borrowing entity, it is based on negligence—that is, on the demonstrated failure of the creditors to take due care. The reason why creditors' liability ought to be based on negligence (and not be strict) has to do with the purpose of liability. As we see it, the purpose of placing the burden on creditors is to induce care. In fact, in many situations, the required level of care is fairly small and not costly. If the small amount of care results in insulation from significant liability, it is likely that the creditor will exercise it. The purpose of liability is *not* to shift the entire cost of the forfeited funds to the creditors, which is what strict liability would effectuate. If creditors were liable regardless of how much care they took, any lost loan to an odious regime would be forfeited. The implications of such a rule would be far reaching in terms of interest rates and the ability of dictatorships to

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<sup>27</sup> In this sense, the liability regime proposed here differs than proposals to place liability on creditors and credit card issuers in domestic markets for what some commentators view as 'reckless lending.' See, e.g., John A.E. Pottow, [insert title] \_\_\_\_ U. Ill. L. Rev. \_\_\_\_ (forthcoming, 2007).

make any kind of borrowing (the “activity level” effect, as it is known in the economics of tort law.) This is not the place to weigh whether such constrictions on the activity of dictatorships are desirable or not. Surely, arguments can be made that suffocating the credit lines of an odious state can have either desirable effects (e.g., increasing internal pressures to change the regime, reducing the incentive to capture control of state) as well as undesirable effects (e.g., increasing the distress of the populace). The point here is that strict liability would have an effect beyond inducing creditors’ care. It would shift much of cost of the odious regime to creditors. It would probably have a crushing effect on lending activity to dictatorships.<sup>28</sup>

In sum, the argument in this section is simple: place liability on the least cost avoider. If creditors are the better preventers of the loss—if the government that succeeded the dictator can show that creditors failed to take due care and to monitor the funds that were stolen—creditors should bear the loss of their failure to take care. In the next section, we turn to discuss the magnitude of creditors’ liability.

## **B. Comparative Benefit**

Not all borrowing by a despotic regime will be bad. While some of the borrowed funds end up stolen by the odious dictator, often portions of it are channeled to desirable purposes. In fact, both the legitimate and illegitimate uses are often tied together in the same transaction. Money that is borrowed to, say, build bridges and schools, is partially used to that end and partially stolen by the corrupt dictator and its bureaucracy. It is rare for modern despots to steal all of the funds that an external lender might provide (even Saddam built hospitals). At worst, a

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<sup>28</sup> On the crushing effect of strict liability, see Steven Shavell, *Strict Liability versus Negligence*, 9 J. Legal Stud. 1 (1980).

fraction goes into the despot's pockets. That means that at least some goes to serve the oppressed public.

If the funds borrowed from a specific creditor were all channeled to a legitimate purpose, there would be no reason for leveling any type of liability on that creditor. (We set aside, for the time being, the possibility that this borrowing made it possible for the dictator to steal from other sources, such as tax revenues. This possibility is discussed below.) In other words, creditors' liability ought to be associated with the social harm from their acts. If there is no social harm—if the money was used for purposes other than the dictator's self enrichment—there is no ground for liability. There is no reason to induce creditors to engage in monitoring if, even in the absence of monitoring, the funds are used legitimately. It is only the fraction of the funds that were stolen that should potentially give rise to liability (and even then, as we said above, only if the creditors were negligent.)

The liability rule should give an incentive for creditors to ensure that their funds produce benefits. One way to do this is to reward creditors whose funds provide benefits with insulation from liability. The question is how much insulation is required. Under the Sackian odious debt doctrine, even a tiny benefit to the populace insulates the entire debt amount from the odious debt defense.<sup>29</sup> That provides nothing but the most minimal incentive for creditors. Under our framework, instead, creditors whose debts provide greater benefits should get greater amounts of the debts insulated from liability. This way, creditors have an incentive to demand credible information from the debtor demonstrating that the funds produced benefits. The greater the demonstration of benefit, the better the insulation from odious debt liability. In the end, creditors ought to be liable only for the fraction of the debt that did not serve legitimate benefits. Their liability extends in magnitude solely to the funds that were stolen or otherwise used in an odious

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<sup>29</sup> See Buchheit et al. *supra* note \_\_\_\_.



fashion. Put differently, if the debtor can demonstrate positive uses for the funds – such as hospitals and schools – there seems to be little need to impose monitoring responsibilities on creditors.

The insulation from liability is akin to a security interest. To the extent the creditor can demonstrate that there was a benefit from its loans, a portion of its loan gets protection/security against the odious debt defense. And, as with a piece of collateral, that reduces monitoring responsibilities for the creditor (they only have to watch over the collateral), creditors who can ensure that there was a benefit derived from their loan reduce their need to monitor the general misbehavior of the debtor. Indeed, what should happen under such a regime is that external creditors will begin to make loans only for projects where corruption and graft are minimal and where the positive benefits from the use of the loan's proceeds (for example, the number of liters of milk produced from a cattle farm or number of children graduating from school), are readily visible. More fuzzy projects where easily measured output benefits do not exist will become disfavored by external creditors

The critical question is how to measure benefit. It is, in a sense, the flip side of the problem of how to measure harm. Benefits from protecting a group of starving children from death are arguably incommensurable. But there is simultaneously the matter of those same funds having perpetuated the despot's reign; allowing him to starve even more children equates to commensurate harm.

Although measuring output (harm or benefit) may be difficult, measuring input may not be as difficult. The problem we have is akin to the familiar problem in labor economics of measuring a worker's output. In situations where output is difficult to evaluate, employers will often reward employees according to input instead (lawyers, for example, are often paid on the

basis of the number of hours they work). Moving that analogy to the current problem, if we look at benefits in terms of how many dollars from a loan went into the production of benefit, we get a measurable quantity. One does not any longer have to worry about how many starving children were saved or even whether the children were starving. The question is simply that of what fraction of the debt went to providing benefits. The downside here is that creditors do not have an incentive to ensure that their dollars go to the uses that produce the maximal benefits. The upside is that the creditors cannot argue that the fact that a small amount of their dollars provide a large benefit to some starving children justifies them having allowed the despot to steal a large fraction of the loan. Under our input measurement scheme, the amount of dollars going to provide benefits would be the amount of liability insulation, no more.

### **C. Partial liability: Breaking the All-or-Nothing Structure of the Odious Debt Doctrine**

The sum of the two elements above – liability for the failure to exercise due care and security when the provision of benefit is assured – produces a partial liability regime. Under this regime, creditors are liable for portions of the debt that are obviously being used for the sole benefit of the despotic leader. The same is true with portions of the debt that are used to pay bribes and such (the corrupt payments that the lender makes so as to induce the lending).

Liability becomes more complicated when some portion of the debt is being used for problematic purposes, such as paying the salaries of the police who then do the work of putting down public demonstrations or purchasing weapons for the military to ostensibly defend the nation. Here, liability will need to be apportioned based on comparative fault of the various misbehaving parties involved. On the flip side, under this partial liability regime, creditors are fully immune from liability for the portion of the debt that was used to benefit the populace.

This rule breaks the existing all-or-nothing structure of creditors' liability. Currently, the rule of strict governmental succession is one where the debtor nation is always liable, despotic debts or not. That is, zero lender liability. As noted at the outset, under the Sackian odious debt doctrine, if certain conditions are met, lenders must bear full liability.<sup>30</sup> Between these two polar solutions, there is no occasion for intermediate liability, no sharing rule, no balancing of the conflicting objectives. Either full debtor liability or full creditor liability; there is no partial odiousness.<sup>31</sup> The problem with this structure is that it leaves not enough room to make comparative judgments of fault. Some creditors might know perfectly well that the loans go to despots and will be used in a bad way. Other creditors might only suspect but do not know for sure. Others, still, suspect that only a fraction of the loan will be misdirected, the other fraction to be used for good purposes. Moreover, creditors may have different degrees of suspicion, some more and other less certain about the bad use of the money. Finally, and perhaps most importantly, some creditors can do something about their suspicions and monitor the use of the funds. Should all these creditors be treated alike? Should the law ignore this information about the relative odiousness of the debt? Shouldn't debtors get at least a partial break in some of these situations? The most basic feature of the odious debt regime that we discussed above is the *division of liability*: its departure from the rigid structure of all-or-nothing underlying existing doctrine.

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<sup>30</sup> See discussion *supra* at \_\_\_\_.

<sup>31</sup> The modern literature on Odious Debt follows this all-or-nothing approach, with some taking the position that there should be no odious debt liability ever for creditors and others proposing full forgiveness under a certain set of conditions (or at least, burden shifting to the creditors to have to prove non odiousness). More specifically, even if some of these commentators implicitly envision a partial odiousness scheme, we are not aware of any discussions of it. For examples of contemporary commentators calling for the implementation of something akin to the Sackian all-or-nothing scheme, see, e.g., Patricia Adams, *Odious Debts: Loose Lending, Corruption and the Third World's Environmental Legacy* (1991); Noreena Hertz, *The Debt Threat: How Debt is Destroying the Third World* Chapter 8 (2004). This all-or-nothing feature is also characteristic of agency law, that a some modern commentators have proposed be used (at least by analogy) in the contemporary odious debt context. See Deborah DeMott, *Agency by Analogy: The Odious Debt Context* \_\_ L. & Contemp. Probl. \_\_ (forthcoming 2007) (suggesting that the all-or-nothing characteristic of agency law makes it an unattractive tool in many contexts).

The criterion for apportioning liability here is creditors' misbehavior; it is not the fact that the debtor is very poor and cannot bear the burden of repayment. This latter "bankruptcy" justification for debt forgiveness may apply independently and in addition to the fault-based forgiveness regime. In fact, to the extent that the debtor cannot pay back all its debt, it becomes all the more critical to apply a criterion for priority among creditors. One can thus view our proposal as a comparative fault scheme, not only between the debtor and a given creditor, but also *among the competing creditors*. Those creditors who are less at fault can recover more of their debt. While the fact that a loan is given to an excessively poor country is not the basis for relief, it is also not irrelevant in our framework. The poverty of the debtor does not directly indicate blameworthiness, but it is a factor that should raise the level of due care on part of the creditors. That is, when lending to a desolate state captured by a despotic ruler, creditors have to be all the more careful and inquisitive. In these dire situations, there are so many ways for the funds to benefit the populace of the recipient state; creditors can more easily demand affirmative assurances that the money is used legitimately.

#### **IV. IMPLEMENTATION ISSUES**

Proposing a partial liability scheme may sound plausible in theory. But where the rubber meets the road is in terms of implementability. An all-or-nothing regime does have the advantage of being simpler. An intermediate liability regime adds new factors on which the legal consequences depend, making it more complex. In this section, we work through several complexity and implementation questions and address some of the principal objections.

##### **A. The Availability of Substitute Pools from Which to Steal**

Even if imposing liability on creditors would force them to monitor and would ensure that the borrowed funds are used for legitimate purposes, stealing by the despot might not diminish. Now, instead of stealing from borrowed money, he would steal from other resources, such as tax revenues or foreign grants. Put differently, the more the despot is driven to apply the borrowed funds to essential uses that benefit the public, the more of the tax revenues and other forms of revenue that are “freed” to be skimmed. While debt would be monitored by creditors, tax and grant revenue is not. Thus, under this scenario, liability on creditors would not be effective in reducing the theft. In fact, it would only operate to increase interest rates and reduce borrowing.

This argument assumes that the different sources of revenue are perfect substitute resources for the purpose of theft by the despot. There are reasons why this assumption might be false. Consider, first, the substitution between credit and tax. Tax revenues tend to be relatively visible and therefore harder for the despot to steal without raising ire; external borrowing is relatively opaque and easy to pilfer. Tax revenues have to be collected internally by local tax agents. There will have to be processes in place to make sure that those revenues are accounted for, so that local agents do not steal the funds. By the time the funds get to the level of the despot, it would be difficult to steal without people noticing. By contrast, external borrowing is relatively easy to steal. The funds come more directly to the despot than tax revenues. Thus, a dictator who stays in power by keeping the collective from rebelling against him must pick his opportunities to steal in a way that is less exposed, that hides from the public the true extent of his misbehavior.

Further, internationally borrowed funds arrive in foreign currency. Tax revenues, on the other hand, are collected in local money and have to be converted into a foreign currency before

they could be meaningfully stolen by the despot (who we assume is planning to squirrel away his ill gotten gains in some foreign jurisdiction). If the despot targeted tax revenues, he would face the additional hurdle of converting large sums of money, possibly exposing the corruption, and likely wreaking havoc with the exchange rate and, in turn, bringing about additional distortions on the economy. By contrast, stealing a portion of the proceeds of an external loan, where the stealing occurs in the Caymans or Switzerland, is going to attract less attention.

Finally, stealing debt is easier than stealing tax revenues because the populace cares less. When tax revenues are skimmed, it is the current generation that pays. When debt revenues are skimmed, it is the future generation (that will have to pay the debt) which bears the burden. So long as the current generation does not feel its pocket directly picked, it might not be as likely to revolt. Indeed, the clever despot will borrow on behalf of later generations and spend some of the proceeds of that borrowing to the current generation and steal the remainder. Thus, to the extent that public outcry is one mechanism that disciplines theft, it is more effective when the stealing targets tax money.<sup>32</sup>

What about stealing from foreign grant money? Anna Gelpern points out that the majority of borrowing by contemporary despots like Saddam Hussein and Sani Abacha was in the form of official credit.<sup>33</sup> Other sovereigns provide grants (albeit formally structured as loans) that are often designed to help the despot stay in power so that he can continue serving the interests of the donor country. Would a dictator who is monitored by his commercial lenders target instead the country's foreign aid?

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<sup>32</sup> The subject of why governments are reluctant to tax and prefer to borrow has, as one might expect, been much discussed in the tax literature. See, e.g., Daniel Shaviro, *Reckless Disregard: The Bush Administration's Policy of Cutting Taxes in the Face of an Enormous Fiscal Gap*, XLV B.C.L.Rev. 1285 (2004); Neil Buchanan, *Social Security, Generational Justice, and Long-Term Deficits*, 58 Tax L.Rev. 275 (2005).

<sup>33</sup> With Iraq, private credits made up approximately \$20 billion of the \$120 billion in unpaid debts that the Saddam regime had accumulated at the time of his overthrow. See Gelpern, *Odious, Not Debt*, \_\_ J. L. & Contemp. Prob. \_\_ (forthcoming 2007).

True, greedy despots might turn and skim off some of the foreign aid. If this foreign aid was in the form of credit, the successor government might want to have a similar defense against repayment as it has vis-à-vis commercial creditors. But since foreign aid is largely in the form of grants, the potential for increased stealing from this source is not as bothersome. It does not raise the repayment burden on the populace, nor the tax burden. It might come at the expense of other, more essential projects that were meant to be financed by the grant money and to benefit the populace. But here again a donor state who cares that its support money benefit the oppressed populace can take affirmative steps to monitor the use of the grant. Indeed, stealing from foreign credit or grant is often more difficult than from external private credits because (a) foreign governments typically want something significant for their support (oil, suppression of Islamic or other political movements) and (b) foreign governments can monitor their funds quite well.

A fuller treatment of the substitution problem would recognize that the choice of where to steal from for a despot is generally wider than taxes, grants, or external credit. Often, the country will have other sources of income such as export revenues (e.g., diamond exports from Sierra Leone, oil from Venezuela, cocoa from Ghana, copper from the Congo) that are also susceptible to stealing. But the basic point should hold; that external sources of funds—money received from lenders and buyers in foreign currency on foreign land—is far more attractive (or available) to steal from than money raised through an internal bureaucracy from local sources in local currency.

## **B. Distinguishing Between Legitimate and Illegitimate Uses of Funds**

With any scheme imposing liability on creditors for a failure to monitor, a threshold question will be that of how creditors are to distinguish between legitimate and illegitimate uses

of funds. Even some of the most despotic uses of funds (such as purchases of arms to assist the despot's military or the building of a giant statue of the despot on a horse) can have legitimate aspects (the military keeps the peace and these statues someday become tourist attractions). Are credit institutions capable of making these determinations; of figuring out what uses of funds are legitimate? The liability scheme then presents the danger of forcing them to be excessively cautious in their lending decisions; that is, lending only where the legitimacy of the project is certain.

There are two points worth making here. First, the foregoing problem is a different manifestation of the problem that the creditors are limited in their abilities to police wrongdoing. This is why the optimal liability scheme needs to be calibrated so as to require them to take action only when reasonable. If the dictator is in the middle of a ruthless repression of an ethnic minority, where he is using illegal poisonous gas, creditors should probably pay attention to the fact that the letter of credit is being used to purchase additional canisters of this chemical. But due care on the part of creditors will not enable them to control every transaction.

The second point is that even if creditors are excessively strict in demanding that funds from their lending be used for purposes that are clearly legitimate (e.g., only for chicken farms where the output is distributed equitably among the populace by internationally recognized NGOs), this is not necessarily bad. If the despot thinks that a high-risk project (that is, with a high stealing potential if done using external financing) is in the interest of the populace, he still has access to tax revenues. He may not like using tax revenue because the level of monitoring and control exercised by his populace vis-à-vis the use of those revenues is going to be high as compared to external debt. But the populace will likely prefer the second scenario, where the despot's spending, especially in terms of pet projects or general expenditures, is controlled. The



optimal system then, from the point of view of the populace, will be one where the despot is restricted from financing projects with a high stealing potential using external debt. For those projects, he needs to go to the tax revenues and justify the spending to his inevitably skeptical and risk-averse public.<sup>34</sup>

We still have not answered the question of what to do about the ambiguous cases. Working through an example will help illustrate. Take the example mentioned above, of spending for military equipment. Given that a significant portion of odious lending likely occurs so as to fund military spending, the example is particularly apt for any discussion of how creditors would detect odious debts.<sup>35</sup> Military spending could arguably be for purposes of protecting against external threats or internal protests that destabilize the economy; but they also could also be used to oppress peaceful internal dissent seeking to overthrow an evil despot. How should a creditor evaluate such a case, especially given that it is often possible that the spending could be applied to both purposes?<sup>36</sup>

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<sup>34</sup> The populace may be relatively powerless under the despot, but the despot is always going to be worried that something will happen to solve the collective action problem and produce an uprising. More sophisticated expositions of the basic idea that what despots fear is being overthrown look to the types of groups that are most likely to lead an uprising (e.g., the military or some political party) and the question of how the despot either coopts or suppresses them so as to stay in power. See, e.g., Bueno de Mesquita, et al., *The Logic of Political Survival* (2003);

<sup>35</sup> In response to our draft, a leading expert in sovereign lending estimated for us that approximately 80% of what would qualify as odious lending was likely in the form of funding for military spending. Email dated 12/25/06 (on file with authors). There is, of course, a long history of scholarship pointing to the involvement of large banks in the funding of wars around the globe. The classic work on this topic being, H.C. Engelbrecht & F.C. Hanigen, *Merchants of Death: A Study of the International Armament Industry* (1934); see also T. Hunt Tooley, *Merchants of Death Revisited: Armaments, Bankers and the First World War*, 19 *J. Libertarian Stud.* 37 (2005).

<sup>36</sup> Military spending is potentially problematic for at least three reasons. First, the items are typically big ticket matters (jet planes, warships, tanks) that have no clearly defined market price. The lack of a visible market price means that outside observers will find it hard to tell, for example, whether a warship really cost \$600 million or \$800 million. Second, the government has the ready excuse of “national security” for keeping matters secret from both the creditors and the public. So, if the planes are second-rate and keep crashing into the ocean, the public might never know that the \$80 million plane was really a \$8 million bucket of bolts. Vis-à-vis the hypothetical bank issuing, for example, a letter of credit, it is likely that the invoice for arms will not specify “poison gas”, but will rather say something vague along the lines of “special equipment.” Third, this is an item that can always be used to harm the populace. Chicken farms or children’s hospitals, by contrast, are do not present similar dangers.

In light of this ambiguity, of the difficulty in drawing the line between legitimate and illegitimate uses, it might be tempting to say that creditors should be in the clear in such cases. After all, determinations of whether military expenditures are needed are matters of sovereignty, the kinds of matters that foreign creditors lack expertise in deciding.<sup>37</sup> But perhaps our liability regime offers, once again, a way out of the zero-one determinations. What is needed is better information regarding the actual use of the military borrowing. Where the potential use of loan proceeds is ambiguous and there is a high danger of despotic behavior, creditors should demand additional information. With more information at hand, creditors may be able to exercise prudence in the release of funds.<sup>38</sup> The information might not always enable them to discern the legitimacy of the use of the funds. But demanding it would at least go a significant distance towards satisfying the due care burden.

Perhaps there is room for hardened presumptions regarding military lending. Because of the likelihood of corruption, the potential lack of public disclosure, and the possibility of the goods being used to harm the populace, such credit is known by most creditors to be suspect, and it should be made only with greater reluctance. To induce this reluctance, ex post scrutiny of such funding should be heightened. This way, creditors will not as easily accept the excuse that the nature of the goods and their quality cannot be disclosed for reasons of national security. Of course, heightened skepticism by a court about the legitimacy of military spending is going to raise the cost of capital. That means that when it comes to military spending, those with despotic

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<sup>37</sup> For example, in the scheme set out by Buchheit, Gulati and Thompson, lenders for military spending would probably find themselves immune because of the lack of clear evidence of wrongdoing. See Buchheit et al., *supra* note \_\_\_\_.

<sup>38</sup> Seventy years ago, Charles Cheney Hyde made precisely this point in his admonition to lenders where he explained to lenders that allowing ambiguity in the use of proceeds was an invitation to later repudiation by debtors. See Hyde, *supra* note \_\_\_\_\_. Hyde was not saying that lenders should bear such a burden, rather that the climate of the time was such that a failure to exercise care might result in repudiation. He then goes on to lecture creditors on the prudent measures they should take when arranging the loans. *Id.* at \_\_\_\_.

tendencies will be forced to look to tax revenues; a place where scrutiny will be more exacting and vague assertions of national security as a justification for secrecy will be less effective.

### **C. Monitoring Abilities of Bondholders versus Banks**

Determining whether the creditors knew or should have known of the regime's propensity for misbehavior is often going to be a difficult question. There will be the occasional easy cases where the creditors directly deposit the loan proceeds into the personal Swiss bank account of the despot; there, we can safely say that the creditors knew or should have known that stealing was occurring. Those cases were likely easier to find in the days when sovereigns located most of their financing from large multinational banks (and that was the case in the period when Alexander Sack coined the term "odious debt"). But a large portion of sovereign debt today is in the form of bonds. These are liquid instruments and the individual holders are often atomistic and don't even know what bond they are holding in their portfolios at any given point in time. The argument can be made that not only are these creditors unlikely to know much about the behavior of the governments that they are lending to, but that the original creditors who did the lending are almost never going to be the ones eventually suing to get paid on their debt instruments. From the perspective of a legal regime, it might be conjectured that the cost of determining what creditors knew or should have known are insurmountable. Assuming that any given sovereign is likely to have thousands of creditors scattered around the world at any given time, it seems impossible to make determinations of what these creditors knew at the time the loans were made. How then, can liability be placed on decentralized uninformed investors?

As we explain below, the presence of an active and liquid bond market may ultimately provide more solutions than problems for the institution of a creditor liability regime. It should be noted, though, that despotic borrowing is rarely in the form of bonds (Saddam's \$130 billion debt, for example, had no bond debt in it at all). And although the question has not been studied, the fact that any bond issue, but especially SEC-registered offerings, requires due diligence by the underwriters, likely results in reduced enthusiasm from despots for such debt.

More importantly, even if sovereign bonds are to be issued by a despotic regime, information about the liability risk would be reflected in the price of the security. As is well known, when small investors participate in many small-scale market trades—of any kind of security or tradable commodity—it is never the case that each individual investor must obtain full information about the fundamental economic value of the traded asset. When efficient markets develop for such assets, they reflect all publicly available information in the market prices. Sophisticated traders, brokers, and various information intermediaries obtain chunks of information about the value of assets. Their own buy-or-sell decisions provide the aggregate information to uninformed, unsophisticated individual traders.

This is true in particular for bond markets. If the market is active and recognizes that certain types of debts will be less likely to be repaid (for example, because the populace has not benefited from the debt in question and/or there was corruption involved in the creation of the debt), then the market will incorporate that information into the price. If information as to despotism is important for pricing – as the threat of liability will force it to be -- then there will be an incentive for institutions to emerge that can acquire, assess, and sell this information. Other institutions might emerge to provide insurance for this particular type of risk; for example, swap contracts where the risk of odious debt liability is exchanged.

The point is that creditors in an active market will not actually do any of the monitoring of debtors themselves. Creditors will be able to purchase different types of bonds. There might be costlier bonds that are certified to be free of odious debt liability; or ones that are bundled with liability insurance. In the same way that bondholders purchase municipal bonds of entities with which they have no familiarity, whereby they rely on market institutions like underwriters and rating agencies to collect the necessary information and sell it to them, bondholders purchasing sovereign debt will rely on sophisticated intermediaries to ascertain the odious debt liability risk.<sup>39</sup>

Non-market institutions are also likely to play a role in taking on monitoring tasks; especially if there is a need for ongoing monitoring of projects. To the extent multilateral development banks (MDBs) like the World Bank begin monitoring for corruption -- and this is something that the World Bank, under Paul Wolfowitz, has already begun to do in spades<sup>40</sup>-- monitoring may be delegated to these organizations. This delegation would produce what one might call a multiplier effect vis-à-vis the World Bank's current anti-corruption efforts. Most sovereign bonds already specify that it is an event of default under that contracts for the

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<sup>39</sup> Intermediaries who are in the business of ascertaining compliance with standards is not a feature of our imagination, but an industry that already exists. For example, firms operating in today's global economy often have to outsource portions of their production into countries where traditional enforcement mechanisms such as courts are underdeveloped. That means that these firms have to use alternative mechanisms to ensure that they receive high quality products and other assurances that they need with respect to matters such as labor practices and pollution. To provide the necessary ongoing monitoring, an entire "assurance" industry has developed that is a combination of private assurance providers and NGOs. See Margaret Blair et al., *The Role of Assurance Services in Global Commerce* (draft dated February 26, 2007, on file with authors), who observe that one of the earliest uses of "assurance" services may have been in a sovereign context, where boards of state accountants verified state revenues and expenditures in ancient Athens 500 to 300 B.C. *Id.* at \_\_\_ (citing George J. Costouros, *Auditing the Athenian State of the Golden Age (500-300 B.C.)*, *The Accounting Historian's Journal*, Spring 1978 at 41-50). What creditors would be looking for in our regime are the services of similar assurance firms; firms who would monitor the use of the money.

<sup>40</sup> See Damle, *supra* note \_\_\_ (describing the recent efforts by the World Bank police state corruption by restricting funds in circumstances where corruption levels are deemed high).

sovereign to lose either its membership of the IMF or its eligibility to draw from the IMF.<sup>41</sup> If the World Bank were to continue policing states for corruption levels, creditors could write in a similar event of default with respect to the Bank or other MDBs.<sup>42</sup>

If, under our proposed creditor liability regime, private lending institutions develop odiousness risk rating for sovereign bonds and price these bonds accordingly, this will begin to resemble the ex-ante certification mechanism proposed by Kremer and Jayachandran.<sup>43</sup> As in their regime, here too the original lending decision will be conditioned on the absence of odiousness (defined in governance terms). If the sovereign passes the test at the initial stage, the lender need have little fear of a subsequent legal challenge based on odious debt grounds. The difference from the Kremer and Jayachandran idea is that no official international institution needs to determine which are the odious regimes. Instead of a centralized political body making this decision and facing controversy and legitimacy concerns, here it is a decentralized assesment made by the market, manifested by whether the MDBs are prepared to lend.

#### **D. Ex-Post Verification and Other Problems in Adjudication**

For a liability scheme to work, the court or other adjudicator has to have enough information to make decisions. Inadequate information will result in erroneous decisions.

Specifically, courts will need good information after the fact to determine (1) what creditors

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<sup>41</sup> See George Triantis & G. Mitu Gulati, *The Economics of Creditor Control: Sovereign versus Corporate Lending*, \_\_U. Cin. L. Rev. \_\_ (forthcoming 2007).

<sup>42</sup> For the foregoing to happen effectively though, the Bank would have to work at engineering at least four actions. First, provide reasonably clear guidance on its policies regarding lending to governance-challenged countries. Second, promise to be more transparent for its reasons for disapproval of a borrowing request. And third, action by private sector lenders (perhaps with the assistance of trade associations) to include in debt contracts (a) a condition precedent to drawdown that the country not have been refused a drawing under an MDB facility based on governance problems and possibly (b) an event of default triggered by an inability to draw from the MDBs for, say, a period of nine months as a result of governance issues. Finally, the event of default point would be strengthened significantly if the Bank were to itself have a similar event of default in its own debt contracts. If the coverage were widespread enough in the market, sovereigns would have a huge incentive to clean up corruption. They could no longer play off the official and private lenders against each other, which is what happens now.

<sup>43</sup> See Kremer & Jayachandran, *supra* note \_\_.

knew or should have known and (2) what benefits ensued from the debt. Creditors, it can easily be imagined, would likely deny in court that they had the ability or information to monitor the borrower, even when they had. And successor governments would likely argue that the debt was odious and unbeneficial to the populace, even when it was not.

The fact that courts might make errors and fail to make accurate determinations of liability and its magnitude is not necessarily an argument against the proposed partial liability regime. Any regime imposes errors, even if it does not require courts to affirmatively assess liability. The current regime of no odious debt liability is no exception. It makes the most extreme “error” of one type (the error of failure to inflict liability when it is socially desirable); and at the same time, the current regime makes zero errors of the second type (the error labeling a legitimate debt odious and relieving states from a socially desirable obligation to pay it back.) A shift towards some liability on creditors would reduce the first type of error and increase the second type.

Is the ex-post liability regime more prone to error than other mechanisms that have been proposed, such as the ex-ante certification regime? Probably not. It is likely that information about the way funds were used is easier to dig out after the fact, after the odious regime was thrown out, than during its tenure. When the despot is in power, he has control of the state police machinery and is presumably using it to further the corruption. Outside investigations can be conducted, but those investigations are inevitably difficult if the state in question is seeking to hide information. Think of any one of the recent attempts by external investigators to determine the extent of some rogue state’s WMD or nuclear capabilities (not only are these investigations near impossible to conduct, but the results of the investigations can produce some significant errors). By contrast, once the despot has been removed from office and the new regime is

seeking to determine how much corruption there was, there are often strong incentives for those with information – for example, those members of the prior regime who want to demonstrate that they are distancing themselves from the prior regime – to come forward. The Oil-for-Food Program investigation led by Paul Volker is a recent example of how such an investigation done, after regime change, can yield enormous results.

Good information as to benefit to the populace from the loans is also more likely to be available after the despot has been dethroned. While the despot is in power he is going to seek to spin the evidence to demonstrate that the loan proceeds are being used for the benefit for the populace. And the creditors, at least the misbehaving ones, have every incentive to help the despot produce evidence suggesting that the project in question was a legitimate, welfare enhancing one.<sup>44</sup> After the despot is gone, information is available about whether the ostensible purpose for which moneys were borrowed was false or not. Imagine an arms purchase – a favorite loan driven purchase of despots who are seeking to siphon off money into their personal accounts. In theory, arms purchases could be a legitimate benefit and it is hard to know in advance how they will be used by the despot. Ex-post, concrete evidence is more likely to be furnished on whether these arms were used either as a front to obtain bribes or, worse, were used to harm the populace.

Another problem has to do with incentives to litigate an odious debt defense. It might be feared, upon first reflection, that the successor government will have an incentive to tar the performance of the prior regime that it overthrew, bringing forth skewed evidence about the

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<sup>44</sup> The Oil-for-Food program illustrates the point. Misbehaving creditors cooperated with the rogue regime to fool others into believing that the resources Iraq was receiving were going only to further vital humanitarian goals. Now, in retrospect, we see that only a small fraction of those funds that were supposed to go for food and health actually went for those purposes. We are grateful to Jeffrey Mayer, one of the investigators of the Oil-for-Food program for this point. For additional details, see Jeffrey A. Meyer & Mark G. Califano, *Good Intentions Corrupted: The Oil-for-Food Scandal and the Threat to the U.N.* (2006).



odious uses of the debt, and leading courts to make erroneous findings. The contemporary reality of the sovereign debt markets, however, suggests that this should not be a big concern.

Sovereigns are loathe to tell their creditors that they will not pay their debts, even where it is patently obvious that at least some of those creditors not only helped prop up an illegitimate regime but also knew that their funds were being used to oppress the populace. South Africa, Iraq, Argentina and the Philippines provide modern examples of instances where the new regime pays debts of a prior regime that are widely agreed to be illegitimate. If anything, sovereigns seem unduly risk averse in asserting that the debts of prior regimes are illegitimate.<sup>45</sup>

Perhaps this predicted reluctance to over-assert an odious debt defense would be due to the fact that new rulers in many of previously odious dictatorships are not as clean as one would hope; they want to be able to borrow and steal money too! And, if so, getting on the moral high horse to refuse illegitimate loans of the prior regime would reduce the likelihood of getting new improper loans. Further, even if it is a pure hearted democratic regime replacing a kleptocrat, the new ruling government might choose to forgo the odious debt defense. The new regime is inevitably seeking to keep itself in power and needs external financing to please the current populace (even if additional burdens are placed on later generations). Creditors might condition the availability of new funds on a promise for continued repayment of the old, odious, debt. As is the case in business bankruptcy, whereby creditors of the ongoing concern often condition new

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<sup>45</sup> Indeed, there is a good argument that the current regimes in South Africa and Iraq could affirmatively sue some of the creditors and corporations that engaged in corrupt dealings that helped prop up the prior regimes in those countries. And yet, in neither of these cases have the current regimes been willing to bring these actions. And this is even where, as in the case of Iraq as a result of the Oil-for-Food program investigations, there was concrete evidence produced by a neutral external body that could have been the basis for suits against a number of foreign corporations. See Mark Turner, et al., Iraq's Oil-for-Food Scandal Perpetrators go Unpunished, Financial Times, December 8, 2006 (available at <http://search.ft.com/ftArticle?queryText=oil+for+food&aje=true&id=061208006300>).

debt on some form of de-facto priority with respect to old debt, the case of sovereign bankruptcy might exhibit similar problems, leading to under-assertion of the odious debt defense.<sup>46</sup>

Whether an odious debt defense would be over- or under-asserted is, therefore, hard to predict. The two effects we identify pull in different directions. If it turns out that the dominant effect is that of under-assertion of the defense, there are potential solutions to it, including, as Paul Carrington suggests, the grant of private rights of action to individual citizens.<sup>47</sup> As a practical matter though, it is premature to deal with solutions to second-order problems that might never arise. Only once an odious debt defense is in place will it be possible to tell what type of fine tuning is needed to adjust its proper scope.

## **E. Cost of Credit**

The partial odious debt regime we propose is likely to make sovereign debt more difficult to collect. This effect might hamper some creditors more severely (those that issue bad credit), others less significantly (those that issue legitimate funding). But so long as it is not fully ascertainable to creditors *ex ante* what the status of their debt will be, there is now an added risk of debtor immunity. And even if courts make sound *ex-post* determinations in this area, it is possible that more nations will try to assert an odious debt defense, making repayment delayed and more costly to enforce. These effects, a critic might point out, will not escape the attention of potential creditors. It is likely that creditors will offset this added risk by increasing the cost of loans.

It is not altogether clear that this conjectured effect on the cost of loans is bad. If credit becomes unaffordable to some dictators, let it be so. The key, of course, lies in the quality of

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<sup>46</sup> For an explication of this problem, see Carrington, *supra* note \_\_\_\_.

<sup>47</sup> *Id.*

information that creditors have when they price the loans. The better the prediction that creditors can make regarding the likelihood of a successful odiousness defense, the more likely it is that the added price of credit will reflect a true fundamental problem with the loan. If, say, creditors can perfectly differentiate good from bad borrowing, they will know that only the bad borrowing carries the new, heightened risk of non-repayment. Only this kind of debt will be subject to an increased price.

Moreover, in this environment in which the odiousness risk is perfectly reflected in the cost of capital, good ex-ante incentives might emerge. First, borrowers will have a stronger incentive, at the margin, to substitute some bad borrowing for good borrowing, to enjoy the price discount. That is, they will turn to projects that more clearly service their populace. Second, borrowers will have a stronger incentive to assure creditors that the debt is good and thus likely to be repaid, rendering the creditors' task of monitoring the uses of the funds more tractable (and also making the assumption that creditors are able to price the risk more plausible). Third, the ability of bad creditors to collude with despots to reduce payments to the good creditors so as to increase payments to the bad ones will diminish.<sup>48</sup> Despots may no longer make credible commitments to repay bad loans – those might be discharged by a subsequent government. Thus, for a variety of reasons, it is plausible that the added cost faced by creditors under our proposed regime will be borne disproportionately by those that more often engage in bad lending.

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<sup>48</sup> The idea that some bad creditors engage in actions that potentially reduce economic growth and the likelihood of the good creditors being repaid is one that has been in the news recently. In the U.K., in a case involving the Republic of Zambia, a vulture fund allegedly bribed officials in the government to refuse a restructuring offer that would have reduced the nation's debt dramatically and instead allow the sale of the debt to a vulture fund that planned to sue Zambia for the full amount. See Alan Beattie, 'Vulture Fund' in Zambia Case Gain, *Financial Times*, February 16, 2007 (available at <http://www.ft.com/cms/s/23104b92-bd5e-11db-b5bd-0000779e2340.html>). Also illustrative is the ongoing litigation in New York involving the Republic of Congo, where a different vulture fund is alleging that the Congolese government has been colluding with certain bad other creditors to corruptly siphon out assets in a manner that has restricted payment to the good creditors. See John Donnelly, In Oil-Rich Nation, Charges of Skimming, *Boston Globe*, November 25, 2005 (available at [http://www.boston.com/news/world/africa/articles/2005/11/25/in\\_oil\\_rich\\_nation\\_charges\\_of\\_skimming/](http://www.boston.com/news/world/africa/articles/2005/11/25/in_oil_rich_nation_charges_of_skimming/)).

## **F. Circumvention by Creditors**

As with any legal regime that imposes penalties, there is a risk that the wrongdoers (here, the creditors) will take actions to circumvent the regime and, therefore, avoid the risk of penalty. To the extent circumvention is easy and cheap, the legal regime will fail. For the proposed regime to work, the cost of compliance must be low; so low that creditors should not have an incentive to circumvent the legal regime. The following discussion identifies several hypothetical circumvention techniques and explores how the liability regime ought to address them.

*Opting Out* -- If one jurisdiction (say, either New York or the U.K., the two that dominate cross border lending) adopts a version of the partial liability regime, creditors will simply move to jurisdiction that is more lenient. Surely, it is in the interest of both creditors and odious borrowers to shortchange any future successor government and deprive it of the repayment immunity that the liability regime might afford it. Of course, this concern proves “too much.” Under this logic, there is no room for policy setters to debate any element of the optimal odious debt regime. No matter what the rule is, creditors and borrowers will always flee to the most lenient jurisdiction.

One way to avoid this race to the bottom catch and to render odious debt rules effective against choice-of-law circumvention, is to have them adopted as part of an international regime that simultaneously binds all jurisdictions. The sovereign bankruptcy regime favored by some proponents of an odious debt regime, including Joseph Stiglitz, would fit such a mold.<sup>49</sup> But the problem with this type of international regime is that, as least based on the markets’ recent and

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<sup>49</sup> See Joseph Stiglitz, *Odious Rulers, Odious Debts*, Atlantic Monthly (November 2003) (available at <http://www.theatlantic.com/doc/prem/200311/stiglitz>).

resounding rejection of the IMF's proposed Sovereign Debt Bankruptcy Regime, is unlikely to come to fruition anytime soon. As a practical matter, to the extent odious debt conceptions are adopted, these adoptions will likely come via municipal courts.

Moreover, this opting-out concerns overlooks another important aspect of lending markets—the network effects. Research and recent events tell us that the markets for sovereign bonds are characterized by significant network effects.<sup>50</sup> The bonds, whether under New York or U.K. law, utilize standard contractual provisions and are traded with the assumption that they are standard. For any individual issuer to switch to the law of a different “shelter” state would likely be prohibitively expensive. The switch could realistically only occur if important market players coordinated. And coordination on a global market of this type can be expensive and complicated. Surely, legitimate borrowers and their creditors will have no reason to participate in the coordination and to switch to new states with new laws—they have no reason to fear the odious debt liability. In addition, it is likely that these private actors will need the assistance of the official sector to help them coordinate. And the official sector, especially if it is backing an odious debt initiative, is hardly likely to support efforts to shift the governing law of contracts to, say, Mongolia.

The harder question has to do with the possibility of competition between New York and U.K., the two already established jurisdictions whose laws govern standard sovereign bond documents. Take a government such as that in China today or Russia. Perhaps it fears that a future regime will seek to repudiate some or all the debts that the current regime incurred. China has issued debt in both the New York and U.K. markets. If New York courts began showing sympathy to odious debt defenses, China could easily switch its lending to the London market

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<sup>50</sup> See Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 Emory L. J. 929 (2004); Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract*, \_\_ Wash. U. L. Rev. \_\_ (forthcoming 2007) (available on [ssrn.com](http://ssrn.com)).

(indeed, Russia today issues exclusively under U.K. law). But would China wish to do this? To take such an action would signal not only to its creditors (current and future), but also to its own populace that it is concerned about the legitimacy of the uses that it is putting its borrowing to. Also, it is not at all clear that China's creditors would prefer a legal regime where loans by good creditors were treated the same as those by bad ones. Indeed, as others in this symposium have argued, most creditors likely prefer a regime where they know that their fellow creditors are helping ensuring that the debtor is not being run by a kleptocrat.<sup>51</sup> Finally, it is hard to imagine either the U.K or New York, for political reasons, seeking to be the regime that attracts the borrowing business of that subset of sovereigns that signals itself to be oppressing its populace.

*Creative Refinancing* – A number of commentators have raised the possibility of “laundering” in response to an odious debt doctrine.<sup>52</sup> The idea is that creditors lending for an odious purpose would then immediately lend additional funds so that the odious debtor could repay the first (and most problematic) debt. The second debt then would have been incurred only to repay a prior debt. This chain can be extended (a third loan to pay the second, and so on) until the connection between the last link in the loan chain and the original odious purpose is so vague and indefinite that it is unlikely to be detected by courts.

Could the foregoing be done? Of course. The IMF has done it quite regularly in the past; the IMF's goal usually being to protect against the possibility that the debtor might default on its IMF obligations. But the continual extension and refinancing of the first loan is hardly going to be cheap. Lenders do eventually want to get repaid, and would worry about lending when the borrower might have a defense against repayment. There is no guarantee that the sovereign's

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<sup>51</sup> See Feibelman, *supra* note \_\_\_\_.

<sup>52</sup> See Raffer, *supra* note \_\_\_\_ (citing Hanlon on this point). In the discussion that follows, we do not use the term “laundering” because to us that connotes illegal conduct under current domestic U.S. and other laws. The conduct being described though, is not clearly illegal under current domestic laws.

records will not reveal that these refinancings lead back to an original odious loan.<sup>53</sup> True, a subsequent lender may be oblivious to the original odious purposes of the debt—especially if this lender is the unsophisticated bond investor. But as we suggested above, market forces are likely to handle this problem through information intermediaries. Finally, even if some such circumvention would work in shielding the creditors from liability, it would raise the cost of borrowing for despotic dictators, reducing their opportunity to steal.

*Ex-Post Circumvention.* Creditors might also bypass an odious debt doctrine by making a side deal with the successor government. Creditors could offer the new government fresh loans, with the promise to turn a blind eye to any new stealing, in exchange for the promise that the new government will not assert any odious debt defenses. To make the deal sweeter, creditors could also offer the new government additional loans to help make payments on the old odious loans. In other words, to assert an odious debt liability claim, the new agent of the populace must be immune to bribes. The political and bureaucratic culture that enabled the previous despot to claim power might tolerate subsequent—albeit more minor—forms of corruption.

This is possible, but it is also expensive for the creditors. Creditors engaging in such circumvention actions are not only paying bribes, but are making additional loans that are just as over even more susceptible to odious debt defenses. Like with the creative refinancing problem discussed above, the essential characterization of the debt as odious survives the multitude of iterations of subsequent refinancing. Once again, our point is not that the solution that we propose makes it impossible for creditors to engage in such circumvention, but that such

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<sup>53</sup> Ecuador, in its current threat to repudiate certain of its debts, has targeted loans made the military rulers from the 1970s. Those loans have subsequently been refinanced using new loans. Ecuador is asserting that all of the refinancings are tainted by the original bad purpose for the loans and, therefore, will not get repaid. For our purposes, the point is that creative refinancing does not appear to have worked with Ecuador; at least, not as yet. See Pimentel & Blount, *supra* note \_\_\_\_.

actions are likely more expensive than the alternative of simply taking the due level of care that our comparative fault scheme requires.

### **G. Shifting Uses by the Debtor**

Another circumvention problem deals, like the *substitutable pools* problem, with the fungibility of money. The despot can promise to use the borrowed funds to build chicken farms, only to redirect the money later to his Swiss Bank account. Or, the despot can actually build the chicken farms, and soon after privatize them through sales to foreign firms, pocketing some of the cash revenues. Creditors, therefore, could claim to have lent funds for chicken farms while fully anticipating that the debtor will turn around and steal some of those funds.

If the creditors took steps to prevent this occurrence, they indeed should be shielded from liability. Recall: we do not require that the creditors warrant the use of the funds, we only require that they take due care. One measure that creditors can often take to prevent circumvention of the designed use by debtors is to make the purposes publicly known. This publicity would not guarantee that the money will reach its purposes, but it would surely make it more difficult for the despot to redirect this money. For the despot to stay in power, it is key to prevent the populace from recognizing harsh injustice, especially such that might lead them to coordinate and rebel. Keeping the populace uninformed about the true levels of despotism is crucial in preventing coordination. The despot who wants to steal, therefore, is going to prefer to steal from funds that his populace is relatively uninformed about. If creditors, however, as part of their due care efforts, have to ensure that the fact of the lending and its purposes and amounts are made public, and if they also have to ensure that the funds are at least routed through official



channels, they will have done a significant amount to increase the costs of stealing the funds for the despot.

## V. CONCLUSION

Let us go back to a version of the scenario sketched at the outset. A corrupt and despotic regime has just been overthrown by the citizens of a poor country. A big bank that had lent money to the despot is seeking repayment from the new democratic regime in federal district court in New York (we assume that the loans were governed by New York law). Say that the overthrown regime can produce evidence that a bribe (say 5% of the loan amount) was paid by the lender to the despot to induce the loan. The temptation here is likely to be to say that the loan should not be collectible. After all, the creditor (typically rich) clearly misbehaved. And the debtor (innocent and powerless at the time the loan was made) is poor. Along these lines, in a recent case decided by an ICSID tribunal,<sup>54</sup> a Canadian businessman who had paid a \$2 million “cash donation” to former Kenyan president Daniel Arap Moi so as to obtain a contract, was denied any recovery on his claim, including that under a restitution theory.<sup>55</sup> Two leading contemporary proponents of the odious debt doctrine applauded the denial of recovery as consistent with how a modern odious debt doctrine should apply.<sup>56</sup>

The problem with the foregoing though is that the perspective fails to consider ex ante effects. What if the remaining 95% of the proceeds had been used to fund a children’s hospital. To penalize lenders to the entire extent of the loan, even when there is a significant benefit to the populace, gives the lenders little incentive to ensure that at least a portion of the loan goes to

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<sup>54</sup> ICSID is the International Center for Settlement of Investment Disputes.

<sup>55</sup> Report available at <http://www.odiousdebts.org/odiousdebts/index.cfm?DSP=content&ContentID=16728> (full opinion on file with authors).

<sup>56</sup> Those commentators were Jeff King and Ashfaq Khalfan, authors, along with Bryan Thomas of the manuscript, *Advancing the Odious Debt Doctrine*, supra note \_\_\_\_\_. For the Khalfan and King quotes on the Kenyan case, see id.

beneficial purposes. So, the proceeds of loans will either be stolen completely or they will not be made at all because of the heightened risks to lenders. To the extent the citizens of this poor nation need funds immediately to buy basic humanitarian goods, a doctrine that results in a complete denial of access to funding might not be optimal.

Against this full creditor liability consequence, the liability regime developed in this article designates a more moderate sanction on the misbehaving creditor: forfeiting part of the debt. In this light, it is more pro-creditor, assuring them greater recovery than the more extreme liability rule would afford them. But in other contexts courts continue to enforce full payment of sovereign debt. In many of these cases the proposed liability rule will have an anti-creditor consequence, limiting the amount they can recover.

Whether the proposed liability regime identifies the ideal way to arbitrate the comparative fault and benefit of the creditors and the populace might not be answered unless tested. It may well be that additional or alternative factors should be accounted for in dividing the liability. Still, the contribution of this article goes beyond the operative criteria it proposes. It lies in the recognition that an odious debt doctrine need not make all-or-nothing determinations. Some creditors can do more, others can do less, to monitor or reduce the theft of the funds. In the same way that bad creditor behavior can vary along a continuum, so should liability.