THE MARKET FOR ODIOUS DEBT

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I

INTRODUCTION

For over one hundred years, political leaders, financiers, lawyers, and scholars in the fields of international law and international finance have struggled to develop an effective means for sovereign debtors to repudiate their odious debts. Despite their efforts, these debts—incurred by a dictatorial regime for its own benefit with the knowledge of the creditors, but without the consent of the nation's citizens—are transferred to new governments. As a result, the citizenry suffers two harms: the first under the dictator's brutal rule, and the second under the new government's severe macroeconomic policies engendered by the need to repay the debts the dictator incurred to finance his reign.

The resurgence of efforts to incorporate a concept of illegitimacy into sovereign debt restructurings is one of the most salient developments in the modern legal history of sovereign debt. In a few instances, governments have claimed that the country's existing debt is unlawful and so need not be repaid. For example, Rafael Correa, the President of Ecuador, established the Public Debt Audit Commission in July of 2007 to investigate the legitimacy of the debts the country incurred during the thirty-year period from 1976 through 2006.[1] The Commission issued its report in November of 2008, concluding that two series of bonds issued in 2000,[2] the global bonds maturing in 2012 and the global bonds maturing in 2030, were unlawful.[3] The Commission thus recommended that Ecuador refuse to make payments on these bonds.[4] The next month, Mr. Correa denounced these bonds as "illegitimate," reportedly arguing that "they were improperly authorised by previous administrations and

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1. Wade Mansell & Karen Openshaw, *Suturing the Open Veins of Ecuador: Debt, Default and Democracy*, 2 L. & DEV. REV. 151, 153 (2009).

2. Lee C. Buchheit & G. Mitu Gulati, *The Coroner's Inquest*, INT'L FIN. L. REV., Sept. 2009, at 22, 23 [hereinafter *Coroner's Inquest*].

3. Mansell & Openshaw, *supra* note 1, at 168.

4. Naomi Mapstone & David Oakley, *Ecuador Hints at Default over "Illegitimate" Debt*, FIN. TIMES, Nov. 18, 2008, at 26.

involved onerous interest rates, commissions and prepayments."[5] On April 20, 2009, Ecuador completed a restructuring of these bonds, repurchasing them at a price of thirty-five cents on the dollar.[6]

Yet, governments are reluctant to invoke the doctrine of odious debt.[7] Moreover, upon invoking the doctrine, governments are hesitant to pursue application of the doctrine.[8] While the subject of intense debate in the political sphere and the academy, the doctrine of odious debt has never been used in an international tribunal.[9] To invoke it in support of the repudiation of sovereign debts would, in the absence of acquiescence from creditors, expose a new government to severely negative economic consequences. Assets located outside the country's borders could be seized as payments on the debts. The new government would be seen as repudiating valid debts and so would be unlikely to attract needed direct foreign investments or to secure needed extensions of credit.

Thus, the bulk of the recent work concerning the doctrine of odious debt has been devoted to adapting the doctrine to serve as a means of constraining the incentives of creditors to make loans to dictators. For example, scholars have proposed assigning the responsibility of determining which regimes (not debts) are odious to an international authoritative body.[10] Upon the designation of a regime as odious, creditors would be apprised that any loans made to the regime would be illegitimate and so nontransferable to a new government. The reduction in the likelihood of repayment would curtail the benefits of extending credit to the regime, making creditors less willing to do so.

Other scholars have worked to develop mechanisms for declaring sovereign debts to be odious and thus unenforceable while the dictatorial regime is in power, rather than upon the regime's overthrow and the emergence of a new government. These tools include charging an international tribunal, upon the petition of enumerated parties, with the enforcement of the core principles of the doctrine[11] and embedding specified elements of the doctrine into the

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5. Naomi Mapstone, *Ecuador Maintains Bond Default Threat*, FIN. TIMES, Dec. 11, 2008 (on file with author).

6. *Coroner's Inquest*, *supra* note 2, at 25; Mansell & Openshaw, *supra* note 1, at 177–78.

7. The new democratic government of South Africa, for example, continues to service the debt incurred under the Apartheid Regime. *See* Joseph Hanlon, *Defining "Illegitimate Debt": When Creditors Should Be Liable for Improper Loans*, *in* SOVEREIGN DEBT AT THE CROSSROADS 109, 121–23 (Chris Jochnick & Fraser A. Preston eds., 2006).

8. President Correa has refrained from repudiating the sovereign bonds he regards as illegitimate, preferring to use references to the odious debt doctrine as a tool in restructuring the global bonds. *See* Mansell & Openshaw, *supra* note 1, at 180–81.

9. Andrew Yianni & David Tinkler, *Is There a Recognized Legal Doctrine of Odious Debts?*, 32 N.C. J. INT'L L. & COM. REG. 749 (2006) (arguing that a legal doctrine of odious debt does not exist).

10. *See generally* Patrick Bolton & David Skeel, *Odious Debts or Odious Regimes?*, 70 LAW & CONTEMP. PROBS. 83 (Autumn 2007); Seema Jayachandran & Michael Kremer, *Odious Debt*, 96 AM. ECON. REV. 82 (2006).

11. Christoph G. Paulus, *"Odious Debt" vs. Debt Trap: A Realistic Help?*, 31 BROOK. J. INT'L L. 83, 101–02 (2005).

contracts governing loans to sovereigns, thereby placing the responsibility for identifying odious debts on creditors.[12] The risk that a sovereign debt may be determined to be odious, and therefore subject to repudiation, increases the costs of extending credit to dictators, accordingly reducing the likelihood that creditors will make loans to despotic rulers.

Finally, many scholars have investigated the applicability of principles of private (domestic) law to sovereign debts. In particular, they examine the extent to which common-law principles of contract, tort, and lender liability—as well as fundamental principles of insolvency—might provide an effective defense for a new government that is sued for failure to make payments on an odious debt incurred during the prior reign of a despot.[13] The greater expenses of lending created by the risk that a new government might successfully repudiate the debts of a deposed dictator limit the incentives of creditors to make loans to despots.

Each of these proposals, however, lacks a consideration of the structural features of the international financial architecture. The failure to consider the various types of creditors—governments, international financial institutions, and private lenders, comprising both commercial banks and holders of sovereign bonds—and the conditions under which each of these entities makes and enforces loans to sovereign debtors, limits the applicability of the proposals.

To address this concern, part II begins with an overview of the development of the doctrine of odious debt, focusing first on the contours of the initial formulations of the doctrine and then turning to the details of the recent adaptations. In part III, the characteristics of each type of sovereign debt are described, and the motives of each type of creditor in making loans to sovereign debtors are delineated. Part IV offers an alternative proposal for constraining the credit available to dictators. The focal point of the analysis is sovereign bonds, for these investors have the strongest motives for enforcing the terms of the agreements governing their bonds. In particular, these agreements should incorporate modifications to the terms identifying the uses of proceeds from both the issuance of the sovereign bonds and other incurrences of indebtedness. These modifications will permit the sovereign bondholders to accelerate the amounts owed to them in the event the sovereign debtor incurs odious debts.

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12. *See generally* Adam Feibelman, *Contract, Priority, and Odious Debt*, 85 N.C. L. REV. 727 (2007) [hereinafter Feibelman, *Contract*].

13. *See generally* Lee C. Buchheit, G. Mitu Gulati & Robert B. Thompson, *The Dilemma of Odious Debts*, 56 DUKE L.J. 1201 (2007) (examining the use of common-law principles of contract as defenses against the payment of odious debts); Omri Ben-Shahar & Mitu Gulati, *Partially Odious Debts?*, 70 LAW & CONTEMP. PROBS. 47 (Autumn 2007) (examining the use of common-law principles of tort to achieve the aims of the doctrine of odious debts); Adam Feibelman, *Equitable Subordination, Fraudulent Transfer, and Sovereign Debt*, 70 LAW & CONTEMP. PROBS. 171 (Autumn 2007) (examining the use of common-law principles of lender liability as defenses against the payment of odious debts); A. Mechele Dickerson, *Insolvency Principles and the Odious Debt Doctrine: The Missing Link in the Debate*, 70 LAW & CONTEMP. PROBS. 53 (Summer 2007) (examining the use of fundamental principles of insolvency to achieve the aims of the doctrine of odious debts).

II

THE NATURE OF ODIOUS DEBT

A. Development of the Doctrine of Odious Debt

Following the end of hostilities in the Spanish–American War of 1898, representatives of Spain and the United States met in Paris to negotiate the terms of the peace treaty between the two belligerent nations. A central point of contention was the repayment of loans that Spain had incurred to finance its operations in Cuba and for which it had pledged Cuban revenues.[14] These loans were the result of a series of bonds the Spanish government had issued during the 1880s.[15] The bonds, which were held by citizens of a number of nations including Belgium and Spain, were consolidated in 1886 when the Kingdom of Spain issued a royal decree pursuant to which it borrowed funds to repay the bonds and pledged security to guarantee repayment:

> [i]n order to satisfy the interest and the redemption of the [loans], there shall be consigned every year in the Budget of the Island of Cuba the necessary amounts for these costs . . . . The [loans] shall have the special guarantee of the receipts of the Customs, the Seal, and the stamp office, of the Island of Cuba, the direct and indirect taxes existing in the Island, or which may be established there in the future, and the general guarantee of the Spanish nation.[16]

At the Paris Conference, the Spanish commissioner proposed that, in transferring sovereignty over Cuba to the United States, Spain would transfer "all charges and obligations of every kind . . . which the Crown of Spain . . . may have contracted lawfully in the exercise of the sovereignty . . . relinquished and transferred, and which as such constitute an integral part thereof."[17] In support of this proposal, the Spanish Commissioner argued, in part, that

> [i]t would be contrary to the most elementary notions of justice and inconsistent with the dictates of the universal conscience of mankind for a sovereign to lose all his rights over a territory and the inhabitants thereof, and despite this to continue to be bound by the obligations he had contracted exclusively for their régime and government.
>
> These maxims seem to be observed by all cultured nations that are unwilling to trample upon the eternal principles of justice . . . .[18]

In response, the American commissioner argued that the debts were "created by the Government of Spain, for its own purposes . . . in whose

14. *See* ERNST H. FEILCHENFELD, PUBLIC DEBTS AND STATE SUCCESSION 329–43 (1931).

15. *Id.* at 332–34.

16. *Id.* at 332–33.

17. 1 JOHN BASSETT MOORE, A DIGEST OF INTERNATIONAL LAW 352 (1906) (quoting the Spanish commissioners' Oct. 7, 1898, counter proposal to the American commissioners' proposal of October 3, 1898, in the peace negotiations at the Paris Conference, S. DOC. NO. 62, pt. 2, at 28, 33–34, 44–45 (3d Sess. 1898)).

18. *Id.* at 353 (quoting Memorandum of American Peace Commission, S. DOC. NO. 62, pt. 2, at 41–44 (3d Sess. 1898)).

creation Cuba had no voice."[19] The American commissioner further argued that "[f]rom no point of view can the debts . . . be considered . . . for the benefit of Cuba."[20] Moreover, a portion of the proceeds of the loans had been spent to suppress the rebellions in Cuba.[21] Finally, the American commissioner asserted that the creditors were aware that the loans were made and that the pledge of Cuban revenues as security was given in the context of Spanish efforts to suppress the struggles of the Cuban people for independence from Spanish rule. As a result, these creditors "took the obvious chances of their investment on so precarious a security."[22] In this way, the American commissioner based the repudiation of the debts on three principles: (1) the debts were not incurred with the consent of the people of Cuba, (2) the debts did not benefit the Cuban people, and (3) the holders of the debts were aware of the lack of consent and the lack of benefit. These reasons, taken together, have often been regarded as an early expression of the doctrine of odious debt.

The earliest (and only) application of these principles in the judicial context involved an arbitral decision to resolve a dispute between Great Britain and Costa Rica regarding the repayment of two loans following the fall of the Tinoco Regime. These loans were made pursuant to a line of credit established in July of 1919 at the Royal Bank of Canada for the benefit of the government of Costa Rica.[23] In drawing upon this account, Frederico Tinoco received $100,000 "for expenses of representation of the Chief of State in his approaching trip abroad,"[24] and his brother, Jose Joaquin Tinoco, received $100,000 "as Minister of Costa Rica to Italy, for four years' salary and expenses of the Legation . . . in Italy."[25]

In seeking repayment of these loans, representatives of Great Britain argued that the new government of Costa Rica, as the successor to the Tinoco Regime, was bound to honor the loans extended by the Royal Bank of Canada.[26] Representatives of this new government, however, denied the validity of the loans (as well as all other sums owed under the line of credit), citing the Law of Nullities, which the new government enacted to invalidate all contracts between the executive power and private persons made during the Tinoco

19. *Id.* at 358 (quoting Memorandum of American Peace Commission, S. DOC. NO. 62, pt. 2, at 48–50 (3d Sess. 1898)).

20. *Id.* (quoting Memorandum of American Peace Commission, S. DOC. NO. 62, pt. 2, at 48–50 (3d Sess. 1898)).

21. *Id.* at 359.

22. FEILCHENFELD, *supra* note 14, at 341.

23. SABINE MICHALOWSKI, UNCONSTITUTIONAL REGIMES AND THE VALIDITY OF SOVEREIGN DEBT: A LEGAL PERSPECTIVE 38 (2007).

24. Tinoco (Gr. Brit. v. Costa Rica), 1 R.I.A.A. 371, 393–94 (1923) (quoting books of the Government of Costa Rica entry No. 1546 F July 17, 1919).

25. *Id.* at 394 (quoting books of the Government of Costa Rica entry No. 1546 F July 17, 1919).

26. *Id.* at 377.

Regime on the basis that the regime was neither the de facto nor the de jure government of Costa Rica.[27]

In reaching his decision, U.S. Supreme Court Chief Justice William Howard Taft, the sole arbitrator in the case, first held that under general principles of international law, a change of government has no effect upon the international obligations of the state.[28] Chief Justice Taft also held that the Tinoco Regime was the de facto government of Costa Rica from January of 1917 through September of 1919, because President Tinoco governed the nation with the acquiescence of the people of Costa Rica, and his regime was recognized by several nations.[29]

Yet Chief Justice Taft declined to require Costa Rica to repay the loans. In reaching this decision, he stated:

> It is evident from the exhibits that in the spring of 1919 the popularity of the Tinoco [R]égime had disappeared, and that the political and military movement to end that régime was gaining strength. . . . It became perfectly clear from the mob violence and disturbances in June and the evidences of the unpopularity of the Tinoco [R]égime, that it was in a critical condition . . . .
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> . . . .
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> The Royal Bank cannot here claim the benefit of the presumptions which might obtain in favor of a bank receiving a deposit in regular course of business and paying it out in the usual way . . . . The whole transaction here was full of irregularities. . . . The case of the Royal Bank depends not on the mere form of the transaction but upon the good faith of the bank in the payment of money for the real use of the Costa Rican Government under the Tinoco [R]égime. It must make out its case of actual furnishing of money to the government for its legitimate use. It has not done so. The bank knew that this money was to be used by the retiring [P]resident . . . for his personal support after he had taken refuge in a foreign country. . . .
>
> The case of the money paid to the brother . . . is much the same. . . . To pay salaries for four years in advance is a most unusual and absurd course of business. All the circumstances should have advised the Royal Bank that this second draft, too, was for personal and not for legitimate government purposes. It must have known that Jose Joaquin Tinoco in the fall of his brother's government, which was pending, could not expect to represent the Costa Rican Government as its Minister to Italy for four years, that the reasons given for the payment of the money were a mere pretense and that it was only, as in the case of his brother Federico, an abstraction of the money from the public treasury to support a refuge abroad.[30]

Many commentators regard the reasoning of this decision as incorporating the general principles of the doctrine of odious debt,[31] as it is based on the assertions that the citizens of Costa Rica did not consent to the loans and they did not benefit from them, facts of which the lender was aware.

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27. *Id.*

28. *Id.* at 377–78.

29. *Id.* at 381.

30. *Id.* at 393–94.

31. *See*, *e.g.*, Jeff King, *Chapter One: The Doctrine of Odious Debt Under International Law: Definition, Evidence and Issues Concerning Application*, *in* CISDL WORKING PAPER: ADVANCING THE ODIOUS DEBT DOCTRINE 41–42 (2003); MICHALOWSKI, *supra* note 23, at 39; Buchheit, Gulati & Thompson, *supra* note 13, at 1217–18.

Despite these initial developments, the only formal statements of the doctrine of odious debt remain those of academicians and lawyers. In 1927, Alexander Sack, a scholar of international law, developed a characterization of odious debt:

> If a despotic power incurs a debt not for the needs or in the interest of the State, but to strengthen its despotic regime, to repress the population that fights against it, etc., this debt is odious for the population of all the State.
>
> This debt is not an obligation for the nation; it is a regime's debt, a personal debt of the power that has incurred it, consequently it falls with the fall of this power.
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> The reason these "odious" debts cannot be considered to encumber the territory of the State, is that such debts do not fulfill one of the conditions that determine the legality of the debts of the State, that is: the debts of the State must be incurred and the funds from it employed for the needs and in the interests of the State.
>
> "Odious" debts, incurred and used for ends which, to the knowledge of the creditors, are contrary to the interests of the nation, do not compromise the latter—in the case that the nation succeeds in getting rid of the government which incurs them—except to the extent that real advantages were obtained from these debts. The creditors have committed a hostile act with regard to the people; they can't therefore expect that nation freed from a despotic power assume the "odious" debts, which are the personal debts of that power.
>
> Even when a despotic power is replaced by another, no less despotic or any more responsive to the will of the people, the "odious" debts of the eliminated power are not any less their personal debts and are not obligations for the new power. . . .[32]

This characterization of debts incurred by a dictatorial regime—to which the citizens of the nation do not consent and from which they do not derive benefits, all of which is known to the lenders at the time the debts are incurred as the personal debts of the dictator, to be collected from that regime rather than from the successor government of the nation—as "odious debts" remains the foundation of all discussions of the doctrine of odious debt.

In formulating the doctrine, Professor Sack recognized that vagueness in the definition used to distinguish odious debts from other sovereign debts would provide a means for nations to default opportunistically on their debts. To avoid this destabilizing effect on the markets for sovereign debt, he proposed that claims to repudiate debts as odious be resolved in an international tribunal. Specifically, he proposed that

> (1) The new Government would have to prove and an international tribunal would have to ascertain the following:
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>> (a) That the needs which the former Government claimed in order to contract the debt in question, were odious and clearly in contradiction to the interests of the people of the entirety of the former State or a part thereof, and

32. ALEXANDER N. SACK, LES EFFETS DES TRANSFORMATIONS DES ÉTATS SUR LEURS DETTES PUBLIQUES ET AUTRES OBLIGATIONS FINANCIÈRES [THE EFFECTS OF STATE TRANSFORMATIONS ON THEIR PUBLIC DEBTS AND OTHER FINANCIAL OBLIGATIONS] 157–58 (1927), *translated in* PATRICIA ADAMS, ODIOUS DEBTS: LOOSE LENDING, CORRUPTION, AND THE THIRD WORLD'S ENVIRONMENTAL LEGACY 165–66 (1991).

> (b) That the creditors, at the moment of paying out the loan, were aware of its odious purpose.
>
> (2) Upon establishment of these two points, the creditors must then prove that the funds for this loan were not utilized for odious purposes—harming the people of the entire State or part of it—but for general or specific purposes of the State which do not have the character of being odious.[33]

Thus, according to Professor Sack, the determination of whether or not a debt is odious first involves a demonstration by the new government seeking relief from the obligation to repay a debt incurred by the prior regime that: the debt did not benefit the citizens of the nation (and so did not have their consent), and that the lender knew of the uses of the proceeds of the loan when they were disbursed. The lender then has an opportunity to secure repayment of the debt (or a portion of the debt) by showing that the proceeds (or a portion of them) were used to fund projects that were beneficial to the citizens.

B. Adaptation of the Doctrine of Odious Debt

Following this period of activity, the doctrine of odious debt remained fallow, seldom employed in negotiations between governments or examined in the academy. Then, in the spring of 2003, the United States toppled the regime of Saddam Hussein in Iraq. Estimates of the country's foreign debt burden ranged from $120 billion to $130 billion,[34] rising to as high as $350 billion when all claims incurred during the Hussein Regime were considered.[35] Based on the size of the burden and the brutality of the regime, many commentators, including members of the Bush Administration, advocated that the new government in Iraq disavow the debts incurred during the Hussein Regime.[36] In addition to discussions in the political sphere, these events and comments invigorated the debate regarding the doctrine of odious debt among academicians.[37]

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33. ALEXANDER N. SACK, LES EFFETS DES TRANSFORMATIONS DES ÉTATS SUR LEURS DETTES PUBLIQUES ET AUTRES OBLIGATIONS FINANCIÈRES [THE EFFECTS OF STATE TRANSFORMATIONS ON THEIR PUBLIC DEBTS AND OTHER FINANCIAL OBLIGATIONS] 163 (1927), *translated in* Robert Howse, *The Concept of Odious Debt in Public International Law* 3 (U.N. Conference on Trade & Dev., Discussion Paper No. 185, 2007), *available at* http://www.unctad.org/en/docs/osgdp20074_en.pdf.

34. Ester Pan, *Iraq: The Regime's Debt*, COUNCIL ON FOREIGN RELATIONS (Dec. 31, 2003), http://www.cfr.org/publication/7796/iraq.html.

35. *Paying for Saddam's Sins: Should the New Iraq Honour the Financial Obligations of the Old Regime?*, ECONOMIST, May 17, 2003, at 68.

36. *See, e.g.*, Patricia Adams, *Iraq's Odious Debts* 1 (Cato Institute, Policy Analysis No. 526, 2004), *available at* http://www.cato.org/pubs/pas/pa-526es.html; David DeRosa, *Iraq Needs a New Currency and Debt Relief*, BLOOMBERG LAW REPORTS (Apr. 2003) (quoting John Snow, U.S. Secretary of the Treasury, declaring "[c]ertainly the people of Iraq shouldn't be saddled with those debts incurred through the regime of the dictator who's now gone"); *but see Iraq's Debt: The U.S. Should Beware the Principle of Odious Lending*, FIN. TIMES, June 16, 2003, at 20.

37. *See generally* Hanlon, *supra* note 7; MICHALOWSKI, *supra* note 23; Buchheit, Gulati & Thompson, *supra* note 13; Anupam Chander, *Odious Securitization*, 53 EMORY L.J. 923 (2004); Feibelman, *Contract*, *supra* note 12; Anna Gelpern, *What Iraq and Argentina Might Learn from Each Other*, 6 CHI. J. INT'L L. 391 (2005) [hereinafter Gelpern, *Iraq and Argentina*]; Jayachandran & Kremer, *supra* note 10; Joseph Stiglitz, *Odious Rulers, Odious Debts*, ATLANTIC MONTHLY, Nov. 2003,

The work of scholars over the course of the past several years has principally been devoted to designing alternative mechanisms for achieving the aims of the odious debt doctrine.[38] For example, several scholars have offered adaptations of the doctrine that shift the locus of the inquiry from the loan-by-loan analysis inherent in Professor Sack's formulation to an examination of the nature of the regime. Seema Jayachandran and Michael Kremer, for instance, propose that international bodies—such as the United Nations Security Council, as well as significant participants in the sovereign debt markets, including the European Union and the United States—declare that any future debt incurred by a particular dictator will be considered odious and therefore illegitimate and nontransferable to successor regimes.[39] A declaration of this nature, they argue, would impose "loan sanctions" against the dictator by limiting the incentives of creditors to make loans to the dictator.[40]

Similarly, Patrick Bolton and David Skeel propose that a regime be deemed odious if the United Nations determines that it engages in systematic suppression or the International Monetary Fund (IMF) determines that it engages in systematic looting (or both).[41] The United Nations would make its declaration of odiousness based upon a finding of systematic suppression either during the time that the regime was in power or upon the emergence of a new government.[42] In either case, the declaration would render the debts of the regime unenforceable.[43] The IMF, they argue, "could police a regime's looting by imposing conditions on access to IMF assistance as well as by invalidating the regime's debt."[44] Consequently, the sources of funds available to the regime would be severely constrained.

Other scholars have worked to expand the scope of the investigation to encompass dictatorial regimes, so that sovereign debts may be challenged as odious debts even during the dictator's reign. Christoph Paulus, for example, identifies three conditions to the determination of a sovereign debt as odious: "lack of consent on the part of the people, the loan not being in the interests of the people, and the lender's knowledge of the other two facts."[45] Either an existing court institution, such as the Dispute Settlement Body of the World

at 39, *available at* http://www.theatlantic.com/doc/prem/200311/stiglitz; Symposium, *Odious Debts and State Corruption*, 70 LAW & CONTEMP. PROBS. 1 (Summer & Autumn 2007).

38. A few scholars, however, have criticized the doctrine of odious debt. *See, e.g.*, Albert H. Choi & Eric A. Posner, *A Critique of the Odious Debt Doctrine*, 70 LAW & CONTEMP. PROBS. 33 (Summer 2007) (arguing that, while selective application of the doctrine may be beneficial in principle, achieving the desired application is unlikely to be feasible in practice); Gelpern, *Iraq and Argentina*, *supra* note 37, at 393 (arguing that sovereign debtors in dire financial straits inhabit a relatively flexible universe, with sufficient public, private, legal, and political resources to keep their creditors at bay).

39. Jayachandran and Kremer, *supra* note 10, at 82.

40. *Id.* at 90.

41. Bolton & Skeel, *supra* note 10, at 84–85.

42. *Id.* at 85.

43. *Id.*

44. *Id.*

45. Paulus, *supra* note 11, at 92.

Trade Organization, or a new adjudicative body created by the United Nations could be charged with enforcing this new legal principle.[46] The parties permitted to petition the international tribunal to hear claims that a regime's debts are odious would be specified through "an appropriate process which guarantees access to the panel in cases of 'odious debts' without imposing an unbearable control mechanism on the parties involved."[47] Upon a favorable finding, each sovereign debt considered in the hearing would be declared null and void, and the creditor would be precluded from demanding repayment on the grounds of unjust enrichment.[48]

Proposing the application of a similar approach in a different context, Adam Feibelman seeks to develop a "contractual odious debt mechanism" through which a sovereign debtor expressly promises its creditors that it will refrain from incurring odious debts.[49] The sovereign debtor also "promise[s] each creditor that it will inform subsequent creditors of the contractual arrangement and that it will make similar arrangements with these creditors."[50] The contract governing the loan will define the characteristics of an odious debt, and it will grant a majority, or a supermajority, of the creditors the authority to designate obligations of the debtor as odious in accordance with the contractual definition.[51] If an obligation is deemed to be odious, the sovereign debtor will be required to repudiate it.[52]

Finally, rather than proposing the development of new frameworks for designating regimes as odious or the inclusion of new terms in the agreements governing sovereign debt, other scholars have investigated the extent to which the aims of the doctrine of odious debt may be achieved through the application of principles of private (domestic) law to sovereign debts. In particular, they examine the extent to which common-law principles of contract, tort, and lender liability, as well as fundamental principles of insolvency, might provide a successful defense for a new government that is sued for failure to make payments on an odious debt incurred during the prior reign of a despot. For example, Lee Buchheit, Mitu Gulati, and Robert Thompson argue that whenever the odious debt involves a bribe, the new government should be able to assert (and would likely be successful in its assertion) that enforcement of the payment obligations related to the debt would be contrary to the public policy of the United States and its constituent states.[53] Similarly, these scholars posit that, in the event the dictator stole the proceeds of the loan, the new government should be able to assert (and would likely be successful in its

46. *Id.* at 101.
47. *Id.* at 102.
48. *Id.* at 100.
49. Feibelman, *Contract*, *supra* note 12, at 748.
50. *Id.* at 731.
51. *Id.*
52. *Id.*
53. Buchheit, Gulati & Thompson, *supra* note 13, at 1232–35.

assertion) that the lender has "unclean hands" and so is not entitled to payment.[54]

Working within the framework of tort law, Omri Ben-Shahar and Mitu Gulati offer a means of apportioning the losses associated with an odious debt.[55] Specifically, they propose that upon a suit for failure to make payments on an odious debt, the sovereign debtor should be entitled to assert a defense of contributory negligence.[56] To the extent the new government is able to show that the lender was at fault, the portion of the debt that was not used for the benefit of the country's citizens would be discharged. For example, if the proceeds of the loan were deposited into a personal account of the dictator, then the entire debt would be discharged. If only a portion of the proceeds of the loan was used to pay a bribe to the dictator, then only that portion of the debt would be discharged. Professor Ben-Shahar and Professor Gulati note that they are, in effect, proposing a comparative-fault scheme for odious debts—one that is applicable not only to disputes between the new government and each of its creditors, but also to disputes among the creditors because those creditors who are less at fault would be able to secure greater payments on the debts owed to them.[57]

To address disputes among creditors, Professor Feibelman draws upon the doctrines of lender liability, particularly equitable subornation and fraudulent transfer.[58] He argues that the creditors of a sovereign debtor should be able to employ these doctrines to subordinate or avoid odious debts that the sovereign owes to other creditors pursuant to state law in federal district courts or state courts in the United States.[59] By providing creditors with a means to reduce (or to eliminate) the likelihood that a creditor acting opportunistically or fraudulently will be entitled to payment in respect of its debt, these doctrines provide incentives for creditors to monitor one another, particularly with respect to the incurrence of odious debts.[60]

Mechele Dickerson relies upon fundamental principles of insolvency to achieve the aims of the doctrine of odious debt. In particular, she argues that the core "business" of a new government is to "protect the safety and provide for the general welfare of its citizens."[61] Thus, it is consistent with general insolvency principles to allow a new government, encumbered with enormous debts that provided little (or no) benefits to the citizens of the country, to

54. *Id.* at 1235–37.

55. *See generally* Ben-Shahar & Gulati, *supra* note 13.

56. *Id.* at 50.

57. *Id.* at 65.

58. *See generally* Feibelman, *supra* note 13.

59. *Id.* at 179 (noting that asserting these doctrines under bankruptcy law is unavailable because sovereigns cannot file for bankruptcy under U.S. bankruptcy law).

60. *Id.* at 189.

61. Dickerson, *supra* note 13, at 72.

repudiate those debts if repaying them would render the government functionally insolvent and unable to perform its critical functions.[62]

Over the course of the more than one hundred years during which the doctrine of odious debt was initially developed and then recently adapted, the nature of international lending has changed dramatically. At the time of the Spanish–American War of 1898 and the Tinoco Arbitration in 1923, and continuing until the middle of the 1940s, sovereign debtors borrowed funds almost exclusively from investors who purchased sovereign bonds.[63] Beginning in the Cold War, sovereign debtors procured loans from other governments[64] as well as from the international financial institutions, notably the World Bank.[65] During the 1970s, sovereign debtors borrowed funds from commercial banks.[66] These loans were securitized and converted into bonds (known as Brady bonds) during the 1990s.[67] As a result of these transitions—from bonds to bilateral loans and multilateral loans, to commercial-bank loans, and then again to bonds—as well as the continuing role of private lenders, international financial institutions, and governments in providing credit to sovereigns, the international financial architecture is comprised of distinct creditors with diverse interests.[68]

To be sure, the extent of involvement of any of these creditors in lending to sovereigns fluctuates over time. In addition, the particular mix of debt—sovereign bonds, commercial-bank loans, multilateral loans from the international financial institutions, and bilateral loans from other governments—varies from sovereign debtor to sovereign debtor. Nonetheless, each of these creditors and each of these types of debt are present in the international financial architecture. An analysis of the odious debt doctrine, as well as of the recent adaptations of the doctrine, then, requires an understanding of the nature of the salient features of each type of sovereign debt.

62. *Id.*

63. Vinod K. Aggarwal, *The Evolution of Debt Crisis: Origins, Management and Policy Lessons*, *in* SOVEREIGN DEBT: ORIGINS, CRISES AND RESTRUCTURING 11, 13 (Vinod K. Aggarwal & Brigitte Granville eds., 2003); Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguards? The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L.J. 1043, 1051–53 (2004).

64. Anna Gelpern, *Odious, Not Debt*, 70 LAW & CONTEMP. PROBS. 81, 87 (Summer 2007) [hereinafter Gelpern, *Odious, Not Debt*].

65. Aggarwal, *supra* note 63, at 14.

66. James V. Feinerman, *Odious Debt, Old and New: The Legal Intellectual History of an Idea*, 70 LAW & CONTEMP. PROBS. 193, 202–03 (Autumn 2007).

67. Fisch & Gentile, *supra* note 63, at 1067.

68. *Id.* at 1070–71; Anna Gelpern, *Building a Better Seating Chart for Sovereign Debt Restructurings*, 53 EMORY L.J. 1115, 1115–16 (2004).

III
THE ELEMENTS OF SOVEREIGN DEBT

A. Bilateral Loans

As tensions during the Cold War escalated, the government of the United States, as well as the government of the Soviet Union, began to provide financing to governments to advance strategic objectives. These new programs had a variety of goals ranging from the improvement of military capabilities to economic development to humanitarian assistance.[69] The enactment of the Foreign Assistance Act of 1961,[70] together with the founding of the U.S. Agency for International Development (USAID),[71] comprised a comprehensive foreign-assistance program. Through this program, Congress has authorized myriad foreign loan initiatives related to the spread of democracy, the growth of exports, the reduction of poverty, and the eradication of disease.

The primary form of assistance from the United States was, and remains, loans.[72] Yet, in many instances, the government does not expect that the loans will be repaid. Rather than enforcing the payment provisions, a portion (or all) of the loans is often forgiven or converted to a grant.[73]

In the event the bilateral loans must be restructured, the work is conducted through the Paris Club, an informal group of nineteen creditor governments from the major industrialized countries.[74] Representatives of these countries meet monthly in Paris to assist sovereign debtors in restructuring their debts.[75] Agreements between the governmental lenders and the sovereign debtors are typically reached quickly and inexpensively because the governments are willing to make concessions based on geopolitical, rather than financial, considerations.[76]

These arrangements, of course, arise from the nature of bilateral loans. These types of loans are, in essence, political accommodations rather than economic transactions. In making a loan to an ally, the United States (like all creditor countries) is concerned with achieving its tactical goals—such as

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69. Gelpern, *Odious, Not Debt*, *supra* note 64, at 94.

70. Act for International Development of 1961 (Foreign Assistance Act of 1961), Pub. L. No. 87-195, § 503, 75 Stat. 424, 435 (codified as amended at 22 U.S.C. § 2311).

71. *See About USAID*, USAID, http://www.usaid/gov/about_usaid/ (last visited Dec. 2, 2010).

72. Gelpern, *Odious, Not Debt*, *supra* note 64, at 95.

73. *Id.*

74. *See* THE PARIS CLUB, http://www.clubdeparis.org/ (last visited Dec. 2, 2010).

75. *Paris Club Meetings*, THE PARIS CLUB, http://www.clubdeparis.org/sections/composition/fonctionnement-du-club/reunions (last visited Dec. 2, 2010).

76. A. Mechele Dickerson, *A Politically Viable Approach to Sovereign Debt Restructuring*, 53 EMORY L.J. 997, 1008–09 (2006).

influencing the ally's policies—not with generating additional revenues for the public fisc. Consequently, loans are often made to dictatorships.[77]

B. Multilateral Loans

The IMF, with nearly two hundred members, was established in 1945[78] to promote international monetary cooperation and exchange stability, to foster economic growth, and to provide temporary financial assistance to countries that are experiencing balance-of-payments difficulties.[79] The principal means by which the IMF works to achieve these goals is multilateral loans,[80] financed with funds provided by its members.[81] The terms and conditions of these loans, which typically include stipulations regarding specific economic policies to be implemented,[82] are the subject of negotiation between the IMF and the member country requesting the loan.[83]

Over the course of the half-century since its creation, and in response to changes in the international financial architecture, the IMF has altered its rationale for making loans to sovereigns.[84] Rather than assisting countries in resolving temporary difficulties in their current account payments, the efforts of the IMF have shifted to promoting economic development and managing restructurings of sovereign debt.[85] Specifically, IMF loans are now designed (1) to assist countries in adjusting to shocks caused by a variety of events, including changes in the terms of trade and national disasters, as a means of avoiding severe economic disruptions and costly defaults on sovereign debts, (2) to provide a catalyst for other lenders, particularly commercial banks and investors, to extend credit to countries experiencing disruptions and restructurings, and (3) to prevent capital account crises.[86]

In addition to these concerns for economic development, multilateral loans often entail political considerations. For example, Strom Thacker has demonstrated that the United States, which controls the largest portion of the

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77. Indeed, Professor Choi and Professor Posner suggest that cooperation with dictatorships is more common than sanctioning them. Choi & Posner, *supra* note 38, at 33.

78. *The IMF at a Glance*, INT'L MONETARY FUND (Sept. 15, 2010), http://www.imf.org/external/np/exr/facts/glance.htm [hereinafter *IMF at a Glance*].

79. ARTICLES OF AGREEMENT OF THE INTERNATIONAL MONETARY FUND art. I–Purposes, *available at* http://www.imf.org/external/pubs/ft/aa/.

80. Yilmaz Akyűz, *Rectifying Capital Market Imperfections: The Continuing Rational for Multilateral Lending*, *in* THE NEW PUBLIC FINANCE: RESPONDING TO GLOBAL CHALLENGES 486, 486 (Inge Kaul & Pedro Conceiçáo eds., 2006).

81. *IMF at a Glance*, *supra* note 78.

82. *Lending by the IMF*, INT'L MONETARY FUND, http://www.imf.org/external/about/lending.htm (last visited Dec. 2, 2010) [hereinafter *Lending by the IMF*].

83. *Factsheet: IMF Lending*, INT'L MONETARY FUND (Oct. 5, 2010), http://www.imf.org/external/np/exr/facts/howlend.htm.

84. *Lending by the IMF*, *supra* note 82.

85. Akyűz, *supra* note 80, at 492–94.

86. *Lending by the IMF*, *supra* note 82.

voting power in the IMF,[87] favors granting loans to countries that serve as allies, particularly in their respective voting patterns on matters presented in the United Nations General Assembly.[88] Axel Dreher and Nathan Jensen have shown that loans made to countries voting with the United States in the United Nations General Assembly have fewer conditions than those made to countries that are not allied with the United States in this way.[89]

Multilateral loans thus share important characteristics with bilateral loans. They are designed to achieve specific objectives—protecting and strengthening the international financial architecture—not to earn profits for the IMF. Decisions to extend credit as well as determinations of the applicable prerequisites for receiving credit are influenced by efforts to advance political aims. Finally, restructurings of these loans involve a dialogue between the IMF and the relevant sovereign debtor, and so are seldom time consuming or costly.

C. Private Loans

1. Commercial Loans

Commercial banks make loans to sovereigns through lending syndicates.[90] Each syndicate is organized by a large, international commercial bank that serves as the manager of the syndicate.[91] The managing bank advises the sovereign of market conditions, principally the terms on which it expects to be able to obtain commitments from a sufficient number of commercial banks to satisfy the sovereign's borrowing needs.[92] The manager also negotiates, on behalf of the syndicate, the terms of the loan agreement with the sovereign.[93] To complete the syndication process, the managing bank prepares, in conjunction with the sovereign, an information memorandum describing the sovereign's financial condition and the loan terms.[94] The manager then secures the commitments of the banks participating in the syndicate, and it arranges for the funds to be disbursed to the sovereign debtor.[95]

Restructurings of commercial loans are accomplished through the London Club, a collection of informal arrangements including the use of bank advisory

87. Strom C. Thacker, *The High Politics of IMF Lending*, 52 WORLD POL. 38, 41 (1999).

88. *Id.* at 67–69.

89. Axel Dreher & Nathan M. Jensen, *Independent Actor or Agent? An Empirical Analysis of the Impact of U.S. Interests on International Monetary Fund Conditions*, 50 J.L. & ECON. 105, 121 (2007).

90. JOHN D. FINNERTY & DOUGLAS R. EMERY, DEBT MANAGEMENT: A PRACTITIONER'S GUIDE 31–32 (2001).

91. Leo Clarke & Stanley F. Farrar, *Rights and Duties of Managing and Agent Banks in Syndicated Loans to Government Borrowers*, 1982 U. ILL. L. REV. 229, 229 (1982).

92. *Id.*

93. *Id.* at 233. *See also International Banking Survey*, ECONOMIST, Mar. 20, 1982.

94. Clarke & Farrar, *supra* note 91, at 233.

95. *Id.* at 244–45.

committees and standard processes for negotiating with sovereign debtors.[96] The terms of each restructuring are, in large measure, influenced by the IMF, which requires the commercial banks in the lending syndicate to make new loans to the sovereign debtor as a condition to the extension of multilateral credit.[97] In many instances, the U.S. government also plays a significant role in the negotiations, counseling (and pressuring) both members of the bank advisory committees and representatives of the sovereign debtor.[98]

Although the work of the London Club proceeds slowly—requiring, in some cases, years to complete the restructuring of a sovereign debtor's commercial loans—the informal processes tend to be effective.[99] Commercial banks are typically reluctant to disavow the work of the London Club by declaring a default and accelerating their loans because there are few advantages and significant disadvantages. Upon the declaration of a default on a loan in its portfolio, a commercial bank is required, pursuant to applicable regulations, to increase its loan-loss reserves or write off a portion of the loan.[100] Both of these actions diminish the commercial bank's financial condition. Moreover, rejection of a restructuring proposed through the London Club would jeopardize, for the commercial bank serving as the manager of the lending syndicate, important business relationships with the sovereign debtor[101] and, for small, regional commercial banks participating in the lending syndicate, vital banking relationships with the managing bank.[102]

Unlike bilateral loans and multilateral loans, commercial loans are, to a significant degree, subject to market forces. Commercial banks must operate profitably to remain in business. In determining whether to enforce the right to repayment of a loan against a sovereign debtor or to accept the partial payment to be made as part of a proposed restructuring of the loan, commercial banks weigh the likely impact of each course of action on revenues and expenses. Due to the high regulatory costs and the impairment of crucial relationships caused by the declaration of an event of default, commercial banks acquiesce to the demands of the London Club.

96. *See* Fisch & Gentile, *supra* note 63, at 1055–63; Daniel McGovern, *Different Market Windows on Sovereign Debt: Private-Sector Credit from the 1980s to the Present*, *in* SOVEREIGN DEBT: ORIGINS, CRISES AND RESTRUCTURING 69, 82–83 (Vinod K. Aggarwal & Brigitte Granville eds., 2003).

97. Fisch & Gentile, *supra* note 63, at 1061–62. The extension of multilateral credit, of course, is necessary for the sovereign to resolve the financial crisis giving rise to the restructuring and to resume payments on its debts.

98. *See* Lee C. Buchheit, *Sovereign Debt: A Change of Hat*, INT'L FIN. L. REV., June 1990, at 12 (describing the conflicting roles of the U.S. government in restructurings of sovereign commercial loans).

99. McGovern, *supra* note 96, at 82–83.

100. Clarke & Farrar, *supra* note 91, at 232.

101. Fisch & Gentile, *supra* note 63, at 1058–59.

102. *See id.* at 1060–61.

2. Sovereign Bonds

Sovereign bonds are sold in the capital markets, including the domestic market in the United States and the international Eurobond market.[103] The investors purchasing an issue of sovereign bonds may be citizens of the issuer or other countries, as well as financial institutions or single individuals.[104] They include commercial banks, investment banks, insurance companies, pension funds, mutual funds, and purchasers in the retail sector.[105]

These diverse purchasers differ in their investment strategies, in the regulations to which they are subject, and in the nature of their relationships with sovereign debtors.[106] Furthermore, they purchase their sovereign bonds at different prices, as bonds in the secondary market often trade at deep discounts to their face values.[107] Vulture funds, notably, trade in distressed debt, including sovereign bonds. These investors seek short-term gains by purchasing the debt of troubled issuers for pennies on the dollar and then, once a violation of the terms of the bonds occurs, seek to enforce their rights (including, when applicable, the right to the repayment of the full value of the debt) through litigation.[108]

Restructurings of sovereign bonds take place in the capital markets through exchange offers.[109] In these transactions, sovereign debtors propose to replace existing bonds with alternative bonds that reschedule or reduce the payments owed under the original bonds.[110] Rather than negotiating directly with the creditors, or with an advisory committee following standard processes, sovereign debtors consult with groups of financial institutions holding large positions in the bonds, and they also meet individually with these investors.[111]

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103. Michael G. Kollo, *Underwriter Competition and Gross Spreads in the Eurobond Market* 9 (Eur. Cent. Bank, Working Paper Series No. 550, 2005), *available at* http://www.ecb.int/pub/pdf/scpwps/ecbwp550.pdf. *See also* INT'L MONETARY FUND, ACCESS TO INTERNATIONAL CAPITAL MARKET FOR FIRST-TIME SOVEREIGN ISSUERS 16, 20 (2003), http://www.imf.org/external/np/icm/2003/eng/111703.pdf (describing factors for consideration in selection of market for issuance of sovereign bonds).

104. McGovern, *supra* note 96, at 77.

105. *Id. See also* Lee C. Buchheit, *How Ecuador Escaped the Brady Bond Trap*, INT'L FIN. L. REV., Dec. 2000, at 17, 18 [hereinafter Buchheit, *Bond Trap*] (describing diversity among holders of Ecuador's Brady bonds); Lee C. Buchheit & Jeremiah S. Pam, *Uruguay's Innovations*, 2004 J. INT'L BUS. L. REV. 28, 28 [hereinafter Buchheit, *Innovations*] (noting fragmented and dispersed holders of sovereign bonds).

106. *See* Fisch & Gentile, *supra* note 63, at 1071–74.

107. *See* Buchheit, *Bond Trap*, *supra* note 105, at 18 (noting discounts in secondary markets for Ecuador's Brady bonds).

108. For a discussion of the role of vulture funds in sovereign debt restructurings, see Fisch & Gentile, *supra* note 63, at 1071–72, 1088–90.

109. Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA. L. REV. 59, 60 (2000).

110. *Id.* at 60, 62–64.

111. *See, e.g.*, Buchheit, *Bond Trap*, *supra* note 105, at 18 (describing the restructuring process for Ecuador's Brady bonds); Buchheit, *Innovations*, *supra* note 105, at 28–29 (describing the restructuring process for Uruguay's bonds); Anna Gelpern, *What Bond Markets Can Learn from Argentina*, INT'L FIN. L. REV., Apr. 2005, at 19, 20–21 [hereinafter, Gelpern, *Bond Markets*] (describing the restructuring process for Argentina's bonds).

This consultative process is designed to allow sovereign debtors to determine the restructuring terms that are likely to be acceptable to all (or nearly all) investors.[112]

The diversity of investors and the heterogeneity of their interests make this task impossibly difficult.[113] Additionally, some investors, namely vulture funds, pursue a strategy of rejecting exchange offers and seeking preferential treatment in court. This holdout litigation, while often beneficial for the vulture funds, disrupts the restructuring process, causing delays and inflicting losses on the sovereign debtor and the other creditors.[114] Efforts to preclude, or constrain, these types of suits against sovereign debtors[115] have not been entirely successful,[116] and this litigation remains a persistent characteristic of restructurings of sovereign bonds.

IV

LIMITING ODIOUS CREDIT

Recent efforts to adapt the doctrine of odious debt to shift the onus of limiting the harms a dictator inflicts on the citizenry from new governments to creditors are an essential component of the modern legal history of sovereign debt. Recognizing the reluctance of new governments to employ the doctrine to repudiate debts incurred by despots, these proposals seek to raise the costs of extending credit to dictators and thereby reduce incentives to lend. Yet, many creditors have motivations other than profit in making loans to sovereigns and so are unlikely to alter their behavior upon the implementation of these plans. And, some of the creditors that are motivated by financial gain are likely to find the profitable course of action to be to accept short-term losses in order to secure long-term gains.

In making bilateral loans, the U.S. government (like other creditor governments) seeks to advance its strategic objectives, and so it agrees to restructure its loans to sovereigns to achieve tactical goals. Similarly, the IMF, in making and in agreeing to restructure multilateral loans, seeks to achieve specific objectives regarding the soundness of the international financial architecture and, in many instances, to advance partisan interests. Moreover, commercial banks, although subject to market forces in making loans to

112. Buchheit, *Innovations*, *supra* note 105, at 29 (noting the purpose of consultations in the restructuring process for Uruguay's bonds).

113. *See* Felix Salmon, *Stop Selling Bonds to Retail Investors*, 35 GEO. J. INT'L L. 837, 838 (2007) (describing discrimination against retail investors in sovereign bond restructurings).

114. G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635, 637–38 (2001).

115. For a description of these efforts, see Fisch & Gentile, *supra* note 63, at 1090–97.

116. Michael Bradley, James D. Cox & Mitu Gulati, *The Market Reaction to Legal Shocks and Their Antidotes: Lessons From the Sovereign Debt Market*, 39 J. LEGAL STUD. 289, 295 (2010). *See, e.g.*, Gelpern, *Bond Markets*, *supra* note 111, at 21 (noting judgments received through holdout litigation in restructuring of Argentina's bonds); Ashley Seager & James Lewis, *How "Vulture Funds" Prey on Poor Nations*, THE HINDU, Oct. 19, 2007, *available at* http://www.hinduonnet.com/2007/10/19/stories/2007101954771300.htm.

sovereigns, maximize revenues and minimize expenses by agreeing to restructuring terms that reflect political pressures and impulses to protect valuable relationships.

Investors, however, base their decisions to purchase and to agree to restructure sovereign bonds upon financial considerations. These calculations include the profit to be earned by purchasing sovereign bonds in the secondary market for a fraction of their face values and enforcing payment of the entire amount owed on the bonds in court. This inclination of vulture funds to pursue opportunistic litigation may be harnessed to limit the credit available to dictators.

A. Uses of Proceeds and Covenants

To sell bonds in the capital markets, sovereigns must provide investors with extensive information regarding their financial condition and the terms of the bonds. As Lee Buchheit has noted,

> Borrowers face a cruel choice: tell or pay. The finest pricing terms for a debt obligation are usually available only for instruments that have a significant degree of liquidity ([i.e.,] instruments that can be readily sold or resold to a broad range of investors). But the securities laws of most jurisdictions say that a borrower which issues its debt instruments to a broad range of investors should disclose a good deal of information about itself, its business and its financial condition to the prospective purchasers of those instruments. Thus, a disclosure-averse borrower may be consigned to raising funds through commercial bank loans . . . ; borrowings that typically command some premium in terms of pricing in comparison with publicly-issued debt instruments.[117]

In describing the market practice regarding issuances of sovereign bonds, Mr. Buchheit states that sovereigns "generally provide . . . information about their country, its history and political situation, foreign relations, economic and financial information including balance of payments, balance of trade and exchange rate policies, and external debt service statistics."[118] With respect to the agreements governing the bonds, Stephen Choi and Professor Gulati examined the information provided by ten sovereigns issuing bonds from 1985 to 2005.[119] They found that an explicit change in the actual contract language relating to the individual rights of holders of the bonds during a restructuring of the bonds was disclosed prominently, and continued to be disclosed prominently almost two years after the change in terms became widely known in the market, by all but one of the sovereigns.[120]

Moreover, sovereigns issuing bonds in the U.S. market must comply with the disclosure requirements of Schedule B to the Securities Act of 1933.[121] These

117. Lee C. Buchheit, *The Schedule B Alternative*, INT'L FIN. L. REV., July 1992, at 6, 6.

118. *Id.*

119. Stephen J. Choi & G. Mitu Gulati, *An Empirical Study of Securities Disclosure Practice*, 80 TUL. L. REV. 1023 (2006).

120. *Id.* at 1025, 1032–33, 1051–52, 1062.

121. 15 U.S.C. § 77g (2009).

requirements include information regarding the "specific purposes in detail and the approximate amounts to be devoted to such purposes, so far as determinable, for which the security to be offered is to supply funds . . . ."[122]

Rather than merely identifying the purposes for which the proceeds are to be used, sovereign debtors could promise to apply the funds in the manner specified. In effect, the description in the offering document for the bonds would be repeated as a covenant in the agreement governing the bonds. So, if the disclosed uses of the proceeds were to build hospitals and schools in rural areas, then the governing agreement would contain a covenant that the sovereign debtor will use the proceeds of the bonds to build hospitals and schools in rural areas.[123] In addition to promising to use the sale proceeds in a specified manner, sovereign debtors could also covenant to use the proceeds from all subsequent incurrences of debt for similar purposes that benefit the citizenry.[124]

Incorporating a covenant regarding the uses of the proceeds from an issuance of sovereign bonds into the agreement governing the bonds would provide investors with a way to restrict the ability of dictators to use borrowed funds for purposes that have deleterious effects on the citizenry.[125] Were a sovereign debtor to breach the covenant, the investors would have the right to accelerate the amount owed on the bonds, including the principal, making the debt due immediately, rather than on the maturity date of the bonds.[126] The exigencies of immediate repayment would severely constrain the funds available to the dictator.

Investors are likely to be able to obtain information regarding covenant breaches. Funds borrowed to finance projects that are beneficial for the citizenry typically involve large-scale public works, such as infrastructure development through the construction of power plants, waterways, sewage plants, and roads, and community development through building hospitals and schools. The results of these types of projects—utilities, dams and reservoirs,

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122. 15 U.S.C. § 77aa (2009).

123. This approach is similar to the treatment of the payment terms of the bonds. Every offering document for an issue of sovereign bonds contains a description of the amounts to be paid (principal and interest) as well as the method of payment (the applicable paying agent and the means by which the amounts paid are to be distributed to the holders of the bonds). And, the underlying governing agreement contains a covenant to pay the principal and interest on the bonds using the paying agent and means described in the offering document.

124. Recall that Professor Dickerson describes the core business of government as protecting the safety and providing for the general welfare of its citizens. Dickerson, *supra* note 13, at 72. This proposed covenant, then, may be viewed as analogous to business continuation covenants in agreements governing corporate bonds. Through a covenant of this type, a corporate debtor promises to remain in the same line of business as the one it is operating in on the date the bonds are issued.

125. Remedies for violations of the anti-fraud provisions of the federal securities laws are limited to damages. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: ESSENTIALS 102–03 (2008).

126. For a description of the workings of acceleration clauses in agreements governing sovereign bonds, see Lee C. Buchheit & G. Mitu Gulati, *Soveriegn Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1330–32 (2002).

waste treatment facilities, highways, and sizable buildings—are easily observed by investors.

Moreover, vulture funds, like all hedge funds, regularly engage specialist research firms to provide them with detailed information regarding their investments.[127] Each consultant employed by these firms has extensive experience in the industry with respect to which research services are provided, as well as access to information that is not widely available in the capital markets. Upon the adoption of use-of-proceeds covenants in agreements governing sovereign bonds, specialist research firms can be expected to expand the areas and events they cover to encompass the progress on, and completion of, the public-works projects promised to be funded with the proceeds from issuances of sovereign bonds.[128] Similarly, the credit rating agencies are likely to expand their analyses of the creditworthiness of sovereign debtors to include, for each country, a review of compliance with the use-of-proceeds covenants in the agreements governing its sovereign bonds.[129] Finally, as Professor Gulati and George Triantis have explained, the IMF serves as a delegated monitor in the sovereign debt context, bearing responsibility for scrutinizing the actions of sovereign debtors.[130] This scrutiny includes monitoring "economic performance, debt burdens and servicing strategies, and macro economic policies. Its staff conducts site visits, prepares country reports, and provides expert assistance to help members address debt servicing or macro economic challenges."[131] Through this work, the IMF will promptly uncover evidence of failures to comply with use-of-proceeds covenants, and it can be expected to share this information with investors.

Investors are likely to favor the incorporation of covenants regarding uses of proceeds into agreements governing sovereign bonds. For vulture funds, these covenants would provide an additional opportunity to pursue their strategy of seeking, through litigation, preferential treatment for repayment of sovereign bonds purchased in the secondary market. Other investors are also likely to value the protection the covenants would provide against efforts of sovereign debtors to restructure their bonds on advantageous terms. For example, Mr. Buchheit and Professor Gulati describe the conduct of President Correa as:

> [l]acking a financial justification for demanding concessions from the country's creditors, the Correa administration decided that it would seek a legal pretext for its hostile debt policy. The slogans for this were lying conveniently at hand courtesy of

127. *See* Laurie P. Cohen, *Seeking an Edge, Big Investors Turn to Network of Informants*, WALL ST. J., Nov. 27, 2006, at A1 (describing role of independent research firms in providing hedge funds with access to industry experts).

128. *Id.* (describing the fee structure and revenues of independent research firms).

129. *See, e.g.*, MOODY'S INVESTORS SERVICE, CREDIT ANALYSIS: ECUADOR 1, 5 (Mar. 2010) (describing primary factors determining bond rating range for sovereign debtors as including susceptibility to event risk).

130. Mitu Gulati & George Triantis, *Contracts Without Law: Sovereign Versus Corporate Debt*, 75 U. CIN. L. REV. 977, 991–92 (2007).

131. *Id.* at 993.

> the academic debate about the early twentieth century doctrine of odious sovereign debts . . . .
>
> Shortly after taking office in 2006, Correa appointed a Commission of Integral Audit of Public Credit and ordered it to examine Ecuador's foreign debts. That Commission, composed principally of local and foreign activists for third-world debt cancellation, duly reported its finding that virtually all of Ecuador's external debt stock was fatally tainted by illegality and illegitimacy.[132]

If the agreements governing Ecuador's sovereign bonds had contained use-of-proceeds covenants, these actions would have resulted in restructuring terms that were disadvantageous to the country, as claims that its debt negotiators were wicked and corrupt would have provided a basis for investors to assert claims of breach of covenant, which would have strengthened their negotiating position. Finally, some investors may view the covenants as an effective means of limiting the credit available to dictators, and they may value those constraints. In describing the significant degree of debt relief granted to heavily indebted sovereigns, Mr. Buchheit and Professor Gulati note that

> [n]o one will ever be able to determine how much of the relief granted to these countries was attributable to the creditors' own sense of culpability for having lent money, or at least so much money, in the first place. But this was surely an element in the deals cut for certain countries such as Iraq in 2004.[133]

Sovereign debtors are unlikely to resist efforts to incorporate covenants regarding uses of proceeds into agreements governing sovereign bonds. Indeed, they can be expected to support these efforts. Michael Bradley, James Cox, and Professor Gulati "find that sovereign bond pricing is sensitive to changes in legal risk posed by . . . bond covenants."[134] Thus, the more protections the agreement governing the bonds provides to investors, the lower the interest rate investors demand to purchase the bonds (because the bonds are subject to less risk). By including a use-of-proceeds covenant in the agreement governing an issue of its bonds, then, a sovereign debtor can obtain a lower interest rate on the bonds, thereby reducing the cost of the financing. The reduction in financing costs provides strong incentives to incorporate covenants regarding uses of proceeds into agreements governing sovereign bonds.

B. Covenants and Capital Markets

The terms of any covenant regarding the use of the proceeds from any issuance of sovereign bonds will be familiar to investors and sovereign debtors. Indeed, these terms will be drawn from the capital markets. In preparing a covenant for inclusion in the agreement governing an issue of sovereign bonds, a sovereign debtor will review the offering documents used to market issuances of the sovereign debtor's bonds in the past, as well as the offering documents for issuances of bonds of similar countries with comparable financing needs.

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132. Buchheit & Gulati, *Coroner's Inquest*, *supra* note 2, at 23.

133. Lee C. Buchheit & G. Mitu Gulati, *Odious Debts and Nation-Building: When the Incubus Departs*, 60 ME. L. REV. 477, 485 (2008).

134. Bradley, Cox & Gulati, *supra* note 116, at 302.

The sovereign debtor will also review the planned uses for the funds to be obtained upon issuance of the bonds. As a consequence of this process, the description of the uses of the proceeds in the offering document and the related terms of the use-of-proceeds covenant in the governing agreement[135] will be both in a standard form and tailored to reflect the intentions of the sovereign debtor.[136] Moreover, by incorporating the description of the uses of the proceeds in the offering document into a covenant made in the agreement governing the bonds, the sovereign debtor grants investors the right to accelerate the amount owed on the bonds in the event the proceeds are not used as promised in the covenant (and described in the offering document).

As a result, adapting existing disclosure requirements and market practices to incorporate a covenant regarding the use of proceeds from an issuance of sovereign bonds into the agreement governing the bonds is unlikely to disrupt the capital markets. Rather than introducing new adjudicative procedures and seeking to develop new contractual mechanisms, this approach uses existing terms and exploits extant incentives toward litigation to provide a means of limiting the credit available to dictators.

This approach, however, is not without limitations. Although both investors and sovereign debtors have strong incentives to include covenants limiting the uses of the proceeds from issuances of sovereign bonds in the agreements governing the bonds, we cannot be sure that the agreements will be modified in this way. Agreements governing sovereign bonds can be characterized as highly standardized, and they are generally very difficult to modify, even in the face of sustained pressure from governmental officials.[137]

Moreover, even if agreements governing sovereign bonds were modified to include use-of-proceeds covenants, they would serve to constrain only sovereign debtors that issue bonds. Countries that obtain their external financing (or even a substantial portion of their external financing) through bilateral loans and multilateral loans will not be subject to pressures from investors. Indeed, even countries that borrow extensively from other private creditors, like commercial banks, will not be severely constrained in using the proceeds of the loans in ways that do not benefit the citizenry.

Furthermore, even sovereigns that obtain all (or a substantial portion of) their external financing through issuances of bonds governed by agreements containing covenants limiting the uses of the proceeds from the bonds may be able to finance undertakings that are detrimental to their citizens. Money, of course, is fungible. So, if funds from the issuance of the bonds cannot be used in ways that are detrimental to the interests of the country's citizens, tax revenues

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135. The disclosure in the offering document and the terms of the covenant will be identical, with the exception that the disclosure takes the form of a description and the covenant makes a promise.

136. *See* Anna Gelpern & Mitu Gulati, *Innovation After the Revolution: Foreign Sovereign Bond Contracts Since 2003*, 4 CAP. MARKETS L.J. 85, 90, 100 (describing variations in standard terms of sovereign bonds).

137. *Id.* at 85, 87.

will be available for these purposes. Good reasons exist, however, to conclude that opportunities to engage in this type of substitution may be limited.[138]

V

CONCLUSION

The exploration—by governmental officials, participants in the capital markets, lawyers, and academicians—of the doctrine of odious debt remains an enduring hallmark of the modern legal history of sovereign debt. In seeking to adapt the odious debt doctrine to serve as a means of reducing the incentives of creditors to make loans to dictators, this work has embraced myriad approaches. One method of analysis shifts the focus of the inquiry from individual extensions of credit to entire regimes, proposing to designate an international adjudicative forum as responsible for identifying despots against whom debts will not be enforced. Another analytical approach extends the time of the inquiry from the period following the overthrow of the dictator to include the period of his reign, relying on an international tribunal or the enforcement of new terms in commercial bank loans to identify the debts that sovereign debtors must repudiate. A final method of analysis retains the focus on the debts of the sovereign in the aftermath of the dictatorial regime that is inherent in the odious debt doctrine and proposes to use common-law principles of contract, tort, and lender liability—as well as fundamental principles of insolvency—to craft successful defenses against claims for payment upon repudiation of the debts incurred by the despot. As a practical matter, each of these proposed adaptations may prove difficult to implement.

A more effective approach may be to incorporate existing disclosure requirements and market practices into the terms of the agreements governing sovereign bonds. Adopting a covenant regarding the use of the proceeds from an issuance of bonds and subsequent incurrences of debt would provide investors with a direct means—by accelerating the amount owed on the bonds upon a breach of the covenant—of limiting the credit available to dictators. This approach, moreover, is likely to be favored by both investors and sovereign debtors. Finally, in providing only greater enforcement rights for terms that are part of all issuances of sovereign bonds, this approach is unlikely to disrupt the capital markets.

138. Ben-Shahar & Gulati, *supra* note 13, at 65–70.