EQUITABLE SUBORDINATION, FRAUDULENT TRANSFER, AND SOVEREIGN DEBT

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I

INTRODUCTION

Until recently, debates over sovereign debt have primarily focused on whether and how sovereigns in financial distress should be able to restructure their obligations.[1] More recently, however, since the fall of Saddam Hussein's regime in Iraq, a new topic has gained much attention: whether sovereigns' creditors should be able to enforce obligations that were "odious" or "illegitimate" at the time they were made.[2] Obligations are arguably odious or

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1. The literature concerning sovereign indebtedness and general issues of debt relief is vast. *See, e.g.*, DEBT AND THE LESS DEVELOPED COUNTRIES (Joshua D. Aronson ed., 1979); DEBT, STABILIZATION, AND DEVELOPMENT (Calvo et al. eds., 1986); ANALYTICAL ISSUES IN DEBT (Frenkel et al. eds., 1989); DEVELOPING COUNTRY DEBT AND THE WORLD ECONOMY (Jeffrey D. Sachs ed., 1989); NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS? (2004); Jeremy Bulow & Kenneth Rogoff, *A Constant Recontracting Model of Sovereign Debt*, 97 J. POL. ECON. 155 (1989); Jonathan Eaton & Mark Gersovitz, *Debt With Potential Repudiation: Theoretical and Empirical Analysis*, 48 REV. ECON. STUDS. 289 (1981); Jeffrey D. Sachs, *A Strategy for Efficient Debt Reduction*, 4 J. ECON. PERSP. 19 (1990).

The most recent chapter in this literature has focused on the ability of holdout creditors to complicate sovereign-debt restructurings. *See*, *e.g.*, Patrick Bolton & David A. Skeel, *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763 (2004); William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1 (2004); Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317 (2002); Anna Gelpern & Mitu Gulati, *The Political Economy of Altering Standard Form Contracts: A Case Study*, 84 WASH. U. L. REV. (forthcoming 2007); Anne Krueger, First Deputy Managing Dir., Int'l Monetary Fund, Address to the Indian Council for Research on International Economic Relations, A New Approach to Sovereign Debt Restructuring (Dec. 20, 2001), *available at* http://www.imf.org/external/np/speeches/2001/122001.htm (last visited May 9, 2007).

2. Articles in this volume are part of this growing literature. *See also* Lee C. Buchheit, G. Mitu Gulati & Robert B. Thompson, *The Dilemma of Odious Debts*, 56 DUKE L.J. 1201 (2007); Adam Feibelman, *Contract, Priority, and Odious Debt*, 85 N.C. L. REV. 727 (2007); Anna Gelpern, *What Iraq and Argentina Might Learn from Each Other*, 6 CHI J. INT'L L. 391 (2005); Christoph G. Paulus, *"Odious Debts" vs. Debt Trap: A Realistic Help?*, 31 BROOK. J. INT'L. L. 83 (2005); Raghuram Rajan, *Odious or Just Malodorous?*, FINANCE & DEVELOPMENT, Dec. 2004, at 54; Joseph Stiglitz, *Odious Rulers, Odious Debts*, ATLANTIC MONTHLY, Nov. 2003, at 42; Patricia Adams, *Iraq's Odious Debts*, Policy Analysis, No. 526 (Cato Inst. 2004), *available at* http://www.cato.org/pubs/pas/pa-526es.html (last visited May 9, 2007); Seema Jayachandran & Michael Kremer, *Odious Debt*, 96 AM. ECON. REV. 82

illegitimate if they were incurred in exchange for funds that provided no plausible value to their sovereign borrowers or were used to violate the rights of the citizens of those sovereigns.[3] There appears to be general agreement that, in an ideal world, creditors should not be able to enforce such debts. Such obligations are presumably both inefficient and unjust to the citizens of the sovereign. Despite this general agreement in principle, writers and advocates disagree about whether it is possible for sovereigns to repudiate or discharge such obligations without undermining sovereigns' access to capital.[4] Those who believe it is possible to do so disagree about which mechanism or mechanisms would most effectively enable sovereigns to identify and repudiate such odious obligations. Some commentators have proposed ambitious, comprehensive approaches, including a public international institution that would effectively designate certain sovereign obligations or regimes as odious.[5] Others have argued that a formal sovereign bankruptcy scheme[6] or a private contractual arrangement[7] would provide a better mechanism for odious debt relief. Other writers have argued, perhaps more modestly, that sovereigns can challenge enforcement of odious obligations pursuant to doctrines of public international law[8] or private domestic law.[9]

Expanding upon proposals to employ private domestic law as a strategy for addressing the problem of odious debt, this article focuses on two particular

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(2006); Ashfaq Khalfan et al., *Advancing the Odious Debt Doctrine* (Center for Int'l Sustainable Development Law, Working Paper No. COM/RES/ESJ, 2003) *available at* http://www.cisdl.org/pdf/debtentire.pdf. Within the last few years, officials of Iraq, Nigeria, and Ecuador have raised the possibility that some debts owed by their countries are odious. *See* Feibelman, *supra* note 2, at nn.35–36.

3. It will often be debatable whether the extension of any particular funds actually provided a benefit to the sovereign. This is especially true, for example, if the funds supported foolhardy or gratuitous expenditures (say, for example, the building of a vanity palace). This article assumes that there are some uses of funds (say, for example, direct transfer to a government official's private bank account abroad) that can be said to provide no benefit to the sovereign. For a more extensive discussion of this question, see Feibelman, *supra* note 2, at 758–63.

4. *Compare, e.g.*, Rajan, *supra* note 2 (expressing concerns about the financial consequences sovereigns might face if they repudiate obligations) *with* Jayachandran & Kremer, *supra* note 2 (proposing an institutional mechanism that would enable sovereigns to repudiate obligations without foreclosing the opportunity to borrow subsequently).

5. *See, e.g.*, Jayachandran & Kremer, *supra* note 2. *See also* Jubilee Iraq, About Us, http://www.jubileeiraq.org/aboutus.htm (last visited May 9, 2007) (promoting an arbitration tribunal to repudiate odious debt owed by Iraq after the fall of Saddam Hussein).

6. *See infra* note 52 and accompanying text. *See also* NOREENA HERTZ, THE DEBT THREAT 187–94 (2004) ("[D]omestic bankruptcy . . . provides us with a good basis on which to design a mechanism for determining which sovereign debts are unpayable or illegitimate, and how debtors and creditors should be treated as a result."); Stiglitz, *supra* note 2, at 42 (arguing that a bankruptcy system for sovereigns could provide relief from obligations incurred by outlaw or odious regimes pursuant to rules established by the United Nations).

7. In theory, creditors and sovereigns could bargain to ensure that sovereigns do not incur odious debt. Sovereigns could promise not to incur such obligations (or risk default of other obligations), and creditors could bargain for the right to designate, by vote, debts as odious. *See generally* Feibelman, *supra* note 2.

8. *See*, *e.g.*, Khalfan et al., *supra* note 2; Adams, *supra* note 2.

9. *See generally* Buchheit et al., *supra* note 1.

doctrines of lender liability—equitable subordination and fraudulent transfer.[10] Although doctrines of equitable subordination and fraudulent transfer do not appear to have been applied to sovereign debt by U.S. courts in the past, both should be available to sovereigns' creditors in most if not all U.S. jurisdictions. To successfully assert the doctrine of equitable subordination, for example, complaining creditors will have to show that target creditors acted inequitably and that the complaining creditors were harmed by the inequitable conduct. When a creditor extends debt to a sovereign borrower that provides no benefit to the sovereign, it imposes harms on the sovereign's other creditors. Because the target creditors will presumably not be insiders in any meaningful sense, however, the bar for succeeding under the doctrine will be very high; it will be necessary to show that the target creditors engaged in egregious behavior. Knowingly extending credit of no arguable benefit to a sovereign debtor should satisfy this requirement.

If courts employ a narrow definition of fraudulent or inequitable behavior pursuant to these doctrines, then lenders should have relatively clear guidance about what kinds of transactions might trigger liability. Defining odious debt narrowly in this way will discipline lenders from extending credit that provides no value to the sovereign. It should also create incentives for creditors to insist on proof from their sovereign debtors that funds they lend will be used for some arguably beneficial purpose. This would effectively create safe harbors for legitimate lenders.

This article addresses practical, doctrinal concerns as well as normative implications of employing theories such as equitable subordination and fraudulent transfer to respond to the problem of odious debt. These doctrines arguably capture the precise harm of odious debt better than other doctrines of private law. More important, these doctrines can be invoked by stakeholders—especially creditors—who have been harmed by the creation of odious debt.[11] Employing these doctrines, therefore, harnesses the interests and skills of creditors who extend non-odious debt to pursue those creditors who act inequitably. This may be especially valuable when sovereigns do not have good incentives to repudiate their own odious obligations. Unleashing the doctrines will create some costs, but these costs may be offset by the benefits of reducing the amount of odious debt outstanding. Part II briefly describes the doctrines of equitable subordination and fraudulent transfer and explains how they might be employed to subordinate or avoid sovereign obligations. Part III sets forth the normative dimension of the argument. It argues that if creditors are able to assert these doctrines and if courts apply them narrowly, the cost of potentially

10. Doctrines of fraudulent transfer and equitable subordination are deeply related and, in many circumstances, are interchangeable. *See generally* Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977) (discussing how such doctrines as fraudulent transfer, equitable subordination, and corporate veil-piercing overlap with each other). *See also infra* notes 12–51 and accompanying text.

11. Sovereigns may be able to assert these doctrines as well, but this article focuses on the role of creditors.

odious debt should increase, the amount of odious debt extended should decrease, and the cost of credit that clearly falls outside the scope of liability may decrease.

II
THE DOCTRINAL MOVE

A. The Doctrines

1. Equitable Subordination

The American doctrine of equitable subordination[12] enables a court to subordinate a creditor's claim or interest when the creditor has acted inequitably and harmed its debtor or the debtor's other creditors.[13] The doctrine is conventionally, if erroneously, understood to be exclusive to bankruptcy law.[14] Section 510(c) of the United States Bankruptcy Code provides that a court may

> 1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or 2) order that any lien securing such a subordinated claim be transferred to the estate.[15]

If a court subordinates a claim or interest pursuant to this provision, the claim or interest is generally not discharged; rather, its priority is reduced so that other claims or interests must be satisfied before it.[16] However, a court of equity generally has discretion to disallow or avoid a claim or interest that might otherwise be subordinated.[17] Furthermore, the practical effect of subordinating a claim or interest is often to deny any recovery to the holder of the claim or interest.

Section 510(c) codifies a doctrine of bankruptcy law that was articulated by the Supreme Court in the 1930s in two important cases: *Pepper v. Litton*[18] and

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12. Equitable subordination is a doctrine of lender liability. Lender liability is itself actually a collection of legal claims and defenses that have historically been applied to lenders in different contexts, arising from express or implied contractual duties, tort law, equitable principles, or fiduciary duties. *See* Adam Feibelman, *Commercial Lending and the Separation of Banking and Commerce*, 75 U. CIN. L. REV. 943, 971 (2007). For a classic critique of lender-liability doctrines, see Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131 (1989).

13. *See, e.g.*, *In re* Mobile Steel, 563 F.2d 692 (5th Cir. 1977). *See also* David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WM. & MARY L. REV. 157 (2003); Adam J. Levitin, *Rough Justice? The Nature and Limits of Equitable Subordination* (Social Science Research Network Working Paper, 2006), *available at* http://ssrn.com/abstract=900444. For an early important work on the topic, see Aza S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L REV. 83 (1961).

14. *See infra* note 56 and accompanying text.

15. 11 U.S.C. § 510(c) (2006).

16. *See id. See also* Carlson, *supra* note 13, at 199–200 (citing E. Minerals & Chems. Co. v. Mahan, 225 F.3d 330, 338 (3d Cir. 2000); Levitin, *supra* note 13, at 2.

17. *See infra* notes 84–85 and accompanying text.

18. 308 U.S. 295 (1939). In *Pepper*, a controlling shareholder of the debtor caused the debtor to confess liability to a salary claim asserted by the shareholder. *Id.* at 296–302. The Court found that the

Taylor v. Gas & Electric Co.[19] Prior to these cases, it appears that U.S. courts had occasionally subordinated the claims of creditors for inequitable conduct.[20] In *Pepper* and *Litton*, the Supreme Court acknowledged that the doctrine ultimately derives from Anglo American equity jurisprudence. American bankruptcy courts have historically had the powers enjoyed by courts of equity,[21] and early courts engaging in equitable subordination did so pursuant to basic principles of equity.[22] These equitable principles have helped define the scope of the doctrine since it was formally recognized as a part of bankruptcy law. In fact, the legislative history of § 510(c) explicitly acknowledges that the provision should be understood as granting bankruptcy courts the power to subordinate claims and interests on any grounds recognized in equity.[23]

Given this broad scope, it is not surprising that the doctrine of equitable subordination has been applied in a wide variety of factual contexts. Paradigmatic instances of equitable subordination involve creditors who are insiders to a debtor corporation—usually officers, directors, managing shareholders, or corporate parents of the debtor.[24] Under the Code, an insider of a corporation includes any "person in control of the debtor."[25] Thus, otherwise independent creditors who exercise a high degree of control over

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shareholder-creditor had engaged in inequitable conduct warranting subordination or disallowance. *Id.* at 312–13.

19. 306 U.S. 307 (1939). *See also* Miller v. Borton, 67 F.2d 792 (7th Cir. 1933). *See generally* Carlson, *supra* note 13, at 198. The codified rule was initially articulated by the Fifth Circuit in *In re* Mobile Steel, 563 F.2d 692 (5th Cir. 1977).

20. *See*, *e.g.*, *Miller*, 67 F.2d 792; *In re* Star Car & Foundry Co., 2 F.2d 53 (4th Cir. 1924); Spencer v. Lowe, 198 F. 961 (8th Cir. 1912); *In re* Ewald & Brainard, 135 F. 168 (N.D. Iowa 1905).

21. *See* Andrew DeNatale & Prudence Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW 417, 419 (1985); Herzog & Zweibel, *supra* note 13, at 83–85; Rafael Ignacio Pardo, Note, *Beyond the Limits of Equity Jurisprudence: No-Fault Equitable Subordination*, 75 N.Y.U. L. REV. 1489, 1490 (2000). *See also Pepper*, 308 U.S. at 307 ("[T]he bankruptcy court in passing on allowance of claims sits as a court of equity."). Questions about the jurisdiction of bankruptcy courts have been complicated since the Supreme Court's decision in N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982). The discussion here does not purport to address any questions of jurisdiction under the 1978 Bankruptcy Code. Rather, the point here is that equitable subordination originally made its way into bankruptcy law through the substantive content of nonbankruptcy equity jurisprudence, and the bankruptcy doctrine still incorporates basic equitable principles.

22. *See In re Mobile Steel*, 563 F.2d at 698–99; Local Loan Co. v. Hunt, 292 U.S. 234 (1934). *See also* Carlson, *supra* note 13, at 208 & n.158.

23. H.R. REP. NO. 95-595, at § 510 (1978) ("[Section 510(c)] is intended to codify case law . . . . The Bankruptcy court remains a court of equity . . . . The court's power is broader than the general doctrine of equitable subordination and encompasses subordination on any equitable grounds."); *see generally* Levitin, *supra* note 13, at 4–6; Pardo, *supra* note 21, at 1491.

24. *See* Carlson, *supra* note 13, at 198–99 ("Most often insider creditors are the ones punished by equitable subordination."); DeNatale & Abram, *supra* note 21, at 424 ("Generally, application of equitable subordination has been limited to the claims of management creditors . . . ."); Herzog & Zweibel, *supra* note 13, at 101–02. For a very early case in this category, see Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1875) (setting aside claims by directors). For early cases involving parent corporations, see Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939) and Forbush Co. v. Bartley, 78 F.2d 805 (10th Cir. 1935). More recent cases involving parent corporations include Ansel Props., Inc. v. Nutri/Sys. of Fla. Assocs., 178 B.R. 645 (E.D. Pa. 1995).

25. 11 U.S.C. § 101(31)(B)(iii) (2006); *see also* Pardo, *supra* note 21, at n.12.

their debtors have been characterized as insiders of a corporation for these purposes.[26] Insiders generally have some degree of influence or direct power over the actions of a corporation; this is one important reason that the law generally imposes fiduciary responsibilities on them.

The fact that a creditor is an insider is not sufficient to warrant subordination of its claims. The creditor must also have engaged in some inequitable conduct that caused harm to other stakeholders. Thus, courts have subordinated claims based on factors including mismanagement, undercapitalization, fraud, spoliation, or some combination of these.[27] A common underlying logic of most of these cases is that the offending party has unreasonably shifted risk to other parties.[28]

If being an insider is not sufficient to trigger subordination, neither is it a necessary factor.[29] Courts have subordinated claims by non-insider creditors who made fraudulent misrepresentations to help induce other creditors to lend to a common debtor.[30] In the well-known case of *In re Bowman Hardware & Electric Co.*, for example, a creditor faced subordination of its claims because it had encouraged the debtor not to include certain obligations on its books.[31] Courts have also subordinated claims that were based on illegal conduct or violation of a regulation.[32] Generally, the misconduct of non-insider creditors must be particularly bad to be characterized as inequitable.[33] Courts tend to require gross misconduct or egregious behavior before subordinating claims of parties who are not insiders.[34]

2. Fraudulent Transfer

The doctrine of fraudulent transfer is closely related to equitable subordination.[35] Fraudulent transfers are avoidable under federal bankruptcy

26. *See*, *e.g.*, Comstock v. Group of Inst'l Investors, 335 U.S. 211 (1948); *In re* Process-Manz Press, Inc., 236 F. Supp. 333 (N.D. Ill. 1964). *See also* DeNatale & Abram, *supra* note 21, at 432–45; Herzog & Zweibel, *supra* note 13, at 102–12.

27. *See* Pardo, *supra* note 21, at n.12. In fact, the inequitable conduct does not have to relate directly to the creditor's claim. *See In re* Enron, 333 B.R. 205 (Bankr. S.D.N.Y. 2005).

28. *See, e.g.,* DeNatale & Abram, *supra* note 21, at 446–47 (citing *In re* Carolee's Combine, Inc., 3 Bankr. 324 (Bankr. N.D. Ga. 1980)).

29. *See* Carlson, *supra* note 13, at 199; DeNatale & Abram, *supra* note 21, at 419, 429–47 (discussing cases in which courts have subordinated the claims of nonmanagement creditors who engaged in fraud, exercised a degree of control over their debtors, or engaged in other inequitable conduct such as violating the automatic stay of bankruptcy law). *See also Enron*, 333 B.R. 205 (subordinating claims by creditors without suggesting that they were insiders).

30. *See*, *e.g.*, L & M Realty Corp. v. Leo, 249 F.2d 688 (4th Cir. 1957). *See generally* Herzog & Zweibel, *supra* note 13, at 99.

31. 67 F.2d 792 (7th Cir. 1933).

32. *See, e.g.*, Columbia Gas & Elec. Corp. v. United States, 151 F.2d 461 (6th Cir. 1945); *In re* Sayman's, Inc., 15 Bankr. 229 (Bankr. N.D. Ga. 1981). *See generally* Herzog & Zweibel, *supra* note 13, at 101.

33. *See* Pardo, *supra* note 21, at n.12.

34. *See* Carlson, *supra* note 13, at 199; William L. Medford, *Debt-to-Equity Recharacterization: Is It More Than Equitable Subordination's Evil Twin?* 23 AM. BANKR. INST. J. 26 (Nov. 2004).

35. *See* Carlson, *supra* note 13; Clark, *supra* note 10.

law[36] and are prohibited under state law in every state. Many states have enacted the Uniform Fraudulent Transfer Act (UFTA),[37] which provides that

> [a] transfer made or obligation incurred by a debtor is fraudulent . . . if the debtor made the transfer or incurred the obligation: (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor: (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.[38]

The primary remedy for fraudulent transfer is "avoidance of the transfer or obligation to the extent necessary to satisfy the [harmed] creditor's claim."[39] As necessary, however, remedies may also include such actions as attachment of a transferred asset, injunctions against the transferee, and appointment of a receiver.[40]

A paradigmatic example of fraudulent transfer involves a gift or donation by an insolvent debtor of some or all of its assets to a favored third party to avoid giving those assets to its creditors.[41] Because proving actual intent to defraud can be challenging, the Uniform Fraudulent Transfers Act incorporates a doctrine of constructive fraud.[42] Thus, a transfer that is not an exchange for "reasonably equivalent"[43] value may be constructively fraudulent if the transferor "was financially impaired, or rendered financially impaired, by the transaction."[44] Thus, fraudulent transfers usually occur when a debtor is insolvent or experiencing financial distress. But a debtor does not have to be insolvent to make a fraudulent transfer.[45] Furthermore, transfers for value—that is, actual exchanges—can be fraudulent transfers if made for the purpose of hindering or defrauding creditors.[46]

Over the last couple of decades, fraudulent transfer laws have been applied well beyond their traditional or paradigmatic contexts. Most notably, for example, creditors have challenged leveraged buyouts of their debtors as

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36. *See* 11 U.S.C. § 548(a) (2006). See also 11 U.S.C. § 544(b)(1) (2006) (providing that a trustee may avoid certain transfers that are voidable under state fraudulent transfer laws).

37. *See* Carlson, *supra* note 13, at 167.

38. Unif. Fraudulent Transfer Act § 4(a) (1984).

39. *Id.* § 7(a)(1); Carlson, *supra* note 13, at 167–68.

40. *See, e.g.*, In re Saylor, 178 B.R. 209 (B.A.P. 9th Cir. 1995).

41. *See* Carlson, *supra* note 13, at 166–67 (distinguishing between fraudulent-transfer cases involving "exchanges" and "donations"); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 829–36 (1985) (noting that the doctrine has its roots in the Statute of Elizabeth, adopted by England in the sixteenth century).

42. See Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1165–67 (1995); Unif. Fraudulent Transfer Act § 4(a)(2) (1984).

43. Unif. Fraudulent Transfer Act § 4(a)(2) (1984).

44. Zaretsky, *supra* note 42, at 1166.

45. *See id*. at 1166 & n.23.

46. *See id*. at 1166 (noting that bona fide transferees who give value for an exchange are generally protected from liability).

fraudulent transfers.[47] These transactions implicate the doctrine to the extent that they may impair the financial position of the target firm and may not involve exchange of equivalent value (especially when the buyout loans are secured by all of the firm's assets). Although most courts have found that leveraged buyouts are not fraudulent transfers,[48] at least some courts have been willing to evaluate these transactions as potentially fraudulent.[49] These cases and others have led some writers to conclude that an animating purpose of fraudulent transfer law is to "regulate the permissible degree of risk" that debtors can take with funds they obtain from creditors.[50] Thus, both fraudulent transfer and equitable subordination appear to be largely concerned with regulating unreasonable or unfair shifting of risks by one stakeholder to other stakeholders.

Nonetheless, there are some notable differences between the doctrines of equitable subordination and fraudulent transfer. Perhaps most significantly, fraudulent-transfer doctrines tend to focus on the actions and motivations of a debtor—whether the debtor made a transfer to harm the interests of its creditors. In contrast, equitable subordination tends to focus on a creditor's conduct—whether a creditor has taken action that harms the interests of other creditors. Furthermore, the conventional remedies that these doctrines provide—subordination and avoidance—are formally quite different.[51]

In many circumstances, however, these two doctrines will serve essentially the same function and address essentially the same harm. This is especially true when a common debtor has colluded with a creditor to harm other creditors, which is often the case when either doctrine applies. As explained below, both doctrines should be implicated if a sovereign incurs odious debt. It is hard to say with any confidence which of the doctrines applies most directly to odious debt. This article tends to emphasize the application of equitable subordination to odious debt because it aims to draw attention to the conduct of creditors. In any event, carefully delineating the distinction between these doctrines is beyond the scope of this article.

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47. *See id.* at 1178–92; Baird & Jackson, *supra* note 41, at 850–54.

48. *See* Bruce A. Markell, *Following Zaretsky: Fraudulent Transfers and Unfair Risk*, 75 AM. BANKR. L.J. 317, 327 (2001).

49. *See* Zaretsky, *supra* note 42, at 1181–92.

50. Zaretsky, *supra* note 42, at 1173. *See also* Markell, *supra* note 48 (discussing Zaretsky's approach and applying it to evaluate absolute priority); R. Stephan Painter, Jr., *Subprime Lending, Suboptimal Bankruptcy: A Proposal to Amend §§ 522(F)(1)(B) and 548(A)(1)(B) of the Bankruptcy Code to Protect Subprime Mortgage Borrowers and Their Unsecured Creditors*, 38 LOY. U. CHI. L.J. 81, 125–26 (2006)(discussing Zaretsky's approach).

51. *See supra* notes 12 (equitable subordination) and 39 (fraudulent transfer) and accompanying text. David Carlson has argued that equitable subordination is properly understood as a remedy for fraudulent transfers. Carlson, *supra* note 13, at 200 ("[E]quitable subordination is simply a fraudulent transfer remedy.").

B. The Move

A sovereign's creditors should be able to employ doctrines of fraudulent transfer or equitable subordination to avoid or subordinate odious obligations owed by the sovereign to other creditors. However, these creditors cannot assert either doctrine pursuant to bankruptcy law. Sovereigns cannot file for bankruptcy under U.S. bankruptcy law; in fact, there is no bankruptcy regime available to sovereigns.[52] Although bankruptcy law is unavailable to them, however, creditors of a sovereign should be able to assert doctrines of equitable subordination or fraudulent transfer pursuant to state law in federal district courts or in state courts in most U.S. jurisdictions.

1. Equitable Subordination

If the power to subordinate a party's claim or interest in bankruptcy originally derived from general equitable principles,[53] these general principles presumably continue to be viable aspects of equity jurisprudence. In fact, some jurisdictions expressly recognize nonbankruptcy claims of equitable subordination.[54] In *Nerox Power System*, for example, an Alaskan court found

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52. As sovereign-debt restructuring has grown more commonplace and arguably more important, there has been growing interest in developing a sovereign-bankruptcy-type scheme. A number of observers believe that sovereigns could borrow money at better rates if they had the benefits of a bankruptcy or insolvency law. *See* NOREENA HERTZ, THE DEBT THREAT 187–94 (2004); Steven Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956 (2000); Stiglitz, *supra* note 2, at 42. A bankruptcy or debt-restructuring scheme could reduce the power of holdout creditors, enable sovereigns to create priorities, and give sovereigns some protection from their creditors. *See* Bolton & Skeel, *supra* note 1. The IMF recently proposed a sovereign-debt-restructuring mechanism. Bratton & Gulati, *supra* note 1, at 26–43; Gelpern, *supra* note 2, 398–99; Krueger, *supra* note 1. The IMF proposal attracted some significant opposition and appears to be off the table for now. It is important to note, however, that any sovereign-bankruptcy or debt-restructuring scheme could include a provision for avoidance of fraudulent transfer or for subordination of claims and interests on equitable grounds.

53. *See supra* notes 18–23 and accompanying text. *See also* Carlson, *supra* note 13, at 208, 212–13 (suggesting that the *Pepper* Court acknowledged that equitable subordination was available under state law at the time).

54. *See* Nerox Power Sys. v. M-B Contracting Co., 54 P.3d 791, 794–95 (Alaska 2002) ("The Alaska Supreme Court has recognized that the doctrine of equitable subordination, whereby the court may 'undo or offset any inequity in the claim position of a creditor that would produce injustice or unfairness to other creditors in terms of bankruptcy results,' can exist outside of the standard bankruptcy context.") (quoting White v. State ex rel Block, 597 P.2d 172, 176 n.13 (Alaska 1979)); Haydu v. Wellner, 1994 Conn. Super. Lexis 1105 (Conn. Super. Ct. 1994) (considering but refusing to apply equitable subordination in a foreclosure action); Shultis v. Woodstock Land Dev. Assocs., 594 N.Y.S.2d 890 (App. Div. 1993) (subordinating the amount of senior liens that were obtained without necessary consent of junior lienholders); Carlson, *supra* note 13, at 218–19 (discussing cases in which equitable subordination was applied outside of bankruptcy); Levitin, *supra* note 13, at 2 ("Equitable subordination is not exclusively a bankruptcy action . . . ."). Carlson argues that equitable subordination is actually best thought of as part of fraudulent-transfer law, and "the equation of fraudulent transfer and equitable subordination proves that equitable subordination is a remedy that can be instituted under state law when appropriate." Carlson, *supra* note 13, at 200. *See also* Gaff v. FDIC, 919 F.2d 384, 393 (6th Cir. 1990) (finding that equitable subordination is exclusive to bankruptcy law but drawing analogies from the doctrine to determine the content of federal common law); City of Parkersburg v. Carpenter, 507 S.E.2d 120, 123 (W.Va. 1998) (noting that equitable subordination is "applied 'almost exclusively' in bankruptcy proceedings," and declining to apply the doctrine in the case at hand).

that investors and insiders had received a fraudulent transfer from an undercapitalized debtor. The court subordinated their liens on a coal mine to other liens that had been junior.[55] Whereas other jurisdictions have concluded that equitable subordination is exclusive to bankruptcy law,[56] this position is at least questionable. It certainly underappreciates the fact that the bankruptcy doctrine is a codification of principles derived from equity jurisprudence. In any event, it is a wholly separate question whether equitable subordination is available outside of bankruptcy in the context of sovereign debt, where bankruptcy law is unavailable.[57] In that context, the underlying principles of equity that gave rise to the doctrine of equitable subordination should apply. If so, a sovereign's creditors—alone or as a group—can assert that obligations of the sovereign owed to other creditors who have acted inequitably should be subordinated. It is true that equitable subordination is generally associated with collective proceedings, but cases applying the doctrine outside of bankruptcy suggest that the doctrine is viable in noncollective proceedings as well.[58] It should be feasible in various contexts to subordinate a claim to other claims without the participation of all other claimholders. In the private context, for example, this is true when a lienholder asserts that a competing lienholder's claim should be subordinated. Furthermore, it will be feasible for courts to apply the doctrine in noncollective proceedings if, as suggested below, the formal or practical remedy sought is to avoid or discharge the inequitable claim.

Creditors asserting equitable subordination would have to show that a creditor seeking to enforce a debt (the target creditor) acted inequitably and that the complaining creditors were harmed as a result. It should be possible to satisfy these elements if the target creditor has extended odious debt.[59] The primary inequitable aspect of odious debt is that a lender has created an obligation for which there was no meaningful value given to the sovereign or its citizens. To be sure, the creditor has given value for its claim. But it has given value to the sovereign's government, not to the party or parties who will have to repay the obligation. It has extended funds knowing that they would not benefit the sovereign itself. This inequitable conduct harms the sovereign's other existing creditors by reducing the value of their competing claims to their

55. *Nerox*, 54 P.3d at 794–95.

56. *See* HBE Leasing Corp. v. Frank, 48 F.3d 623 (2d Cir. 1995) (finding that equitable subordination is exclusively a feature of federal bankruptcy law and thus not part of New York law); Paul H. Schwendener, Inc. v. Jupiter Elec. Co., 829 N.E.2d 818, 826 (Ill. App. Ct. 2005) ("Because the principle of equitable subordination is particular to bankruptcy law, it is an issue 'which can only be decided in a bankruptcy setting.'") (quoting *In re* Poughkeepsie Hotel Associates Joint Venture, 132 B.R. 287, 292 (Bankr. S.D.N.Y. 1991)); PCL/Calumet v. Entercitement, L.L.C., 760 N.E.2d 633 (Ind. Ct. App. 2001); Hilo Crane Serv. v. Ho, 693 P.2d 412 (Haw. Ct. App. 1984). *See also* Levitin, *supra* note 13, at 2, n.5 (noting that some states limit equitable subordination to receivership or liquidation contexts).

57. *See supra* note 52 and accompanying text.

58. *See supra* note 54.

59. This article does not consider whether or to what extent the doctrines of equitable subordination or fraudulent transfer might be fruitful in other cases involving sovereign obligations that would not be considered odious.

common debtor's assets.[60] Put another way, extending odious debt could be understood as unreasonably or unfairly shifting risk to a sovereign's non-odious creditors. Another inequitable aspect of extending odious debt is that the creditor may have thereby given material support to an oppressive regime that helped the regime abuse the sovereign's citizens.

Such a claim would admittedly differ from paradigmatic cases of equitable subordination in certain respects. As most equitable subordination cases arise under bankruptcy law,[61] the debtors in these cases are insolvent or experiencing financial distress, which may assist in establishing that other creditors have been harmed. But sovereigns do not become insolvent or experience financial distress in the ways that private borrowers do.[62] Because the resources ultimately available to a sovereign are difficult to measure, it is often not possible to discern how the sovereign's obligations compare to its available assets. It may be possible to establish that the sovereign has an unsustainable level of debt according to some metric, but doing so will likely be much more complicated than establishing that a firm is insolvent. Also, unlike corporate borrowers, a sovereign cannot be liquidated and will (almost always) continue as a going concern.

Furthermore, under conventional analysis, the fact that a creditor is an insider weighs heavily in determining whether the creditor's conduct was inequitable. A creditor's actions are more likely to be deemed inequitable if the creditor takes advantage of formal or informal levers of control that it has over its debtor. Yet sovereigns' creditors are rarely, if ever, insiders in this sense. Private creditors do not appear to perform the same kinds of governance and control functions that they tend to perform in the context of private debtors.[63] Some official creditors (sovereigns who extend credit to other sovereigns) may exercise a degree of control over their debtors.[64] Even if some do perform a kind of governance function, however, presumably not all official creditors are rich or powerful enough to do so.

In any event, these factors should not be determinative under existing law. Equitable subordination does not appear to require that the common debtor be insolvent or be in financial distress. Conduct can be inequitable even if it does

60. For a discussion of this point, see Feibelman, *supra* note 2, at 768–69. It is arguable that subsequent creditors would not be harmed because they presumably knew of the odious claim. The interest rate those creditors demanded should reflect the sovereign's balance of obligations, resources, and assets at the time of their transaction with the sovereign.

61. *See supra* note 14 and accompanying text.

62. Financial distress or insolvency in the sovereign context is generally described in terms of unsustainability. *See* Feibelman, *supra* note 2, at 3–4. *See also* Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 EMORY L.J. 1159 (2004).

63. *See* G. Mitu Gulati & George G. Triantis, *Contracts Without Law: Sovereign Versus Corporate Debt,* 75 U. CIN. L REV. 977, 977–78 (2007) (proposing that, although banks may have previously monitored sovereign borrowers, creditors currently appear to delegate monitoring and governance functions to the IMF).

64. *See* Anna Gelpern, *Odious, Not Debt*, 70 LAW & CONTEMP. PROBS. 81, 98 (Summer 2007) ("For governments financing other governments, policy influence is a central objective, regardless of the form the transfer takes.").

not cause financial distress or occur in the shadow of financial distress. Actions that increase the probability of default, unnecessarily increase the leverage of a firm, or siphon unbargained-for benefits from a common debtor presumably impose some actual harm on other stakeholders whether or not they are ultimately paid in full. Similarly, control is not a *sine qua non* of equitable subordination.[65] Creditors who exercise only limited or no control over their debtors can nonetheless act in ways that are inequitable and that harm the interests of their debtors and of other stakeholders. The scope of the doctrine in the context of sovereign debt should be defined by the traditional power of courts of equity to subordinate inequitable claims and interests. Sovereigns or their creditors should therefore have significant latitude to argue for subordination from first principles—they should have doctrinal room to argue that the extension of odious debt is itself inequitable conduct justifying subordination.[66]

2. Fraudulent Transfer

There should be little question about whether the doctrine of fraudulent transfer is available in the context of sovereign debt. The doctrine has explicit foundation outside of bankruptcy law; states' fraudulent-transfer provisions clearly give creditors the authority to pursue other transferees. Sovereigns' non-odious creditors have two avenues for asserting fraudulent transfer claims against other, potentially odious creditors. First, they might argue that extending an odious obligation to the sovereign reflects an actual intent to hinder other creditors. Creating an obligation for which no value was exchanged harms, and thus hinders, other stakeholders, especially other creditors. The value of other creditors' claims decreases and chances that the sovereign will default on their claims increases.[67] Extending odious debt may thus unreasonably or unfairly shift additional risk to non-odious creditors. The doctrinal challenge for parties pursuing this avenue will be establishing that the odious debt was extended with intent to hinder other creditors in this way.

Second, creditors of sovereigns that have arguably unsustainable levels of debt might assert that odious debt incurred by the sovereign are constructively fraudulent.[68] This would obviate the need to prove that a creditor that extended odious debt acted with intent to defraud. The complaining creditors would need to show that the sovereign did not receive value in exchange for the obligation

65. *See supra* notes 27–28 and accompanying text.

66. Cases decided under § 510(c) would be persuasive authority, however, and they could lend support to any argument that a particular odious debt should or should not be subordinated.

67. *See* Baird & Jackson, *supra* note 41, at 851 (noting that a leverage buyout technically "hinders" a target firm's creditors because it "leaves them with fewer assets" with which they might satisfy their claims).

68. For a similar argument, see Painter, *supra* note 50, at 123–28. Painter proposes to amend the Bankruptcy Code to allow trustees to avoid certain predatory consumer loans as constructively fraudulent transfers pursuant to § 548(A)(1)(B). According to Painter, loans designed to erode home equity without providing benefit to the borrower should be avoidable in part because they harm the borrower's other unsecured creditors.

it incurred while it was financially impaired. An obvious challenge for this argument will be showing that the sovereign was financially impaired. This may not be a significant obstacle for heavily indebted sovereigns, especially those that are able to obtain voluntary debt relief from other private, official, and multilateral creditors.

C. The Remedy

Assuming that creditors of a sovereign can assert doctrines of fraudulent transfer or equitable subordination, there may be some significant formal and practical challenges to fashioning a remedy that is not present in the context of private debt. The formal problems arise primarily with respect to equitable subordination. Subordination of a claim or interest formally alters its priority vis à vis other claims or interests; it does not discharge the obligation itself.[69] The remedy for fraudulent transfer, in contrast, is to disallow or avoid the obligation.[70] Other writers have noted that subordinating a debt is a somewhat clunky remedy.[71] In the context of private creditors and debtors, the remedy does not necessarily have any effect on the creditor whose debt is subordinated; the doctrine may fail to provide full compensation to injured parties; and it may provide a benefit to parties who were not injured.

Consider a case in which a creditor acts inequitably in a way that harms one creditor but not others.[72] Under the conventional approach, bankruptcy courts generally subordinate an inequitable claim or interest to all other creditors.[73] Critics of this approach point out that in such cases, the creditors who were not harmed may receive a windfall.[74] More troubling, the creditor who was actually harmed may end up being undercompensated by the conduct.[75] The harmed creditor can recover no more than the amount of the bad creditor's claim as a result of subordination, and it may have been harmed more than that amount.[76] And if the bad creditor's claim is subordinated to the claims of creditors it did not harm, then the harmed creditor may effectively have to share the benefit of subordination with the unharmed creditors.[77] Furthermore, if the common debtor is solvent, then the harmed creditor will effectively receive nothing from

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69. *See supra* note 16 and accompanying text.

70. *See supra* note 39 and accompanying text.

71. *See generally* Carlson, *supra* note 13; Fischel, *supra* note 12; Levitin, *supra* note 13.

72. Imagine that the harmed creditor might, for example, have decided to lend money to the common debtor based on a misrepresentation of fact by the "bad" creditor. The other creditors loaned money knowing the fact that had been misrepresented. This example is based on Allstate Life Ins. Co. v. Linter Group Ltd., 994 F.2d 996 (2d Cir. 1993), which is discussed at some length in Carlson, *supra* note 13, at 159.

73. *See* Carlson, *supra* note 13, at 199–200; Levitin, *supra* note 13, at 31 (noting that this practice is due "in part [to] the difficulties in quantifying the exact harm"). This is what Carlson calls a "demotion" approach to equitable subordination. Carlson, *supra* note 13, at 199–202.

74. *See id.* at 200–02.

75. *See* Levitin, *supra* note 13, at 8–11.

76. *See id*. at 8–9.

77. *See id*. at 9.

the bad creditor, and the bad creditor will presumably recover its debt in full.[78] Finally, the conventional remedy can have the result of penalizing the bad creditor, especially if the amount of the subordinated claim is much greater than the amount of harm that creditor caused. Equitable subordination is conventionally thought to be a compensatory rule;[79] punitive damages are not generally available in equity.[80]

Whatever appeal it may have in other contexts, the conventional approach to equitable subordination is particularly inappropriate in the context of sovereign debt. Because the sovereign cannot be liquidated, a subordinated claim will never be extinguished. Thus, if a claim is found to be inequitable and subject to subordination, it will still survive as an obligation against the sovereign. Not only will this continue to harm the sovereign, but it will likely harm the existing creditors to whom the claim is subordinated. These creditors presumably have an ongoing interest in the sovereign's ability to borrow funds, and they have a direct stake in its risk of default.

For these reasons, the remedy for inequitable conduct by sovereigns' creditors should be to avoid the underlying obligation to the extent that it is odious[81] and up to the amount of the amount of the subordinated claim.[82] As should be clear, this is essentially the conventional remedy for fraudulent transfers, and it may not seem like subordination at all. However, the practical effect of subordination in most cases is the elimination of the "subordinated" claim.[83] Furthermore, equitable subordination is a discretionary remedy, and courts have wide latitude to fashion appropriate remedies.[84] It is worth noting that the *Pepper* Court disallowed the subordinated claim in that case, stating, "Equity will undo the wrong or intervene to prevent its consummation."[85] This approach may have the effect of compensating some unharmed creditors if it

78. *See id.*

79. *See id.* at 7 (citing Herzog & Zweibel, *supra* note 13, at 86). Levitin criticizes this view and argues that equitable subordination should be considered a penal remedy.

80. *See* Levitin, *supra* note 13, at 33–34.

81. *See*, *e.g.*, Omri Ben-Shahar & Mitu Gulati, *Partially Odious Debts?* 71 LAW & CONTEMP. PROBS. 47 (Autumn 2007) (describing an approach to identify partially odious debts).

82. Carlson describes this form of remedy as a kind of assignment; the amount of the claim is effectively assigned to the harmed creditor. Carlson, *supra* note 13, at 202. Taking this approach can often be quite difficult, especially if the harmed creditors enjoy different priority and if other creditors in the same classes as these creditors are not harmed. *See* Levitin, *supra* note 13, at 10. In that case, priority rules conflict with targeted subordination. *See id.* at 10–11. Levitin proposes that equitable subordination should be viewed as a quasi-punitive claim. *See id.* at 30–36. In addition, Levitin argues that behavior justifying equitable subordination also generally gives rise to direct causes of action between creditors. *Id.* at 24. In those cases, there should be distribution of a debtor's assets without subordination and injured creditors can then pursue the inequitable ones. *Id.* at 25. Meanwhile, the amounts recovered from the debtor by the inequitable creditors should be kept in a constructive trust for the benefit of the injured creditors. *Id.* at 25, n.103.

83. *See supra* note 17 and accompanying text.

84. *See* Levitin, *supra* note 13, at 8. Under § 510(c) of the Bankruptcy Code, for example, a claim or interest can be subordinated to some claims and not others.

85. Pepper v. Litton, 308 U.S. 295, 311 (1939).

turns out that incurring odious debt does not harm a sovereign's subsequent creditors.[86]

The practical challenges of applying any doctrine of lender liability to sovereign debt are significant. To appreciate the scope of these practical challenges, imagine a grossly simplified scenario in which one or more "good" creditors assert that a debt owed to a "bad" creditor by a common sovereign debtor is odious. The dispute may occur before the sovereign has begun repaying the bad creditor, or it may occur after some or all of the repayment has been made. If they can prevail on the merits before payment is made, the good creditors may seek to temporarily or permanently enjoin the sovereign from repaying the bad creditor. It is doubtful whether such a judgment could formally bind the sovereign unless the sovereign is a party to the litigation. Of course, the sovereign may be eager to avoid paying the odious obligation, especially if the obligation was incurred by a previous regime. The sovereign regime may want to repay the obligation, however, perhaps because it wants to maintain a relationship with the bad creditor or because it is concerned about harming its reputation as a debtor. Thus, even if the judgment could formally bind the sovereign, it may be difficult or impossible to enforce such a judgment if the sovereign is determined to repay the debt. For this reason, the good creditors will presumably prefer to seek a remedy that would enable them to reach any proceeds of the odious debt that the bad creditor receives from the sovereign. A court could conceivably create a receivership for the benefit of the sovereign's other creditors or impose a constructive trust, forcing the bad creditor to hold the proceeds for the benefit of other creditors.[87]

Another potential problem for the application of equitable subordination and fraudulent transfer to sovereign debt is the existence of *pari passu* clauses in contracts for sovereign debt. These clauses became a ubiquitous feature in sovereign-debt contracts over the course of the later part of the twentieth century.[88] The clauses provide, in effect, that the debt created by contract will not be subordinated to any other debt.[89] The importance of these clauses has increased in recent years as restructuring of sovereign debt has grown more common. Creditors have relied on the clause in challenging efforts by sovereigns to reward creditors that agree to terms of restructurings and lean on creditors who do not.[90] In the prominent case of *Elliott Associates, L.P. v. Banco*

86. *See supra* note 64 and accompanying text.

87. *See* Levitin, *supra* note 13, at 25, n.103 (noting the possible use of constructive trusts).

88. For a good summary of this history, see William W. Bratton, *Pari Passu and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823 (2004); Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clauses in Sovereign Debt Instruments*, 53 EMORY L.J. 869 (2004).

89. *See generally* Bratton, *supra* note 88. Consider this example of such a clause: "The obligations of the Guarantor hereunder do rank and will rank at least pari passu in priority of payment with all other External Indebtedness of the Guarantor, and interest thereon." *Id.* at 824.

90. G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635, 636 (2001). *See also* Buchheit & Pam, *supra* note 88, at 880–82 (discussing recent cases in which sovereigns' creditors have relied on the *pari passu* clause).

de la Nacion, for example, a creditor successfully asserted the clause to enjoin payments to creditors that had opted into Peru's restructuring.[91]

Lee Buchheit and Jeremiah Pam suggest persuasively that the primary reason for the common use of these clauses (in both the private and sovereign borrowing contexts) is to preclude involuntary subordination under domestic laws.[92] It is not at all clear, however, whether the clause should preclude the operation of doctrines like fraudulent transfer or, especially, equitable subordination. After all, the operation of either doctrine depends on a finding that the creation of an obligation or interest involved fraud or inequitable conduct. Contractual terms are rarely impervious to such conduct. More formally, parties are generally not able to contract out of equity jurisdiction; precluding equitable remedies because of a *pari passu* clause would seemingly allow them to do so.

D. Summary

This Part has explained how creditors might assert doctrines of fraudulent transfer or equitable subordination against other creditors who extend odious debt to a common sovereign debtor. The doctrines should be available even though this litigation will not occur in the context of a bankruptcy filing. Fraudulent transfers are prohibited by statute in most states. Extending odious debt presumably hinders other creditors, perhaps intentionally so, and may constitute constructive fraud if the sovereign debtor is highly indebted. The scope of equitable subordination should easily include the power to subordinate credit extended with knowledge that it will provide no benefit to the sovereign itself. The remedy under either doctrine should be avoidance of the odious debt. The forgoing only explores how creditors might employ these doctrines against other creditors; it does not consider whether or how the sovereign debtor itself might do so.

III
NORMATIVE CONCERNS

If it is possible to apply doctrines of fraudulent transfer or equitable subordination doctrines in the context of sovereign debt, this does not mean that it is desirable to encourage parties to do so. Lender liability is a surprisingly undertheorized topic,[93] and we know relatively little about whether doctrines like equitable subordination or fraudulent transfer are beneficial and, if so, to what extent. As explained below, if courts are scrupulous in subordinating or

91. 194 F.3d 363 (2d Cir. 1999).

92. *See* Buchheit & Pam, *supra* note 88, at 912–17. *See also* Bratton, *supra* note 88, at 10; Debra J. Schnebel, *Intercreditor and Subordination Agreements—A Practical Guide*, 118 BANKING L. J. 48, 49 (2001).

93. *See, e.g.*, Fischel, *supra* note 12, at 133 ("Lender liability cases have led to the creation of an area of commercial law that has not been accompanied by the development of a coherent theoretical framework establishing the rights of lenders and their duties . . . .").

avoiding only those debts that provide no plausible benefit to sovereign debtors, then these doctrines can have a significant effect in reducing the cost of non-odious debt. This should reduce the amount of odious debt extended in the first place. This Part considers some of the costs and the benefits of applying these doctrines to sovereign debt and proposes that doing so could create a net benefit.

A. Costs

Criticism of lender liability tends to focus on the welfare effects of the doctrine. The doctrines of equitable subordination and fraudulent transfer create direct and indirect costs. The direct costs include, for example, increased transaction costs and the expense of any resulting litigation. These direct costs are not trivial, but they may not be as important as the indirect costs of the doctrine. Such indirect costs include increases in the cost of credit or reduction in its availability.[94] A related potential indirect cost of these doctrines is that they may reduce the amount of valuable governance activity that creditors would otherwise do. Creditors generally engage in monitoring and governance to increase the chances that they will be repaid.[95] The threat of lender liability presumably increases the cost of this type of governance activity by creditors if liability is a function of creditor control.

Most of the indirect costs described above should be a function of the scope of potential liability under the doctrine. The less precise the definition of inequitable conduct, the larger the range of behavior by creditors it will likely affect and the more uncertainty creditors will face about their potential liability under the rule. This should in turn increase the cost of lending and reduce the extent to which creditors are willing to risk subordination or avoidance by

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94. *See, e.g.,* Gelpern, *supra* note 64, at 15 & n.42 (noting that creditors respond to risks of subordination and default by lending less to sovereigns than they otherwise would).

95. The risks that lenders must take into account when they extend credit include the risk of exogenous events and the risk that their debtor will behave in ways that reduce the expected chances of recovery. *See* Fischel, *supra* note 12, at 133–34. *See also* Buchheit et al., *supra* note 2. Creditors price these risks to the extent that they are able to do so; to the extent that they cannot precisely predict the effects of these risks, they will raise prices enough to ensure that they will not face a net loss in making their investment. *See* Fischel, *supra* note 12, at 135–36. In this environment, if a creditor can find a way to reduce or more precisely price risk, it should enjoy a competitive advantage. Similarly, if a borrower can find ways to credibly commit to avoid opportunistic behavior, it can reduce its borrowing costs. *See* Feibelman, *supra* note 12, at 949 (citing Fischel, *supra* note 12; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)). One significant way for creditors to reduce risk is to reduce the ability of borrowers to behave in ways that increase the risk of default. They can do so by monitoring and controlling the actions of debtors. *See* Fischel, *supra* note 12; George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073 (1995). Thus, creditors who lend to commercial firms engage in various forms of corporate governance, that is, direct as well as indirect control mechanisms. *See* Feibelman, *supra* note 12, at 946–53. Not only do these control mechanisms arguably reduce the amount that any particular creditor will charge for credit, they appear to increase their debtors' value by reducing inefficient behavior by managers. *See* Nishant Dass & Massimo Massa, *Bank-Based Governance: A Tradeoff Between Lower Risk And Greater Information Asymmetry* 8 (Fed. Reserve Bank of N.Y., Working Paper, 2006), *available at* http://www.newyorkfed.org/research/conference/2006/fin_intermed/Massa_INSEAD_August18.pdf.

engaging in governance. In theory, these costs could be significantly reduced, however, if the doctrine provided a careful standard for liability. In so doing, it could effectively create safe harbors in which creditors can lend and act without fear of incurring liability.[96]

At least some of these costs are likely to occur if either equitable subordination or fraudulent transfer is applied in the context of sovereign debt. The parties would certainly incur direct transaction and litigation costs. And it is likely that the new potential liability would create indirect costs, such as an overall increase in the cost or availability of sovereign debt. Creditors to sovereigns will presumably respond to any new potential liability by passing actual or expected costs along to their sovereign borrowers. But these costs can be significantly curtailed if courts narrowly apply these doctrines to debt that is clearly odious or clearly inequitable on other grounds.[97] If the doctrine were applied only where there is strong proof that creditors knowingly extended credit that provided no benefit to the sovereign, this could create a fairly effective safe harbor. Creditors who made efforts to ensure that the regime was using their funds to benefit the sovereign would be confident that their obligations are not odious. Some uncertainty would surely remain, at least to the extent that there is dispute about what the creditor knew or whether a particular use of funds provided a benefit to the sovereign. But creditors should be able to structure their transactions to reflect that they have reason to believe a benefit is being transferred to their sovereign borrowers. If so, the doctrine should not significantly increase the cost of credit that falls within the safe harbor, if at all; in fact, the cost of non-odious lending may decline if the borrower is effectively constrained from engaging in opportunistic behavior or from borrowing odious debt. Finally, employing doctrines of equitable subordination or fraudulent transfer in the sovereign-debt context should not significantly reduce the governance exercised by creditors because most creditors who lend to sovereigns apparently do not engage in significant governance of their sovereign debtors.[98]

B. Benefits

Credit relationships often create incentives and opportunities for creditors to engage in inefficient and harmful behavior toward their debtor and other creditors.[99] A primary ex post benefit of lender liability is to compensate parties that are harmed by such behavior—to return the parties to a *status quo ante*. In some cases, compensatory remedies simply involve wealth transfers from one

96. *See generally* Mitchell Berlin & Loretta Mester, *Optimal Financial Contracts for Large Investors: The Role of Lender Liability* (Fed. Reserve Bank of Philadelphia, Working Paper No. 00-1, 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=213815.

97. *See supra* discussion on page 173. For discussions of optimal definitions or optimal liability in the context of odious debt, see, for example, Feibelman, *supra* note 2, at 758–63; Ben-Shahar & Gulati, *supra* note 81.

98. *See supra* note 63. *But see* Gelpern, *supra* note 64 and accompanying text.

99. *See* Fischel, *supra* note 12, at 138–40.

party to another. Yet compensatory remedies can theoretically create value. For example, they may help reallocate resources back to their highest-valued use. Furthermore, they may have other normative benefits—promoting justice or fairness, for example.

The ex ante beneficial effects of equitable subordination and doctrines of fraudulent transfer may be more important than any potential ex post benefits. By exposing creditors to potential liability, the doctrines should reduce the value that a creditor can obtain from fraudulent or opportunistic behavior. And by increasing the cost or reducing the benefit of inequitable behavior, this potential liability should reduce the incentives for creditors to engage in harmful or inefficient opportunistic behavior in the first place. That other creditors could assert these doctrines themselves increases the chances that the doctrines will have this desirable effect. Creditors can be effective monitors of each other.[100] They have particular skills at monitoring their debtors' activities, and they usually have information advantages over other parties who might do so. By giving creditors the ability to derive direct benefits from exposing each others' inequitable conduct or fraudulent transfers, doctrines of lender liability give them additional incentives to monitor each other for such behavior and to act upon information they acquire.

The benefits of doctrines like equitable subordination and fraudulent transfer may be significant in the context of odious debt. Giving creditors an incentive to monitor each other and to expose the creation of odious obligations is particularly important in the context of sovereign debt because other governance mechanisms that exist in the private context do not affect sovereign debtors. With private borrowers, for example, shareholders, regulators, and markets presumably have some beneficial governance effects. In addition, it is relatively easy to nudge a private debtor into bankruptcy, where a broad range of enforcement mechanisms kick in. Such mechanisms are largely absent from the realm of sovereign debt. Credit rating agencies and public institutions like the International Monetary Fund play some monitoring and governance roles.[101] Citizens of the sovereign borrower may have some power to elect new leaders or to stage revolts. But these various governance mechanisms may be weaker than those that obtain in the context of private borrowers, which would help explain why sovereigns are able to incur significant amounts of odious debt. Thus, if the doctrines of equitable subordination and fraudulent transfer were clearly available, this might spur creditors to play a more aggressive role in monitoring the transactions of their sovereign debtors and in effectively policing the behavior of other creditors who engage in inequitable conduct.

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100. *See id*.

101. *See* Gulati & Triantis, *supra* note 64. Under the leadership of Paul Wolfowitz, the World Bank has apparently increased its efforts to monitor sovereign regimes for corruption. *See* Jai Damle, *The Odious Debt Doctrine After Iraq*, 70 LAW & CONTEMP. PROBS. 139 (Autumn 2007) (discussing Wolfowitz's plan to make assistance from the Bank conditional on anticorruption policies).

There are reasons to believe that creditors will respond to these incentives. In recent years, creditors have grown considerably more assertive in litigating claims against sovereigns.[102] It may be that not all of this litigation is productive, especially if it hinders the ability of sovereigns to conduct restructuring efforts.[103] More recently, and perhaps more promisingly, there have been some indications that sovereigns' creditors will in fact pursue other creditors to recover funds that should not have been transferred from their common debtor. The case of *Kensington International, Ltd. v. BNP Paribas, S.A.*,[104] is a prominent example of this inter-creditor dynamic. Kensington, a creditor to the Republic of Congo, sued BNP Paribas and others, alleging that the French bank had helped the Congolese government hide assets from which BNP Paribas itself had been repaid. An initial case was dismissed on procedural grounds, and Kensington is now suing BNP and other defendants pursuant to the Racketeer Influenced and Corrupt Organizations Act.[105]

C. Net

As others have noted, it may not be possible to determine as a matter of theory whether the costs or benefits of lender liability predominate.[106] There is some tentative evidence, however, that the benefits outweigh the costs in the context of some private commercial transactions. A recent study suggests that optimal contracts between commercial firms and large investors would include the ability to apply equitable subordination against the large investor.[107] If so, the doctrine will provide a net benefit, at least with respect to the two parties to the lending contract.

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102. *See* Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L.J. 1043 (2004); *Defaulted Sovereign Debt? Litigate It!*, N.Y. L.J., Feb. 22, 2005, *available at* http://www.law.com/jsp/nylj/PubArticleNY.jsp?id=1108992913591 (last visited Feb. 25, 2007). Prominent examples include *Elliott Associates*, the *pari passu* case noted above. *See supra* note 91 and accompanying text. The Argentinean debt crisis has generated a significant amount of litigation. *See, e.g.*, H.W. Urban GmbH v. Republic of Argentina, No. 02 Civ. 5699, 2004 WL 307293 (S.D.N.Y. Feb. 17, 2004) (certifying a class of creditors suing the sovereign); Lightwater Corp., Ltd. v. Republic of Argentina, No. 02 Civ. 3804, 2003 WL 1878420 (S.D.N.Y. April 14, 2003) (rejecting the sovereign's request for a stay of litigation to negotiate with creditors). Other recent cases include Af-Cap, Inc. v. Republic of Congo, 383 F.3d 361 (5th Cir. 2004) (defining tax revenue and royalties received by the sovereign as "commercial activity" and subject to attachment because it was transferred to another creditor); Turkmani v. Republic of Bolivia, 193 F. Supp. 2d 165 (D.D.C. 2002); Hirshon v. Republic of Bolivia, 979 F. Supp. 908 (D.D.C. 1997). Most recently, Donegal International successfully sued Zambia to recover on $55 million in Zambian obligations that Donegal had purchased at a steep discount from Romania in 1999. *See Zambia Pays 'Vulture Fund' $15m*, BBC NEWS, Apr. 24, 2007, http://news.bbc.co.uk/1/hi/business/6589287.stm.

103. *See supra* notes 90–91 and accompanying text.

104. No. 03602569 (N.Y. Sup. Ct., Jan. 24, 2005) (unpublished opinion, on file with author).

105. *See* Kensington, Int'l, Ltd. v. Société Nationale Des Pétroles Du Congo, No. 05 Civ. 5101 (LAP) 2006 WL 846351 (S.D.N.Y. Mar. 31, 2006) (denying defendants' motions to dismiss).

106. *See* Fischel, *supra* note 12, at 140 ("Whether the increased risk of lender misbehavior created by loan covenants imposes costs that outweigh the benefits from limiting debtor misbehavior cannot be resolved at the theoretical level. The answer will vary depending on the situation and particular covenant involved.").

107. *See* Berlin & Mester, *supra* note 96, at 1.

There are reasons to be optimistic that the net effects of unleashing equitable subordination or fraudulent transfer in the context of sovereign debt could also be positive. If these doctrines succeed in motivating creditors to begin to act as monitors of their sovereign debtors, this could be a rather dramatic benefit. Furthermore, if these doctrines create a reliable safe harbor for non-odious debt, this might limit the costs of the new source of liability. The cost of credit within the safe harbor should decrease; borrowers should be all the more motivated to structure their transactions to fall within the safe-harbor protection. Together, these factors could help significantly reduce the amount of odious debt outstanding, which could yield significant positive externalities for the populations of many sovereigns that are, or have been, afflicted with oppressive regimes. But these benefits will largely depend on the ability of courts to narrowly and consistently apply the doctrines. Admittedly, this may be asking too much of a judicial system, which by its nature is ad hoc and susceptible to idiosyncratic factors of particular cases.

IV

CONCLUSION

This article proposes that creditors of a sovereign might employ the doctrines of equitable subordination or fraudulent transfer to pursue other creditors who extend odious debt to their common debtor. Creditors should be able employ such doctrines in nonbankruptcy proceedings pursuant to state law in most jurisdictions. Employing these doctrines against sovereign debtors would certainly unleash some costs. These costs might be dramatic, especially if courts are not careful to employ the narrowest definition of odious debt or to provide reliable safe harbors. Still, these doctrines might yield net benefits by reducing the amount of odious debt extended, perhaps reducing the overall cost of sovereign debt. Even if they would yield net benefits, however, it would still remain to be seen whether such benefits were greater than those of alternative doctrines and institutions that might be used to address the problem of odious debt.