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THE DILEMMA OF ODIIOUS DEBTS

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ABSTRACT

When a corrupt governmental regime borrows money in the name of the state, and then steals or squanders the proceeds, must the future citizens of that country repay the loan? The law says yes, but the moral instinct of most people says no.

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The odious debt controversy is, at base, a struggle to find a workable legal doctrine that will avoid a morally repugnant result (visiting the sins of corrupt governors on innocent citizens), without undermining the legal basis of all sovereign borrowing. No counterparty, at least no commercial counterparty, would lend money to a sovereign believing that the loan was personal to the administration that contracted it, and could legally be disavowed following the next election, the next revolution or the next coup d'état.

One possible solution is to craft a doctrine of public international law that would relieve successor regimes from the legal obligation to repay the debts incurred by their odious predecessors. This would be a formidable task and there are others who have already set out on it. We propose a less dramatic step—asking whether a successor regime, if sued on an “odious” loan, might have available defenses founded in existing doctrines of domestic law.

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INTRODUCTION

“If we were all responsible for the misdeeds of the governments that represent us, thought Isabel, then the moral burden would be just too great.”¹

Public international law requires that states and governments inherit (“succeed to”) the debts incurred by their predecessors, however ill-advised those borrowings may have been. There are situations in which applying this rule of law strictly can lead to a morally reprehensible result. Example: forcing future generations of citizens to repay money borrowed in the state’s name by, and then stolen by, a former dictator.

Among the purported exceptions to the general rule of state succession are what have been labeled “odious debts,” defined in the early twentieth century as debts incurred by a despotic regime that do not benefit the people bound to repay the loans. The absconding dictator is the classic example.

The removal of Iraq’s Saddam Hussein in 2003 sparked a resurgence of interest in this subject. By enshrining a doctrine of odious debts as a recognized exception to the rule of state succession, some modern commentators have argued, a successor government would be able legally to repudiate the loans incurred by a malodorous prior regime. This, they contend, would have two benefits: it would avoid the morally repugnant consequence of forcing an innocent population to repay debts incurred in their name but not for their benefit, and it would simultaneously force prospective lenders to an odious regime to rethink the wisdom of advancing funds on so fragile a legal foundation.

In this recent debate, the adjective “odious” has quietly migrated away from its traditional place as modifying the word “debts” (as in “odious debts”), so that it now modifies the word “regime” (as in “debts of an odious regime”). This is a major shift. If this new version of the odious debt doctrine is to be workable, someone must assume the task of painting a scarlet letter “O” on a great many regimes around the world. Who will make this assessment of odiousness and on what criteria? The stakes are high. An unworkable or vague doctrine could significantly reduce cross-border capital flows to sovereign borrowers generally.

1. ALEXANDER MCCALL SMITH, *FRIENDS, LOVERS, CHOCOLATE* 32 (2005).

We are skeptical that this definitional challenge can be met. Rather than jettison the initiative as quixotic, however, we investigate how far principles of private (domestic) law could be used to shield a successor government from the legal enforcement of a debt incurred by a prior regime under irregular circumstances. A wholesale repudiation of all contracts signed by an infamous predecessor may be more emotionally and politically satisfying for a successor government, but establishing defenses to the legal enforcement of certain of those claims based on well-recognized principles of domestic law may be the more prudent path. Such defenses exist under United States law (and presumably elsewhere) and could be used to address many, although admittedly not all, cases of allegedly odious debts.

I. THE INTERGENERATIONAL TENSION IN SOVEREIGN BORROWING

Imagine a not-unimaginable legal regime in which the debts of deceased persons pass automatically to their children or, failing offspring, to the nearest blood relative. Under such a regime, debt collection would not be restricted to the assets of the estate of the deceased. The debts would instead be collectible from the surviving blood relatives as personal obligations of those survivors.

Born into such a regime, might you not watch with mounting alarm mother's fondness for Capri in September? Or father's routine capitulations in the face of advertisements for the latest in computer technology? Or perhaps Uncle Otto's acquaintance with his turf accountant?

And when your turn came to receive unsolicited credit card applications, would you be able to resist that devastating Gucci handbag, secure in the knowledge that your niece will only have to work slightly harder during *her* career to pay for it? As the victim of the extravagance of your predecessors, can you be sure that mercy alone would instruct your behavior toward your progeny?

Under such a system, debts, once incurred, would be carried by each generation in the bloodline and passed on to each succeeding generation like a bucket brigade at a house fire. Naturally, the members of each generation would be sorely tempted to defer the repayment of their inherited debts for as long as possible in the hopes that final payment could be delayed to a date, *any* date, falling after they have managed to shuffle off this mortal coil. Whenever and

wherever feasible, bucket carriers might also be tempted to top up the bucket with their own new liabilities before passing it on.

Every once in a while virtuous bucket carriers may resolve to repay the debts of their ancestors, and to refrain from new borrowing themselves, in order to pass on a light and empty bucket to the next generation. Human nature, however, counsels that such examples of virtue will be rare. Whenever the act of borrowing money is physically detached from the disagreeable task of receiving and paying the bill, virtue and temptation struggle on unequal ground. Ask any parent who has ever given a credit card to a teenage child as a birthday present.

The inheritance laws in the United States do not operate in this way. The debts of a natural person are personal in the sense that they may be collected from the individual while alive and from the estate of that individual upon death. They do not, however, trickle down some path of consanguinity to be visited upon innocent relatives.² Stated differently, if someone dies owing more money than can be collected from the assets of their estate, the creditors attending the funeral will weep for reasons that go beyond simple bereavement. As the Bard would have it: “He that dies pays all debts.”³

This may not be the system that has been adopted for the transmission of personal debts, but it is precisely the system that public international law imposes with respect to sovereign debts. Under the public international law doctrine of “state succession,”⁴ a government automatically inherits the debts of its predecessor governments, regardless of how dissimilar the forms of government may be.⁵ The state, together with its rights and obligations, continues; its governments come and go.

2. See 23 AM. JUR. 2D *Descent and Distribution* §§ 138–145 (2002) (discussing the common law and statutory liability of heirs for the debts of their ancestors).

3. WILLIAM SHAKESPEARE, *THE TEMPEST* act 3, sc. 2.

4. See generally ERNST H. FEILCHENFELD, *PUBLIC DEBTS AND STATE SUCCESSION* (1931) (providing a historical survey of state succession and discussing its legal consequences); 1 D.P. O’CONNELL, *STATE SUCCESSION IN MUNICIPAL LAW AND INTERNATIONAL LAW* 369–453 (1967) (analyzing the doctrines of acquired rights and state succession with respect to national and local debts). For a more recent work, see TAI-HENG CHENG, *STATE SUCCESSION AND COMMERCIAL OBLIGATIONS* (2006).

5. See RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 208 cmt. a (1987) (“[A state’s duties] are not affected by a mere change in the regime or in the form of government or its ideology.”); BARRY E. CARTER, PHILLIP R. TRIMBLE & CURTIS A. BRADLEY, *INTERNATIONAL LAW* 449–55 (4th ed. 2003) (discussing the international rights and obligations that transfer from preceding governments upon recognition of a new

“State succession” is somewhat misleading. A line is often drawn, sometimes drawn very sharply, between governmental succession (when the state itself remains intact) and state succession (when the state undergoes some territorial change).⁶ Public international law is particularly strict in requiring successor governments to shoulder the debt obligations of their predecessors. So in the United States, it does not matter whether the Democrats or the Republicans win a presidential election: the massive national debt comes strapped to the keys to the White House. Corazon Aquino (a democratically elected leader of the Philippines in the mid-1980s) may have displaced a dictator, Ferdinand Marcos, but that did not give her the ability under international law to disavow the debts incurred under the Marcos regime.

The doctrine of state succession also applies, although in a more checkered way, to situations in which the state itself undergoes a major change. This occurs both in cases of cession of territory as well as in cases of secession or the disintegration of a state.⁷ When the Republic of Texas joined the United States in 1845, for example, the United States inherited (and had to settle) the debts of Texas.⁸ When the USSR disintegrated in 1991, the international community pressured the dominant successor state, Russia, to assume all of the debts of the former Soviet Union.⁹ A squabble over the appropriate

government). Aristotle asked, but famously did not answer, this question in Book III of his *Politics*: “[W]hether it is right or wrong for a state to repudiate public obligations when it changes its constitution into another form.” THE POLITICS OF ARISTOTLE 115 (Ernest Barker trans. & ed., 1948).

6. See RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 208 reporter’s note 2 (1987) (“International law sharply distinguishes the succession of states, which may create a discontinuity in statehood, from a succession of governments, which leaves statehood unaffected.”); CHENG, *supra* note 4, at 4 (“Specialists in international law often distinguish between state and government succession. In the former, the international legal personality of a state is altered or destroyed, and the rules of state succession are triggered. In the latter, the internal political structure of a state changes, but the international legal personality does not, and so the rules of state succession do not apply.”).

7. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 209(2) (1987); CHENG, *supra* note 4, at 38–39; FEILCHENFELD, *supra* note 4, at 69–75, 175–76, 313–17, 425–27.

8. FEILCHENFELD, *supra* note 4, at 271–78.

9. Paul Williams & Jennifer Harris, *State Succession to Debts and Assets: The Modern Law and Policy*, 42 HARV. INT’L L.J. 355, 369–70 (2001).

division of the assets and liabilities of the former Yugoslavia among its various provinces is only now being resolved.¹⁰

In the sovereign context, therefore, debts are congenital (in that each generation of citizens inherits a responsibility to contribute toward repayment of the old debts merely by being born in the state) and astonishingly adhesive. The obligations will remain legally glued to the territory notwithstanding changes of government (constitutional or extraconstitutional), a churning population, or even the disintegration of the state itself.¹¹

Contrast this to corporate debts. Acme Corporation borrows money. Over the years, the management and the board of directors of Acme may change many times. Over a long enough period of time, the entire corpus of Acme shareholders will change. But the debt remains.¹² In that sense, corporate debts are also adhesive.

There are two important differences, however, between corporate debts and sovereign debts. If Acme Corporation becomes indebted beyond its capacity to repay, it may seek to have its obligations legally reduced or expunged in a bankruptcy proceeding. Moreover, the corporate planners of Acme are relying on the venerable corporate law principle of limited liability to block creditors' efforts to collect their claims, absent unusual circumstances, from Acme's shareholders.¹³ So, in the final extremity, the debts of an individual and the debts of a corporation are treated similarly: the debts do not pass involuntarily to those surviving the demise of the individual or the company.

Not so with sovereign debts. Sovereigns cannot look to death, dissolution, or bankruptcy for liberation from the consequences of imprudent borrowing. Sovereign debts devolve involuntarily on subsequent generations of citizens, long after the people who borrowed the money have departed and, in many cases, long after

10. See, e.g., Carsten Stahn, *The Agreement on Succession Issues of the Former Socialist Federal Republic of Yugoslavia*, 96 AM. J. INT'L L. 379, 390–93 (2002); Milena Sterio, *Implications of the Altmann Decision on Former Yugoslav States*, 20 CONN. J. INT'L L. 39, 39, 46–47 (2004).

11. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 209(2) (1987).

12. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 109 (9th ed. 2004) (“[D]ebts incurred by employees of the corporation are strictly obligations and debts of the corporation, not of the shareholders (or the employees or directors).”).

13. *Id.* at 145.

anyone can even remember why the debts were incurred in the first place. When a sovereign sins in this context, it therefore does so without hope of absolution or redemption, apart from whatever debt relief the sovereign may be able to negotiate or impose on its creditors down the road.¹⁴

Under a strict application of the doctrine of state succession, sovereign debt is thus congenital, adhesive, *and* ineradicable.¹⁵ It is the combination of these three attributes that sets the stage for intergenerational conflict. The incumbent government of a country may incur debts that successor governments will be obliged to pay off. By the very nature of things, those successor governments and the citizens they represent are not consulted when the money is borrowed. They lie somewhere in offing—mute, disenfranchised and wholly reliant on the forbearance of their ancestors. They are, in fact, perfect victims of the linear progression of time.

When these new citizens finally appear on the scene, they will inherit many things: a territory, a history, and the infrastructure of a society. They may also inherit a stock of unpaid debts—debts that public international law requires them to assume as their own obligations.¹⁶ The obvious question is whether there are any circumstances in which such a bequest can legally be declined, with the consequence that the old debts will not bind successor generations of citizens. Stated differently, are there any exceptions to the strict rule of state succession?

II. A TAXONOMY OF SOVEREIGN DEBT

Of all the people who have pondered the intergenerational conflict inherent in sovereign borrowing, only one has ever offered a truly crisp solution: Thomas Jefferson. On September 6, 1789,

14. If a state borrows in its own currency, of course, it has one other possible avenue of escape—inflation. But inflating one's way out of a sovereign debt problem (as tempting as it sometimes seems) is just another way of taxing the citizens and stakeholders in the country to pay for the debt.

15. See Geoffrey R. Watson, *The Law of State Succession*, in CONTEMPORARY PRACTICE OF PUBLIC INTERNATIONAL LAW 121–24 (Ellen G. Schaffer and Randall J. Snyder eds. 1997). *But see id.* at 123 (“[T]he [Vienna Convention on Succession of States in Respect of State Property]’s rules on succession of debt contain a striking (and controversial) exception for ‘newly-independent states.’ Under the Convention, such states are liberated from debt, just as they are liberated from their colonial masters.”).

16. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 209 (1987).

Jefferson wrote a letter to his friend James Madison in which he declared: “[T]he earth belongs in usufruct to the living: . . . the dead have neither powers nor rights over it.”¹⁷

Jefferson was then ending his stint as the American Minister in France and was poised to return home soon to become the nation’s first Secretary of State. He had been in France long enough to see the early ravages of the French Revolution. Jefferson wrote this sentence with particular reference to what he had come to see as the pernicious practice of sovereigns incurring debts that had to be repaid by succeeding generations. He called this principle—that the earth belongs in usufruct to the living—a principle of natural law. He described it as “self evident”¹⁸ (a phrase with which he had some success earlier in his career).

The solution he proposed was splendidly Jeffersonian. After studying life expectancy tables, Jefferson had determined that if a person of his time reached the age of twenty-one, that person was likely to live another thirty-four years. Jefferson’s conclusion was that each generation may contract debts or, for that matter, may pass laws or enact constitutions, that must automatically expire within that generation’s thirty-four-year average tenure. Thus, when a generation comes into its majority, it may legitimately contract a debt in the first year having a duration of no more than thirty-four years, and in the second year, thirty-three years, and so forth. In this way, one generation can never burden a successive generation with its own debts, its own laws, or its own constitutions.¹⁹

This was, of course, one of Jefferson’s more wobbly ideas. Generations are not born on the same day nor do they depart the world at precisely the same moment in the future. A Jeffersonian “shelf life” approach to public debt obligations therefore becomes, in practice, impossible to administer.

If one abandons the hope for a solution that absolves each succeeding generation of liability for *all* previously contracted debts, the task becomes one of deciding which types of inherited debts, if any, are candidates for repudiation by the involuntary heirs. The task

17. Letter from Thomas Jefferson to James Madison (Sept. 6, 1789), in 1 THE FOUNDERS’ CONSTITUTION 68 (Philip B. Kurland & Ralph Lerner eds., 2001).

18. *Id.*

19. *Id.* at 68–69. For a discussion of Jefferson’s proposition, see HERBERT E. SLOAN, PRINCIPLE AND INTEREST: THOMAS JEFFERSON AND THE PROBLEM OF DEBT 51–53 (1995).

is complicated at every turn by the patchwork, ad hoc nature of international law.²⁰

A. *Virtuous Debts*

The classical writers on public international law offered a principled justification for the rule that debts pass involuntarily to successor governments and states. It is fair to impose the burden of a debt on future generations, the theorists said, because those who follow will enjoy—often in a very direct way—the benefit of the credit that had been extended to their predecessors.²¹ An easy case: a municipality borrows money (secured by a pledge of future tax revenues) to build a bridge. Future taxpayers will indeed inherit the burden of paying the debt, but they will also have the benefit of driving or walking over the bridge.

Similarly, a nation may borrow money to defend itself against aggression.²² Future citizens may be the remote beneficiaries of the debt. Or a government may attempt to jump-start a national economy out of a depression, as Franklin Roosevelt did in the United States in the 1930s, through deficit financing of public works projects.²³

This Article calls debts incurred for purposes such as financing durable infrastructure improvements and the waging of defensive wars “Virtuous Debts.” Opinions may differ about whether a particular use of proceeds is indeed virtuous, but it is enough for present purposes to conclude that certain types of sovereign

20. This area of the law is far murkier than the following description suggests. Public international law is derived both from what sovereign states say and from what states do. But what a state says at any particular time may not comport with what it says at another time. What it says may not correspond to how it acts, then or thereafter. And how it acts on one occasion may not constrain its later behavior when its interests have changed. Multiply this pandemonium by the 190 or so sovereign states on the planet and the aspirational element in the phrase “doctrine of public international law” becomes apparent.

21. HUGO GROTIUS, *DE JURE BELLI AC PACIS LIBRI TRES*, reprinted in 2 *THE CLASSICS OF INTERNATIONAL LAW* 314–15, 319 (James Brown Scott ed., Francis W. Kesley trans., 1964); ARTHUR KEITH, *THE THEORY OF STATE SUCCESSION* 2–3 (1907); SAMUEL PUFENDORF, *DE JURE NATURAE ET GENTIUM LIBRI OCTO* 915–16 (1688), reprinted in 2 *THE CLASSICS OF INTERNATIONAL LAW* 1345–46 (James Brown Scott ed., C.H. Oldfather & W.A. Oldfather trans., 1964).

22. Access to loans “in time of public danger, especially from foreign war,” said Secretary of the Treasury Alexander Hamilton, are an “indispensable resource,” even to the wealthiest of nations. ALEXANDER HAMILTON, *First Report on the Public Credit*, reprinted in 2 *THE WORKS OF ALEXANDER HAMILTON* 227, 227–28 (Henry Cabot Lodge ed., 1904).

23. See JOHN STEELE GORDON, *HAMILTON’S BLESSING* 122–24 (1997).

borrowing will benefit the people expected to repay the debt, even if that benefit is temporally remote.

B. Profligate Debts

Regrettably, sovereigns do not always borrow for virtuous purposes. Representative governments, as well as monarchs, potentates, and dictators of all stripes, are equally free to pledge the full faith and credit of their countries for nonvirtuous purposes. No modern reader needs a catalog of such purposes; that person need only develop the habit of reading a daily newspaper. Nonvirtuous purposes include the waging of aggressive war or the suppression of one's own citizens, corruption on the part of the ruling regime, breathtakingly ill-advised infrastructure projects, expensive (and otiose) toys for the military, and so forth.

Debts incurred to finance current budget deficits may be more debatable. A supply-side economist may portray such debts as benign: they avoid the need for tax increases that stifle economic growth. The more robust economy produced by the government's willingness to finance itself through debt rather than taxes, the argument goes, will not only produce tax revenues in the future sufficient (eventually) to pay off the debts, but that healthy economy is itself a gift to future generations—not unlike a bridge or tunnel.²⁴

The other side of this debate portrays most financing of current budget deficits as being driven by simple political expediency.²⁵ The argument runs along these lines: Elected politicians like to spend money but they do not like to tax the electorate to the point of losing votes. The solution? Borrow the money. The government can spend it now without taxing the current electorate. Naturally, some poor taxpayer/voter will someday have to pay it back, but when that

24. For a recent example of this argument, see Joshua Bolten, *Budget for the Future*, WALL ST. J., Feb. 6, 2006, at A19.

25. David Hume, among many others before and since, warned of the danger in these terms:

It is very tempting to a minister to employ such an expedient, as enables him to make a great figure during his administration, without overburthening the people with taxes, or exciting any immediate clamours against himself. The practice, therefore, of contracting debt will almost infallibly be abused, in every government. It would scarcely be more imprudent to give a prodigal son a credit in every banker's shop in London, than to empower a statesman to draw bills, in this manner, upon posterity.

DAVID HUME, *Of Public Credit*, in *ESSAYS, MORAL, POLITICAL, AND LITERARY* (1752), reprinted in *ESSAYS, MORAL, POLITICAL, AND LITERARY* 349, 352 (Eugene F. Miller ed., rev. ed. 1987).

happens the politicians who incurred the debt will be quietly contemplating their dignity (and their pensions) as *ex*-members of Congress.²⁶

This Article does not express a view on the relative merits or demerits of deficit financing. It is enough to agree that certain types of sovereign debts—called here “Profligate Debts”—convey little or no benefit to the people expected to repay those debts.

It is this category of Profligate Debts that provokes intergenerational tension. Why should a later generation of citizens tax themselves to repay money stolen by a former dictator? Why should they sacrifice their own standard of living, prematurely cut off the education of their own children, or delay their own retirements merely because their grandparents lacked the discipline to live within their means? To return to the scenario painted in the opening part of this Article for the inheritance of family debts, conjure up an image of yourself ten years from now working overtime to pay off the flutter that Uncle Otto unwisely placed on a sure thing running in the third race yesterday at Pimlico.

Under the genus of Profligate Debts (that is, debts incurred for purposes that do not, even indirectly or remotely, benefit the people obliged to repay them) public international law theorists have identified two species that may qualify as exceptions to the general rule about state succession: war debts and hostile debts. A third species, dubbed “odious debts,” has become the subject of an intense debate.

1. *War Debts.* War debts are those incurred by a government to finance the conduct of hostilities against a force, foreign or domestic, that eventually succeeds in overthrowing the contracting government. Bluntly stated, if the rebels get inside the presidential palace, they are not obliged to honor loans incurred by the prior occupants to purchase the bullets employed in the effort to dissuade the rebels from their recent enterprise.

This doctrine is usually traced back to the behavior of Great Britain in 1900 following the Boer War in South Africa. The victorious British announced that they would voluntarily assume the debts of the South African Republics contracted *prior* to the commencement of hostilities, but none incurred following the

26. See GORDON, *supra* note 23, at 175, 195–96.

commencement of the hostilities known as the Boer War.²⁷ The British Government did not at the time articulate the rationale for this policy. Perhaps it believed the justification to be obvious.²⁸ Paying the debts of a former adversary is one thing, particularly when victory brings sovereignty over the disputed territory and resources. But paying off the very loans that both delayed and added to the cost of that victory is quite another thing.²⁹

Moreover, anyone lending to a belligerent power after hostilities have begun is placing an obvious bet—an all-or-nothing bet—on the outcome of the war.³⁰ This aspect of the war-debt limitation to the doctrine of state succession is significant because it introduces into the debate the reasonable expectations of the creditor when extending the loan.

State succession to debt obligations traditionally concerned itself with the allocation of debts in cases of territorial cession, annexation, secession, dismemberment, and so forth.³¹ The validity and enforceability of the debts themselves, however, were rarely an issue; resolving the debts was mostly just a matter of pinning the debts to one part or the other of a map. The unspoken premise was that lenders had a justifiable expectation under international law to be repaid, even if they could not always be sure who would ultimately be held responsible for making the payment.

27. See FEILCHENFELD, *supra* note 4, at 393–95. It later became apparent that the British government did not believe this policy of recognizing the pre-belligerency debts of a vanquished enemy was a requirement of international law. See *W. Rand Cent. Gold Mining Co. Ltd. v. The King*, 2 Eng. Rep. 391, 394 (K.B. 1905) (submission of Sir R. Finlay and Sir E. Carson for the Crown).

28. Feilchenfeld concludes that the British position was based entirely on what Britain regarded as a “natural demand of justice.” FEILCHENFELD, *supra* note 4, at 394.

29. The Fourteenth Amendment to the Constitution of the United States (enacted in 1868 after the Union victory in the American Civil War) reflects a similar approach to the debts incurred by the rebellious Confederate States of America. Section 4 of the Fourteenth Amendment begins by reaffirming the validity of the public debt of the United States. It then goes on to decree that “neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States . . . but all such debts, obligations and claims shall be held illegal and void.” U.S. CONST. amend. XIV, § 4.

30. See John Fischer Williams, *International Law and International Financial Obligations Arising from Contract*, in 2 BIBLIOTHECA VISSERIANA DISSERTATIONVM IVS INTERNATIONALE ILLVSTRANTIVM 1, 55 (Tomvs Secvndvs ed., 1924) (“A creditor who advances money to a belligerent during a war to some extent adventures his money on the faith of the borrower’s success.”).

31. See Watson, *supra* note 15, at 121–24.

A war-debts exception to the doctrine of state succession does not question the existence of debts; it instead asks whether certain types of debts are enforceable, morally and diplomatically, against a conquering state. And in determining enforceability, at least in the context of war debts, the reasonable expectation of the creditor when it advanced the money becomes a relevant factor.

2. *Hostile Debts.* At about the same time as the Boer War, the United States articulated an even broader qualification to the strict doctrine of state succession following the Spanish American War of 1898. When that war ended, the belligerent powers met in Paris to hammer out a peace treaty. Under the terms of that treaty, Spain ceded to the United States its sovereignty over Cuba, the Philippines, Puerto Rico, and certain other territories. As Spain saw things, along with sovereignty came the responsibility for repaying the debts of the transferred territory.³²

A particular point of controversy centered on certain loans that the Crown of Spain had incurred in its own name but for which it had pledged Cuban revenue streams.³³ Spain wanted the United States to assume responsibility for these debts in its capacity as the new sovereign power in Cuba; the United States was disinclined to do so.³⁴

Each side advanced arguments for its position, citing both juristic opinion and state practice. Spain based its case on the traditional rules of state succession. If a debt exists at the time of a transfer of territory, responsibility for that debt must be allocated between the transferor and the transferee, with a strong presumption in favor of the transferee (in this case, the United States). The Spanish delegation went so far as to assert that its position was in accordance with rules “observed by all cultured nations that are unwilling to trample upon the eternal principles of justice”³⁵

For their part, the Americans—uncultured trampers that they were—put forward three justifications for the United States’ reluctance to honor these loans. First, the Americans argued that the loans had not been contracted for the benefit of Cuba; indeed, a portion of the proceeds of the loans had been spent in Spain’s

32. 1 JOHN BASSETT MOORE, DIGEST OF INTERNATIONAL LAW, H.R. DOC. NO. 551-23, at 352-85 (1906).

33. See FEILCHENFELD, *supra* note 4, at 329-43.

34. MOORE, *supra* note 32, at 352-85.

35. *Id.* at 353; FEILCHENFELD, *supra* note 4, at 335.

campaign to suppress rebellions in the island.³⁶ Second, Cuba (meaning, presumably, the Cuban people) had not consented to these debts. The loans had been imposed on those people by Spain.³⁷ Finally, the creditors knew that the pledges of Cuban revenues to secure the loans had been given in the context of efforts to suppress a people struggling for freedom from Spanish rule. The creditors therefore “took the obvious chances of their investment on so precarious a security.”³⁸

The first of the American arguments was not an appeal to the war-debts exception. The Americans were not claiming that the proceeds of the disputed loans had financed Spain’s war with the United States. The argument rather looked to whether the proceeds of the loans had been used for purposes affirmatively harmful to the citizens of Cuba—the suppression of their independence movement. In this sense, the loans were “hostile” to the very people expected to repay them.

The Americans’ second argument—the absence of the consent of the population to the incurrence of the debts—added something new. It may never have occurred to the seventeenth-century jurists who framed the doctrine of state succession to ask whether the population of the debtor country had consented to a borrowing by their ruler or government. The late-nineteenth century Spanish diplomats in Paris certainly did not think this was a relevant factor. But to an American delegation that instinctively viewed the consent of the governed as the touchstone of political legitimacy, a debt incurred without that consent was immediately suspect.

The third argument advanced by the Americans in Paris—creditors holding the disputed loans knew or should have known that the debts would not be recoverable if Spanish sovereignty over the island were to end—was similar to one of the predicates of the war-debt exception. Under certain circumstances, sovereign lending does not reflect a judgment on the part of the investor about whether the country can or will repay the debt; it rather reflects a wager by the lender about whether the incumbent regime will remain in power long enough to repay the debt. Back the wrong horse, to use the racing metaphor, and the money is uncollectible. Only a disingenuous

36. MOORE, *supra* note 32, at 358–59.

37. *Id.*

38. FEILCHENFELD, *supra* note 4, at 341.

lender pretends otherwise. The important shift of emphasis here involves characterizing the debt as personal to a ruling regime, as opposed to assuming that any governing power—by virtue only of the fact that it *is* governing—is legally free to contract debts that bind the state.³⁹

3. *Odious Debts.* By the early twentieth century, therefore, the doctrinal cauldron was bubbling. The concept of hostile debts had embraced two propositions. First, not all borrowings by a government will bind the state as a whole; under certain circumstances, a loan to a government will be treated as a personal debt of the rulers who contracted the loan. The loan may indeed be repaid out of state funds, but only if those politicians retain power over the public fisc long enough to cause this to happen. If the rulers depart, the liability to repay the debt follows them. Second, if a lender knowingly advances funds in these circumstances, it cannot later claim surprise and injury if the regime changes and the new government refuses to treat the loan as a continuing charge against public revenues.

Both of these ideas received an important boost as a result of a 1923 arbitration involving Great Britain and Costa Rica. William Howard Taft (a former Yale law professor, colonial administrator of the Philippines, president of the United States and then Chief Justice of the United States Supreme Court) served as the sole arbitrator.⁴⁰ The facts were these: In January 1917, the government of Costa Rica was overthrown by Frederico Tinoco and his brother. Frederico Tinoco's government lasted two years.⁴¹ Before he left the country, however, Tinoco managed to borrow some money from the Royal Bank of Canada. That money also left the country . . . in the company of Messrs. Tinoco.⁴²

39. In the end, neither Cuba nor the United States assumed these debts in the Treaty of Paris, although Spain never formally abandoned its position on the matter. *Id.* at 343.

40. Great Britain and Costa Rica jointly chose Taft for this assignment. *See Choose Taft as Arbitrator*, N.Y. TIMES, Nov. 2, 1922, at 28. From Great Britain's perspective, however, Taft was an unhappy choice as sole arbitrator. Taft's experience as the colonial administrator of the Philippines left him with an acute distaste for political corruption in what we would today call developing countries. *See* STANLEY KARNOW, IN OUR IMAGE: AMERICA'S EMPIRE IN THE PHILIPPINES 231 (1989) ("Taft . . . deplored the pervasive 'tyranny' of Filipino officials who never understood that 'office is not solely for private emolument.'").

41. Tinoco (Gr. Brit. v. Costa Rica), 1 R.I.A.A. 371, 376 (1923).

42. *Id.*; *see also* Anna Gelpern, *Sovereign Debt Restructuring: What Iraq and Argentina Might Learn from Each Other*, 6 CHI. J. INT'L L. 391, 411 (2005) ("The Bank had accepted what

In a subsequent arbitration, Great Britain claimed that the successor government of Costa Rica was bound to honor the loans extended by the Royal Bank of Canada. Costa Rica argued that the Tinoco government was neither the *de facto* nor the *de jure* government of Costa Rica and thus could not, under international law, bind successor Costa Rican governments.⁴³ Taft disagreed. Citing various commentators, Taft held that under general principles of international law, a change of government has no effect upon the international obligations of the state.⁴⁴

That said, however, Taft refused to order Costa Rica to repay the Tinoco loans. These were, Taft said, not transactions “in regular course of business” but were “full of irregularities.”⁴⁵ Taft ruled that the bank

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 president, F. Tinoco, for his personal support after he had taken refuge in a foreign country. It could not hold his own government for the money paid to him for this purpose.⁴⁶

Costa Rica’s ability to disown responsibility for the Royal Bank of Canada loans therefore had nothing to do with the questionable legal status or legitimacy of the Tinoco government. Taft expressly rejected this line of argument as being inconsistent with the doctrine of state succession.⁴⁷ Costa Rica *could* avoid responsibility for repaying the debts, Taft held, because the Royal Bank of Canada knew that the proceeds of its loans would benefit only Tinoco himself, not the state or the people of Costa Rica.⁴⁸

The lessons of Cuba, the Boer War settlement, and the Tinoco Arbitration were not lost on the international lawyers of this era. Lenders were repeatedly warned about extending loans that might, following a regime change in the debtor country, be portrayed as hostile to the citizens of that country, personal to a departing dictator,

it knew to be phony currency as collateral for what it knew to be personal loans to Tinoco and his brother on the eve of their escape from Costa Rica.”).

43. *Tinoco*, 1 R.I.A.A. at 376–77.

44. *Id.* at 377–78.

45. *Id.* at 394.

46. *Id.*

47. *Id.*

48. *Id.*

or otherwise lacking the consent of the people ultimately bound to repay the loans.⁴⁹

In 1927, a Russian jurist, Alexander Sack, stirred this cauldron once again and defined a class of what he called “odious” debts.⁵⁰ In Sack’s formulation, a sovereign debt is presumptively odious if

- the debt is contracted by a “despotic” power,⁵¹
- for a purpose that is not in the general interests or needs of the state, and
- the lender knows that the proceeds of the debt will not benefit the nation as a whole.⁵²

Under Sack’s theory, the consequence of tarring a debt with the label “odious” is that the debt is deemed to be personal to the despotic regime that contracted it and can only be collected from that regime.⁵³ It follows that successor governments of the country can legally repudiate the debt once the despot is removed.

The odious debt exception to the general rule of state succession, at least as Alexander Sack defined it, comprised a very narrow corner of what we have called Profligate Debts. The three attributes of Sack’s odious debt definition are conjunctive: the debt must be incurred by a despot (that is, without the consent of the population) *and* it must not benefit the state as a whole *and* the lender must be aware of these facts. Like a Las Vegas slot machine, all three cherries must simultaneously come into alignment before the Sackian odious debt bell starts to ring.

Under this definition, therefore, a Virtuous Debt (one that benefits, however remotely, the people obliged to repay the debt),

49. “[The lender] must, at the present day, anticipate dangers in imposing upon communities having no voice in negotiation fiscal burdens lacking local approval, unless the benefits of the loan through the expenditure of the proceeds are confined to the territory burdened with service.” Charles C. Hyde, *The Negotiation of External Loans With Foreign Governments*, 16 AM. J. INT’L L. 523, 531 (1922); *see also* Williams, *supra* note 30, at 55 (“A creditor who claims for money lent to satisfy the personal whims of a despot or dictator has not so good a claim as one who advanced his money for the economic development of the country on the faith of the legislative act of a representative assembly.”).

50. ALEXANDER N. SACK, *LES EFFETS DES TRANSFORMATIONS DES ETATS SUR LEURS DETTES PUBLIQUES ET AUTRES OBLIGATIONS FINANCIERES* [THE EFFECTS OF STATE TRANSFORMATIONS ON THEIR PUBLIC DEBTS AND OTHER FINANCIAL OBLIGATIONS] 157–84 (1927).

51. *Id.* at 157. The implication here seems to be that the people of a country do not consent to the incurrence of debts by a despot.

52. *Id.*

53. *Id.*

even if incurred by a tyrannical regime, cannot be branded odious. A Profligate Debt, no matter how harebrained the intended use of proceeds, is not odious if it is contracted by a representative government. Finally, a Profligate Debt borrowed by a detestable regime is not odious if the lender genuinely believes that the proceeds will be used for a purpose that benefits the country.

Indeed, the contours of the odious debt category begin to blur almost as soon as one moves beyond debts incurred to suppress the people expected to repay them (the Cuban example) and loans to a dictator, for the dictator, and stolen by the dictator (the Tinoco case). This is not to say that there is any shortage of debts falling under those two descriptions; sadly, there are too many candidates. But pushing the concept of odious debt into more gauzy factual situations reveals its limits as a legal diagnostic tool.

For example, the Tinoco case was remarkable only to the extent that Tinoco appears to have appropriated for his own use the *entire* proceeds of the Royal Bank of Canada loans.⁵⁴ Modern dictators do not behave in this way, and even the most indulgent lender might balk at a credit proposal whose “use of proceeds” line reads “corruption—high, wide and handsome.” The modern technique is to steal only part of a loan, not the whole of it. So, the construction of a new hospital for children with terminal diseases requires financing of \$50 million. The dictator *du jour* demands (indirectly, of course) a modest 5 percent commission, perhaps a level just below what an open-eyed lender would be forced to confront in its due diligence investigation. Is the loan odious? Partially odious (a new concept)? Does the overwhelmingly virtuous purpose of the loan justify, in a moral sense, a small blemish of transactional corruption? How would the terminally ill children vote on that question?

Most of the elements of the odious debt idea were already in play before Alexander Sack added his contribution in 1927.⁵⁵ Among these was the notion that if a country (meaning the population of the country over time) must assume the burden of repaying a debt, it

54. See Tinoco (Gr. Brit. v. Costa Rica), 1 R.I.A.A. 371, 394 (1923) (“[The credit transfers in question were] so closely connected with this payment for obviously personal and unlawful uses of the Tinoco brothers that in the absence of any explanation on behalf of the Royal Bank, it cannot now be made the basis of a claim that it was for any legitimate governmental use of the Tinoco government.”).

55. See *id.* at 377–78 (discussing state succession principles under international law); FEILCHENFELD *supra* note 4, at 329–43 (discussing the principles established in the Cuban case).

should have realized some benefit from the loan when the debt was incurred. Debts imposed on a country without the consent of the citizens are suspect. A creditor that advances money to a ruling regime knowing that the proceeds will not benefit the nation or its people can expect repayment only from the individuals contracting the debt.

Did the odious debt formulation therefore add anything new to this debate, or was it intended merely as a summary and restatement of the discussion as it stood in the late 1920s? We believe that the odious debt doctrine was just a summary and restatement. From the War-Debt and Hostile-Debt exceptions, Professor Sack drew the idea of loans that were used only to “strengthen” the governing regime, “suppress a popular insurrection” or were otherwise “hostile” to the interest of the people of the country.⁵⁶ From Taft’s decision in the Tinoco Arbitration, Sack gleaned the requirement that the lender know about the illegitimate purpose of the borrowing before the loan could be branded objectionable, as well as the notion that such a debt was “personal” to the ruler who commissioned it.

Alexander Sack did, however, contribute two highly emotive adjectives to the debate: “despotic” and “odious.” Had he been less colorful in his choice of adjectives, perhaps this topic would have attracted less public attention than it has in this century.

C. The Rebirth of the Odious Debt Debate

The concept of odious debts languished in something of a doctrinal backwater for many years. The phrase was occasionally enlisted for its emotive force to describe the pillaging of state treasuries by dictators such as Marcos in the Philippines, the Duvaliers (*père* and *fils*) in Haiti, Mobutu in the Congo, or the Abachas in Nigeria.⁵⁷ Only rarely was the legal significance of the

56. SACK, *supra* note 50, at 157.

57. See, e.g., PATRICIA ADAMS, ODIIOUS DEBT: LOOSE LENDING, CORRUPTION AND THE THIRD WORLD’S ENVIRONMENTAL LEGACY 10–14 (1991); James L. Foorman & Michael E. Jehle, *Effects of State and Government Succession on Commercial Bank Loans to Foreign Sovereign Borrowers*, 1982 U. ILL. L. REV. 9, 21; Günter Frankenberg & Rolf Knieper, *Legal Problems of the Overindebtedness of Developing Countries: The Current Relevance of the Doctrine of Odious Debts*, 12 INT’L J. OF SOC. L. 415, 415–17 (1984); M.H. Hoefflich, *Through a Glass Darkly: Reflections upon the History of the International Law of Public Debt in Connection with State Succession*, 1982 U. ILL. L. REV. 39, 54; Juliette Majot, *The Doctrine of Odious Debts*, in FIFTY YEARS IS ENOUGH: THE CASE AGAINST THE WORLD BANK AND THE INTERNATIONAL MONETARY FUND 35, 35 (Kevin Danaher ed., 1994); Theodor Meron, *The*

doctrine tested in municipal courts of law as a defense to the repayment of a sovereign debt,⁵⁸ or in an international arbitration.⁵⁹

This changed abruptly, however, following the American invasion of Iraq in 2003 to oust the regime of Saddam Hussein. During the roughly twenty-five years that Saddam controlled Iraq, his regime managed to rack up approximately \$125 billion of unpaid debts.⁶⁰ Following the invasion, a number of commentators argued that most of these liabilities, in light of their provenance and their purpose (which was in large part to finance domestic tyranny and military aggression), should be declared odious and written off.⁶¹ This in turn kindled a significant resurgence in the literature and debate

Repudiation of Ultra Vires State Contracts and the International Responsibility of States, 6 INT'L. & COMP. L.Q. 273 (1957); Alexander N. Sack, *Diplomatic Claims Against the Soviets (1918–1938)*, 15 N.Y.U. L.Q. REV. 507 (1938); Joseph Hanlon, *Dictators and Debt*, Nov. 1998, <http://www.jubileeresearch.org/analysis/reports/dictatorsreport.htm> (last visited Mar. 5, 2007).

58. *Jackson v. People's Republic of China*, 550 F. Supp. 869, 872 (N.D. Ala. 1982), *aff'd*, 794 F.2d 1490 (11th Cir. 1986). See James E. Feinerman, *Odious Debt, Old and New: The Legal Intellectual History of an Idea*, 70 LAW & CONTEMP. PROBS. (forthcoming 2007) (providing an extended discussion of the Chinese Railroad debt and the treatment of the odious debt issue in the *Jackson* case itself); see also *Lehigh Valley R. Co. v. State of Russia*, 21 F.2d 396, 401 (2d Cir. 1927); *United States v. Nat'l City Bank of New York*, 90 F. Supp. 448, 452 (S.D.N.Y. 1950). The *Lehigh Valley* court quotes the following passage from Moore:

Changes in the government or the internal polity of a state do not as a rule affect its position in international law. A monarchy may be transformed into a republic, or a republic into a monarchy; absolute principles may be substituted for constitutional, or the reverse; but, though the government changes, the nation remains, with rights and obligations unimpaired.

Lehigh Valley, 21 F.2d at 401 (quoting MOORE, *supra* note 32, at 249).

59. In the context of an arbitration before the Iran Claims Tribunal, Iran argued that a certain contract of the prior regime was odious and could not be transferred to the Islamic Republic of Iran. *United States v. Iran*, 32 Iran-U.S. Cl. Trib. Rep. 162, 175 (1996). The Tribunal's decision refused to take a stand on the "doctrinal debate" about the concept of odious debt in international law. *Id.* at 176. The Tribunal did volunteer its view, however, that the concept of odious debt was limited exclusively to cases of state succession, not governmental succession. *Id.*

60. See Ali Allawi, *Why Iraq's Debt Deal Makes Sense*, EUROMONEY, Sept. 2005, at 213.

61. See, e.g., Patricia Adams, *Iraq's Odious Debts*, POL'Y ANALYSIS, Sept. 28, 2004, at 1, 1; *Pentagon Adviser Perle: Private Sector Key to Iraqi Recovery*, THE OIL DAILY, June 12, 2003 (reporting that Richard Perle, member of the Pentagon's Defense Policy Board, called for Iraq's \$100 billion plus of debt to be forgiven because it had been accumulated under a "vicious dictatorship"); Joe Siegle, *After Iraq Let's Forgive Some Other Debts*, INT'L HERALD TRIB., Feb. 19, 2004, at 6, available at http://www.cfr.org/publication/6786/after_iraq_lets_forgive_some_other_debts.html. But see *Iraq's Debt: The US Should Beware the Principle of Odious Lending*, FIN. TIMES, June 16, 2003, at 20.

surrounding the topic of odious debt.⁶² This Article is a specimen of that resurgent literature.⁶³

Much of this renewed interest in odious debt enlists the terminology, but not the actual content, of the conventional doctrine. An odious debt, à la Alexander Sack, called for a loan-by-loan analysis. Some of the recent commentators are prepared to assume that all odious regimes behave odiously all the time and therefore all of their debts must be odious. The emphasis is thus placed on the odious nature of the regime, not on the circumstances surrounding each loan. All loans to a dictatorial regime are thus presumptively odious and liable to repudiation if the regime collapses.⁶⁴

62. See, e.g., NOREENA HERTZ, I.O.U.: THE DEBT THREAT AND WHY WE MUST DEFUSE IT 20–21 (2004); Anupam Chander, *Odious Securitization*, 53 EMORY L.J. 923, 923–24 (2004); Adam Feibelman, *Equitable Subordination and Sovereign Debt*, 70 LAW & CONTEMP. PROBS. (forthcoming Summer 2007); Anna Gelpern, *What Iraq and Argentina Might Learn from Each Other*, 6 CHI. J. INT'L L. 391, 393 (2005); Joseph Hanlon, *Defining "Illegitimate Debt": When Creditors Should Be Liable for Improper Loans*, in SOVEREIGN DEBT AT THE CROSSROADS 109, 109–11 (Chris Jochnick & Fraser A. Preston eds., 2006); Chris Jochnick, *The Legal Case for Debt Repudiation*, in SOVEREIGN DEBT AT THE CROSSROADS, *supra*, at 132, 132–33; Michael Kremer & Seema Jayachandran, *Odious Debt*, AM. ECON. REV., Mar. 2006, at 82, 82–83 (2006); Christoph G. Paulus, *Do "Odious Debts" Free Over-Indebted States from the Debt Trap?*, 10 UNIFORM L. REV. 469, 469 (2005); Joseph Stiglitz, *Odious Rulers, Odious Debts*, ATLANTIC MONTHLY, Nov. 2003, at 39, available at <http://www.theatlantic.com/doc/prem/200311/stiglitz>; Ashfaq Khalfan, Jeff King & Bryan Thomas, *Advancing the Odious Debt Doctrine* 13–20 (Ctr. for Int'l Sustainable Dev. Law, Working Paper No. COM/RES/ESJ, 2003), available at <http://www.cisd.org/pdf/debtentire.pdf>.

63. In pursuing a cancellation and restructuring of the Saddam-era debt stock, the new Iraqi authorities were not oblivious to the potential relevance of the odious debt label. Iraq's Minister of Finance, Ali A. Allawi, described the concept in a sympathetic way in a September 2005 article:

Widely different views have been expressed about the appropriate treatment of Iraq's Saddam-era debts. Some have argued that all of this debt, in view of its provenance, should be classified as odious and cancelled outright. Lend to a despot, they say, and you should expect repayment only from the despot. If a country manages to free itself from the incubus of an odious regime, the citizenry should not be forced to carry the burden of that regime's immoral extravagances for generations to come.

Allawi, *supra* note 60. Notwithstanding these sentiments, the Iraqi Government elected not to base its request (successful, as it turned out) for an 80 percent cancellation of the Saddam-era debt stock on odious debt grounds. *Id.*

64. Khalfan et al., for example, argue that a Sackian debt-by-debt analysis "assumes without justification that absence of consent may not be presumed in instances involving dictatorial governments." Khalfan, et al., *supra* note 62, at 42. They state that a "dictatorial government is one that by definition rules without the consent of the people. It follows that in purported dictatorial polities consent must be presumed absent, unless proven otherwise (by widespread popular approval of the transaction)." *Id.*; cf. Hanlon, *supra* note 62, at 109–11 (emphasizing the odiousness of the regime, rather than creditor consent or benefits to the populace, as the primary reason to nullify the debt).

This approach circumvents much of the definitional swamp that this Article has previously discussed. Sack's formulation calls for difficult judgments about whether a particular loan "benefits" the country, how the "consent" of the population to the incurrence of a debt is established, and what standards are applied in assessing the lender's "knowing" involvement in the transaction.⁶⁵ These questions are largely irrelevant if the only significant criterion for identifying an odious debt is that the loan was extended to an opprobrious regime. From Sack's original list, therefore, only one significant criterion remains—deciding whether the borrowing regime is "despotic" (or at least *was* despotic at the time the loan was made).⁶⁶

To some modern commentators, therefore, the debate no longer involves odious debts; it involves debts of an odious regime.⁶⁷ This is a major shift. It is curious that some of these commentators do not appear to be aware of how far they have left Alexander Sack and Chief Justice Taft behind.

Indeed, it would astonish Alexander Sack to learn that his catchy adjective "odious" had, in the twenty-first century, become the rallying cry of groups advocating the wholesale forgiveness of the sovereign debt of countries victimized by despotic or kleptomaniacal regimes. Sack himself would have recoiled at casually branding debts as odious. Sack envisioned the formation of an international tribunal charged with making the determination of odiousness. In a proceeding before that tribunal, the burden of persuasion would rest with the new government seeking to disavow responsibility for the debt. A new government would be required to establish that the proceeds of the borrowing were used for purposes contrary to the interests of the population of the country and that the lender, at the time the loan was extended, knew this to be the case.⁶⁸ Even then, Sack's tribunal would afford the lender an opportunity to rebut the inference of an odious purpose to the loan.⁶⁹

Throughout the balance of his long career as a law teacher, Alexander Sack advocated a very strict application of the doctrine of government succession to debt obligations. State public debts, he later wrote, are a "*charge upon the territory of the State,*" by which he

65. See *supra* notes 50–52 and accompanying text.

66. Khalfan et al., *supra* note 62, at 42.

67. See generally *supra* note 62 and accompanying text.

68. SACK, *supra* note 50, at 163.

69. *Id.*

meant the entire financial resources of the state within its territorial limits.⁷⁰ He openly ridiculed the argument of the Soviet government in 1918 that it, as the government of the “workers and peasants,” had the legal right to repudiate the debts incurred by prior Russian governments of the “landlords and bourgeoisie.”⁷¹

III. DO WE NEED A DOCTRINE OF ODIIOUS DEBTS?

It is morally repugnant to saddle the population of a country, down unto generations yet unborn, with the obligation to repay debts that are truly odious in the Sackian sense. Most people instinctively believe that the consequences of reprehensible acts should be visited exclusively on the malefactors (in this case, the corrupt regime and its complaisant creditors). The question is whether this moral imperative can be translated into a workable legal theory.

The process of formulating a workable legal theory might begin by questioning the fundamental premise of the rule about government succession to debt obligations. Why should international law start with the presumption that all state debts automatically bind successor governments, forcing the naysayers to wring out begrudging exceptions to this rule? Why not turn the thing on its head and presume that successor governments are bound only by those obligations that they expressly agree to assume? After all, as Part I notes, this is the rule that modern society has found appropriate for the transmission of the unsatisfied personal debts of a decedent.⁷²

There are two answers to these questions. The inheritance of Virtuous Debts by successor governments and generations of citizens does not strike most people as unreasonable. The benefit/burden theory articulated by the early publicists has a foundation in common sense. Modern property and inheritance laws also reflect it.⁷³ Uncle Otto's gambling debts will not automatically pass to Otto's next of kin, but the mortgage on Uncle Otto's house must be assumed by his

70. Alexander Sack, *The Juridical Nature of the Public Debt of States*, 10 N.Y.U. L.Q. REV. 341, 357–58 (1932).

71. See Sack, *supra* note 57, at 516.

72. See *supra* note 2 and accompanying text (referencing the general operation of inheritance laws in the United States).

73. See RESTATEMENT OF PROPERTY § 537 (1944) (discussing the relationships between benefits and burdens).

heir if that person wants to live in the house. With the benefit comes the burden.⁷⁴

On the practical side, no one will lend to a sovereign borrower knowing the debt will automatically be extinguished by the next election or even by the next revolution. Nor, by the way, would anyone lend to a corporate borrower if the debt could be legally repudiated by a successor board of directors or a majority shareholder. The presumption of state succession to previously incurred debts thus provides the legal basis for all cross-border lending to sovereign borrowers. Undermining that presumption could significantly affect the ability of sovereign borrowers to raise capital.⁷⁵

The dilemma therefore boils down to this question: can the strict rule of government succession to debt obligations be moderated to prevent it from sanctioning the morally repugnant consequence of an involuntary transmission of objectionable debts, without bringing a significant part of cross-border sovereign finance to a standstill?

A. *What Is the Objective?*

The muddled nature of the recent debate about odious debts cannot be blamed exclusively on the tendency of some modern commentators to allow the adjective “odious” to migrate away from modifying the word “debt” into a position where it instead modifies the word “regime.”⁷⁶ Beneath the surface of the debate, there is also a fundamental disagreement about the objective of the entire exercise.

A traditionalist—a Sackian—would say that the objective is to identify objectionable cross-border financial transactions that international law should not enforce by legal or diplomatic means, if the governmental regime in the debtor country changes. Others, however, aim at a more ambitious goal. They wish to define both the standard and the mechanism by which odious regimes can be spotted *before* the money is lent.⁷⁷ The theory is very similar to a public notice system for the recording of security interests: once the mortgage or

74. *See id.*

75. *See, e.g.,* Raghuram Rajan, *Odious or Just Malodorous*, FIN. & DEV., Dec. 2004, at 54, 54–55.

76. *See* Gelpern, *supra* note 42, at 393; Khalfan et al., *supra* note 62, at 47; Seema Jayachandran, Michael Kremer & Jonathan Shafter, *Applying the Odious Debts Doctrine While Preserving Legitimate Lending*, ETHICS & INT’L AFF. (forthcoming); Kremer & Jayachandran, *supra* note 62, at 85–87.

77. *E.g.,* Kremer & Jayachandran, *supra* note 62, at 85–87

security interest has been filed, subsequent lenders are on notice that the property is encumbered by a prior lien.⁷⁸ In this case, once a regime has been publicly and authoritatively branded as odious, subsequent lenders are on notice that their credits to the regime may be legally repudiated by a successor government.⁷⁹

For these modern odious debt theorists, therefore, the most important thing is to be able to spot the despot, the dictator, the tyrant—in other words, the odious regime.⁸⁰ From there the analysis can proceed easily through a series of presumptions. Odious regimes can be presumed to act only in their own self-interest; that is how they earned the moniker “odious” in the first place. Creditors who deal with such regimes can be presumed to know their self-dealing habits. Those creditors are thus knowingly placing an all-or-nothing bet on the continuance of the regime when they assess the commercial risk of the loan. And finally, lenders being lenders, one may confidently predict that the pricing of the loan will reflect (upward) this all-or-nothing political gamble on the part of the creditors. If the risk materializes, the theory concludes, the legal judgment and the moral judgment on the lenders should be identical—too bad.⁸¹

The proponents of this approach see in it a significant advantage over and above the ability of the debtor country to repudiate individual loans contracted by an odious predecessor regime. By putting prospective lenders on notice that they may lose their entire investment if the regime changes in the debtor country, this approach seeks to shut off the flow of funds to that regime before it begins. It is the financial equivalent of what oncologists call “starving the tumor.”

At least one principled argument can be marshaled in support of a regime-centric approach to odious debt. An odious regime is, by definition, a curse upon the people of the country. Anything done to support such a regime is therefore hostile to the interests of those

78. See generally 55 AM. JUR. 2D Mortgages § 307 (1996) (“[A]n interest in land, including mortgages, that is created first has priority over an interest created later from the same source, provided that notice of the first-created right is available to those later acquiring rights in the same land.”).

79. See Kremer & Jayachandran, *supra* note 62, at 85–87.

80. See *id.*

81. Richard Perle’s call for the elimination of Iraq’s debts on the ground that this would have the effect of teaching banks about the risks of lending to a “vicious regime” is in this vein. See James Harding, *Top Adviser Backs Debt Forgiveness*, FIN. TIMES, June 12, 2003, at 11; see also Jayachandran et al., *supra* note 76 (proposing an ex ante designation for regimes that are “Odious Debt prone”).

people. If financing a new hospital for children with terminal diseases allows the regime to present itself as compassionate and civilized, and if that illusion allows the regime to remain in power even one day longer than would otherwise have been the case, then the financing for that project is inimical to the general interests of the population. Naturally, this same argument would support the repudiation of any contractual arrangement with an odious regime, not just debt contracts.

Similarly, international humanitarian organizations send emergency relief teams into some of the most appalling conditions imaginable and they are occasionally pilloried for doing so.⁸² By alleviating the suffering inflicted by a barbarous regime, critics argue, these humanitarians are just deferring the time when that regime must face the full unbuffered wrath of its own people and the international community.⁸³ Are the humanitarians not, under the guise of helping a few people, only prolonging the agony of many others?

These are deep moral waters. A regime-centric approach to identifying odious debts seeks to shut off the flow of funds to a contemptible regime—and thus hasten its demise—by threatening to invalidate the loans under public international law if the regime changes. International economic sanctions, of course, have the same goal. But the effect of such sanctions on the people of the target country (sanctions on Iraq between the first and second Gulf wars are a good example) can be terrible, and such sanctions are not lacking in critics.⁸⁴

82. Michael Wines, *When Doing Good Also Aids the Devil*, N.Y. TIMES, Dec. 25, 2005, § 4 (Week in Review), at 5.

83. See, e.g., Doug Bandow, *Help or Hindrance: Can Foreign Aid Prevent International Crises?*, 273 POL'Y ANALYSIS 1, 3 (1997).

84. See, e.g., David A. Baldwin, *Prologamena to Thinking about Economic Sanctions and Free Trade*, 4 CHI. J. INT'L L. 271, 276 (2003) (outlining the criteria for determining if economic sanctions are successful); Justin D. Stalls, *Economic Sanctions*, 11 U. MIAMI INT'L & COMP. L. REV. 115, 146–52 (2003) (highlighting the factors policy makers utilize when judging the effectiveness of economic sanctions); see also Carla Fried, *How States Are Aiming to Keep Dollars Out of Sudan*, N.Y. TIMES, Feb. 19, 2006, § 3, at 5.

B. Is There Now a “Doctrine” of Odious Debts?

Some commentators would like to elevate the category of odious debts into a recognized exception to the rule of state succession;⁸⁵ elevate it in such a way that bilateral (governmental) creditors would not be able to exert diplomatic pressure on successor governments to honor odious debts, and commercial creditors would not be able to enforce odious debts in municipal courts. Before it can be so elevated, however, the characteristics of this odious debt category need to be sharply defined.

In this lies the challenge. Alexander Sack’s response was to lay out a series of criteria, each of which had to be met before a debt could be declared odious.⁸⁶ In practical terms, however, these criteria marked out only loans to corrupt dictators who, with the lenders’ knowledge, used the proceeds for their own private enrichment, and loans whose proceeds were employed to suppress rebellious subjects. These were, interestingly, the only specific examples Sack himself offered of odious debts.⁸⁷

There is no need, by contrast, under the contemporary approach to the issue, to fret about whether the citizens of the debtor country “consented” to a particular loan, or whether the loan “benefited” the country as opposed to the despot. These difficult judgments are swept away in the cascade of presumptions that follow from tagging a borrowing regime as odious. Even that one remaining judgment—is this regime odious?—can be elusive. One is tempted, strongly tempted, to adopt an approach along the lines of Justice Holmes’ rule-of-thumb for distinguishing an unconstitutional statute (“does it make you want to puke?”)⁸⁸ or Justice Stewart’s “I know it when I see it” standard for pornography.⁸⁹ But it is not that easy.

Odiusness—whether of regimes, individuals, or certain cooked green vegetables—is a subjective concept. But in this context it

85. The categories of War Debts and Hostile Debts have probably reached this status already. See *supra* notes 27–39 and accompanying text; see also J.G. STARKE, AN INTRODUCTION TO INTERNATIONAL LAW 274 (5th ed. 1963) (“No obligation accrues for a successor State in respect of a public debt incurred for a purpose hostile to the successor State, or for the benefit of some State other than the predecessor State.”).

86. SACK, *supra* note 50, at 157–82.

87. *Id.*

88. See Letter from Justice Holmes to Harold Laski (Oct. 23, 1926), 2 HOLMES LASKI LETTERS: THE CORRESPONDENCE OF MR. JUSTICE HOLMES AND HAROLD J. LASKI, 1916–1935, at 888, 1124 (Mark DeWolfe Howe ed., 1953).

89. *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

dangerously invites ethnocentrism. Is a democracy a necessary condition for avoiding the label odious? Is it a sufficient condition?⁹⁰ Is universal suffrage a necessary predicate? Equal rights for women? Is a regime odious if it misprizes environmental issues or civil rights? And so forth and endlessly so on.

Can a regime be odious one day and honorable the next? Ferdinand Marcos was twice elected president of the Republic of the Philippines before he declared martial law and became a dictator. One imagines that he yielded to pecuniary temptation both before and after declaring martial law. When, exactly, did he become odious?

Finally, who is to make the judgment? The lender? Obviously not. Were this the test, the municipality of Rome would still be paying off Caligula's gambling debts.

The sovereign debtor? Unlikely. Remember that the sovereign debtor in this case means the *successor* regime, the one that has every economic motivation to paint its predecessor in an unflattering light. After a hard-fought political campaign, much less a hard-fought insurrection, politicians are already predisposed to view the *ancien régime* as a gang of deeply dyed villains. If reaching this conclusion also provides an excuse to repudiate the debts incurred by that prior administration, economy will inevitably beget calumny.

This leaves the international community, or some subset or organ of the international community. But is this realistic? It would thrust the matter into the realm of international politics, a place where morality and predictability rarely penetrate. It is doubtful that the international community, or any part of it, can be relied upon to reach a principled judgment about the odious character of a regime, divorced from the immediate geopolitical interests of the states (or their proxies) making that judgment. Saddam Hussein was, after all, the darling of the United States and its allies in the early 1980s when he was seen as a bulwark against Iran; he became a villain in their eyes only later in his career. Was Saddam odious (but unacknowledged as such) in the 1980s? Or did he mature into rank

90. See, e.g., Renwick McLean, *U.S. Bars Spain's Sale of Planes to 'Antidemocratic' Venezuela*, N.Y. TIMES, Jan. 14, 2006, at A6 (discussing a statement released in January 2006 by the U.S. Embassy in Caracas that noted that "[d]espite being democratically elected, the government of President Hugo Chavez has systematically undermined democratic institutions, pressured and harassed independent media and the political opposition, and grown progressively more autocratic and antidemocratic").

odiousness over time? And if the latter, why should the debts he incurred on behalf of Iraq in his more benignant youth be branded odious twenty years later?

Finally, to be useful in litigation in the United States over an allegedly odious loan, sovereign defendants would have to establish that the odious debt doctrine was now part of “international customary law”—that is, part of the “general and consistent practice of states followed by them from a sense of legal obligation.”⁹¹ Even the advocates of an odious debt doctrine might hesitate before claiming that it is now part of the “general and consistent practice of states.”⁹²

IV. THE ALTERNATIVE: PRINCIPLES OF PRIVATE LAW

A principle of public international law concerning odious debts does not now have, nor is it likely to achieve, the consensus necessary for it to claim the title of “doctrine.” It is equally unlikely to attain the degree of clarity necessary for it to be of much use in invalidating purportedly odious loans without simultaneously discouraging many legitimate cross-border financings. We instead propose to investigate the extent to which relying on well-established principles of private (domestic) law can address the problem.

We focus on three fact patterns, each involving a loan to the hypothetical Republic of Ruritania. The loan agreement is expressed to be governed by the law of the State of New York, and Ruritania

91. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 102(2) (1987).

92. See Christoph G. Paulus, “*Odious Debts*” vs. *Debt Trap: A Realistic Help?*, 31 BROOK. J. INT’L L. 83, 91 (2005) (noting that the doctrine of odious debts has not yet achieved the status of customary international law); Paul B. Stephan, *The Institutional Implications of an Odious Debt Doctrine*, 70 LAW & CONTEMP. PROBS. (forthcoming Summer 2007) (noting the lack of precedent on the matter of odious debt); Jeff King, *Saddam’s Evil Debts*, FIN. POST, Oct. 23, 2003 at FP15 (“[T]he [odious debt] doctrine is contestable under international law . . .”). Anna Gelpern writes:

As it happens, no national or international tribunal has ever cited Odious Debt as grounds for invalidating a sovereign obligation. Each of the treaties and other examples of state practice cited even by the doctrine’s most thorough and principled advocates appears fundamentally flawed—it lacks one or more of the doctrine’s essential elements and/or is accompanied by a chorus of specific disavowals of the doctrine by indispensable parties. But even if the examples were on point, the fact that Odious Debt’s most fervent proponents to this day must cite an 1898 treaty and a 1923 arbitration as their best authorities suggests that the law-making project is in trouble.

Gelpern, *supra* note 42, at 406.

submits to the jurisdiction of New York courts for purposes of disputes about the loan.⁹³ In each case, the Ruritanian minister of finance signs the loan on behalf of the Republic, pledging the full faith and credit of the Republic for repayment of the debt. The three situations are:

- (i) At the time the money is borrowed, Ruritania is ruled by a corrupt dictatorship. The lender knows that all or a part of the proceeds of the loan will be stolen by members of the ruling regime (the “Corrupt Loan”). The lender accepts this pilfering to win the mandate, or perhaps because the government is prepared to pay a higher interest rate on the loan than would have been true in the absence of this special feature of the transaction.
- (ii) Ruritania is ruled by a corrupt dictatorship. The lender suspects, but does not know for sure, that some or all of the proceeds of the loan will be stolen by members of the ruling regime (the “Suspicious Loan”).
- (iii) Ruritania has an elected, representative government. That government uses the proceeds of the loan for the sole purpose of funding a program to count—individually—each grain of sand in the vast Ruritanian desert; the counting to be done by a team composed exclusively of Nobel prize-winning economists. No personal corruption by government officials is involved or suspected (the “Utterly Fatuous Loan”).⁹⁴

Then the following occurs: the ruling regime in Ruritania subsequently changes; the new administration disavows the loan as being contrary to the interests of all honest Ruritarians; the loan goes into default; and the lender brings an action to enforce the loan in a

93. Some advocates of an odious debt doctrine recommend actively trying to *avoid* New York courts as the forum for lawsuits involving sovereign debts that could qualify as odious. See Khalfan et al., *supra* note 62, at 68 (“New York would not be the ideal preliminary site for odious debts litigation.”). They argue—correctly, in our view—that New York courts would not be receptive to a defense based on a purported public international law doctrine of odious debts. The defenses discussed in Part IV.A, *infra*, however, are based upon existing principles of New York law and do not require a resort to a separate concept of an odious debt.

94. In the world of sovereign borrowing, conjuring up a use of proceeds that the reader recognizes as *utterly fatuous* requires creativity. See, e.g., Richard N. Ostling, *The Basilica in the Bush: The Biggest Church in Christendom Arises in the Ivory Coast*, TIME, July 3, 1989, at 38 (reporting on a basilica built in the African bush that is larger than St. Peter’s in Rome and 135 miles from the nearest urban center with an estimated cost of over \$200 million).

U.S. court. What principles of U.S. domestic law might be relevant to the defense of such an action?

A. *Possible Defenses*

1. *Considerations of Public Policy.* Bribery, whether in a commercial,⁹⁵ domestic political,⁹⁶ or foreign governmental context,⁹⁷ is contrary to the public policy of the United States and its constituent states. In our hypothetical about the Corrupt Loan, the lender knew that the Ruritanian officials executing the loan agreement on behalf of the Republic were intending to pocket some or all of the proceeds of the loan. The lender acquiesced in this behavior because, in return, the lender received the mandate (and the fees) to arrange the loan, or perhaps the government officials committed the Republic to paying an above-market rate of interest on the loan. Whether the Ruritanian officials received an outright bribe to issue a mandate or to accept an overpriced loan, or whether the lender agreed to look the other way as the officials skimmed the proceeds of the loan itself, strikes us as irrelevant. The Ruritanian officials were induced to breach their fiduciary duty to Ruritania. They were bribed.

Had the lender been subject to the jurisdiction of the United States at the time the loan was extended, this conduct may have been criminal—a possible violation of the U.S. Foreign Corrupt Practices Act.⁹⁸ But regardless of the lender's domicile, a subsequent lawsuit by the lender to enforce a contract (the loan) procured by the plaintiff's

95. Commercial bribery may violate state laws. *See* Bankers Trust Co. v. Litton Sys., 599 F.2d 488, 492 (2d Cir. 1979) (holding lease contracts for photocopiers unenforceable because they had arisen through an illegal bribe); Pharm. Sales and Consulting Corp. v. J.W.S. Delavau Co., 106 F. Supp. 2d 761, 765–66 (D.N.J. 2000) (stating that under New Jersey law, a public policy defense of commercial bribery can be asserted to avoid enforcement of a contract); *see also* N.Y. PENAL LAW § 180.00 (McKinney 1999) (“A person is guilty of commercial bribery in the second degree when he confers, or offers or agrees to confer, any benefit upon any employee, agent or fiduciary without the consent of the latter’s employer or principal, with intent to influence his conduct in relation to his employee’s or principal’s affairs.”).

96. *See, e.g.,* United States v. Marmolejo, 89 F.3d 1185, 1190 (5th Cir. 1996) (holding that a local sheriff was subject to a federal bribery statute enacted by Congress to further the public policy against bribery of government officials); Brown Constr. Trades, Inc. v. United States, 23 Cl. Ct. 214, 215 (Cl. Ct. 1991) (holding that the conviction of a public contractor on charges of bribery of a government official was sufficient to render a contract unenforceable).

97. Foreign Corrupt Practices Act of 1977, 15 U.S.C. § 78dd-1(a) (2000); Adler v. Federal Republic of Nigeria, 219 F.3d 869, 877–78 (9th Cir. 2000) (finding that an illegal contract entered into by plaintiff to bribe Nigerian officials barred the plaintiff’s ability to recover on a breach of contract claim).

98. 15 U.S.C. § 78m (2000).

own misconduct (the bribe), would not prosper in a U.S. court. As the New York Court of Appeals said: “Consistent with public morality and settled public policy, we hold that a party will be denied recovery even on a contract valid on its face, if it appears that he has resorted to gravely immoral and illegal conduct in accomplishing its performance.”⁹⁹

This principle of U.S. law would render unenforceable (at least in a U.S. court) many of Alexander Sack’s odious debts.¹⁰⁰ Indeed, it would go further. Sack’s doctrine of odious debts could be applied only in cases of despotic regimes. U.S. public policy probably would not distinguish between bribing officials of a despotic or a democratic regime. And it would be unsurprising if public policy considerations in many other countries did not mandate a similar result.¹⁰¹

99. *McConnell v. Commonwealth Pictures Corp.*, 166 N.E.2d 494, 497 (N.Y. 1960); *see also* *Oscanyan v. Arms Co.*, 103 U.S. 261, 277 (1880) (holding that contracts to bribe or influence officials of foreign governments will not be enforced for public policy reasons, and that the parties to the contract themselves cannot waive that illegality).

100. *See supra* Part II.B.3.

101. A recent ICSID arbitral decision, *World Duty Free Co. v. Republic of Kenya* (ICSID Case No. Arb/00/7, 4 Oct. 2006), illustrates this. The plaintiff, a foreign businessman, made a \$2 million “personal donation” in cash to President Daniel Arap Moi to obtain a contract for his company to do business in Kenya. *Id.* ¶ 66. Relations between the businessman and President Moi’s administration subsequently deteriorated, resulting in an expropriation of the Kenyan company. *Id.* ¶¶ 68–70. The businessman commenced an arbitration proceeding. The Republic defended on the ground that the \$2 million bribe made the original contract voidable; the argument being that bribes in the procurement of public contracts violated Kenyan, English, and “transnational” public policy. *Id.* ¶¶ 105–09. Plaintiff defended his actions on the ground that such donations constituted customary business practice in Kenya at the time. After an extensive review of national court decisions and international conventions and declarations, the arbitral panel explained:

[B]ribery is contrary to the international public policy of most, if not all, States or, to use another formula, to transnational public policy. Thus, claims based on contracts of corruption or on contracts obtained by corruption cannot be upheld by this Arbitral Tribunal.

Id. ¶ 157.

Within months, the premise set out in the *World Duty Free* case found application and citation in a bribery case involving a New York law contract. In *Vulcan Energy Solutions LLC v. Ministry of Elec. of the Republic of Iraq* (ICDR of AAA Case No. 50 198 T 00441 05, 28 Mar. 2007), the arbitral panel, citing to the *World Duty Free* case, explained its view of the law regarding the impact of bribery on contract enforceability:

Under the law of the State of New York, “a contract procured through bribery is not enforceable.” *Swig Weiler & Arnov Mgmt. Co. v. Stahl*, 817 F. Supp. 404, 406 (S.D.N.Y. 1993). In *World Duty Free Co., Ltd. v. Republic of Kenya*, it was stated that “bribery is contrary to the international public policy of most, if not all, States . . .” *Vulcan* recognizes that it is “undisputed that a contract procured through bribery may not be enforceable.”

Vulcan Energy ¶ 28 (citation omitted).

But what if the lender assigns its interest in the loan to a third party who has no knowledge, or even a reason to suspect, that the original lender bribed the Ruritanian officials to enter into the loan? Can the assignee enforce the loan agreement against the Republic of Ruritania? If so, then considerations of public policy would have only a limited utility in blocking enforcement of corruptly induced loans.¹⁰²

The general American rule regarding the assignment of contract rights provides that—except in the case of negotiable instruments (which the Ruritanian loans are not)—“[a]n assignee never gets a better right than the assignor had. If for any reason the assignor’s claim was void, voidable, unenforceable, or conditional, so also is the claim of the assignee.”¹⁰³ Consequently, the assignee of an unenforceable loan will thus face the same defenses that the borrower could have raised against the original lender/assignor.¹⁰⁴ An innocent assignee of such a loan, if denied the ability to recover from Ruritania itself, may not be wholly without a remedy. That assignee would presumably have a claim against the original lender/assignor for rescission, fraud, or breach of representation.¹⁰⁵

102. Corruption can also occur after the loan has been disbursed, for example, in the assignment or enforcement process. A creditor holding an unpaid claim but unable to enforce, might bribe a local official to obtain information about where and when the sovereign might have attachable assets in a foreign location. In a recent case involving the Republic of Zambia, creditors were alleged to have paid bribes to local officials to scuttle a restructuring deal between Zambia and the Republic of Romania that would have retired debt owed to Romania at a deep discount. The creditors in question then purchased the Romanian claims for approximately \$4 million and subsequently sued Zambia for full payment of approximately \$50 million. The difficult question is whether corruption in these cases should constitute grounds under which the sovereign can defend against underlying debt claims. In the Zambian case, an English court, although visibly unhappy at what appeared to be creditor misbehavior, still upheld the creditor’s claim. See Alan Beattie, “Vulture Fund” in Zambia Debt Case Gain, *FIN. TIMES*, Feb. 16, 2007, available at <http://www.ft.com/cms/s/23104b92-bd5e-11db-b5bd-0000779e2340.html>.

103. Arthur Corbin, *Assignment of Contract Rights*, 74 U. PA. L. REV. 205, 229 (1926); see also N.Y. GEN. OBLIG. LAW § 13-105 (McKinney 2001).

104. An understandable desire to protect innocent assignees from financial loss can occasionally lead a court astray. An example is *Bankers Trust Co. v. Litton Bus. Tel. Sys.*, 599 F.2d 488 (2d Cir. 1979), in which the court (wrongly) classified a lessee’s obligation under an equipment lease as a negotiable instrument to give commercial bank assignees of the lease payments “holder in due course” status (thereby shielding them from the lessee’s bribery defense against the lessor), *id.* at 490–91.

105. See RESTATEMENT (SECOND) OF CONTRACTS § 333(1)(b) (1979) (suggesting that an assignment for value is deemed to convey a warranty by the assignor that the debt is subject to no defenses good against the assignor other than those stated or apparent at the time of the assignment); see also Lee C. Buchheit, *Legal Aspects of Assignments of Interests in Commercial*

In addition, American law provides ample maneuvering room for a judge who wants to balance equities in a case involving illegal behavior by one or more of the parties to a transaction. In the sovereign context, this flexibility could be used to validate a portion of a debt (for which the borrowing country received a benefit), while invalidating the remainder (for which no benefit accrued to the country as a whole).¹⁰⁶ Under the headings of “restitution” and “unjust enrichment,”¹⁰⁷ a court can fashion a remedy that penalizes a wrongdoer, apportions blame (and the consequences of blameworthy behavior) among multiple wrongdoers, shields the innocent, differentiates between venial and mortal sins against public policy, or does any of the foregoing in a manner that supports public policy while doing justice among the parties.¹⁰⁸

2. *Unclean Hands*. The public policy concerns about enforcing contracts that are tainted by bribery or other illegal activity can also be vindicated through the defense of “unclean hands”—the maxim of equity being that “he who comes into equity must come with clean hands.”¹⁰⁹ This doctrine can also limit the ability of a lender to enforce a debt contracted under irregular circumstances. As explained by the Supreme Court, “This maxim . . . is a self-imposed ordinance that closes the doors of a court of equity to one tainted with inequity or bad faith relative to the matter in which he seeks

Bank Loans, in THE COMMERCIAL LOAN RESALE MARKET 443, 449–50 (J. Lederman et al. eds., 1991).

106. An obvious example might involve a situation in which the corrupt government officials in Ruritania misappropriated only a portion of the proceeds of the loan, the balance having gone into the Ruritanian state treasury. A claim for restitution or unjust enrichment might lie for the recovery of the funds not stolen by the corrupt officials. See Christoph H. Schreuer, *Unjustified Enrichment in International Law*, 22 AM. J. COMP. L. 281, 295–96 (1974) (describing a case in which the U.S.-Mexican General Claims Commission held that Mexico, “under international law, must reimburse claimant to the extent that it has been unjustly enriched”).

107. See RESTATEMENT OF THE LAW OF RESTITUTION: UNJUST ENRICHMENT § 1 (1937).

108. See RESTATEMENT (SECOND) OF CONTRACTS: RESTITUTION: INTRODUCTORY NOTE §§ 197–199 (1979); see also John Wade, *Restitution of Benefits Acquired Through Illegal Transactions*, 95 U. PA. L. REV. 261, 302 (1947) (“[A]s long as the matter [relief by way of restitution] is within the general discretion of the courts, flexibility . . . is possible. It would seem decidedly unfeasible to attempt to reduce the law in this field to a series of inflexible rules which would seek to cover every possible situation.”).

109. See HENRY L. MCCLINTOCK, HANDBOOK OF THE PRINCIPLES OF EQUITY 52 (1948).

relief, however improper may have been the behavior of the defendant.”¹¹⁰

The maxim has been applied in a sovereign context to deny a recovery to plaintiffs that were participating in a criminal scheme with foreign governmental officials. In *Adler v. Federal Republic of Nigeria*, the plaintiff, James Adler, had been lured by Nigerian government officials and others into a bogus scheme through which he hoped to share in a \$130 million bonanza from over-invoiced contracts with the Nigerian government.¹¹¹ Neither the contracts nor the money ever existed; Adler was simply the dupe of what is, in Nigeria, a quotidian confidence fraud. But what an enthusiastic dupe he turned out to be. Adler paid more than \$5 million as bribes and commissions to Nigerian government officials and others to stay in the game.¹¹² When the scales finally fell from his eyes, Adler sued the Republic of Nigeria, its Central Bank, a former Central Bank governor and others in a federal court in California to recover the bribes and commissions.¹¹³

After an eight-day trial, the district court held that the doctrine of unclean hands (which, under California law, applies not only to claims in equity but also in law)¹¹⁴ barred Adler from recovering against the defendants.¹¹⁵ On appeal, Adler argued that denying him a judicial remedy against the Nigerian fraudsters only served to enrich those Nigerian scoundrels.¹¹⁶ In effect, Adler was arguing that when the *dramatis personae* in the case include both domestic and foreign

110. Precision Instrument Mfg. Co. v. Auto. Maint. Mach. Co., 324 U.S. 806, 814 (1945).

111. *Adler v. Federal Republic of Nigeria*, 219 F.3d 869, 872–73 (9th Cir. 2000).

112. *Id.* at 873.

113. *Id.* The Nigerian Central Bank and certain of its officers were alleged to have participated actively in the fraud; their role as defendants in the case was not based exclusively on a “failure to supervise” theory. *Id.* at 871.

114. Under New York law, however, the ability to raise an equitable unclean hands defense in an action at law may not be as clear, despite New York’s abolition of all distinctions between actions at law and suits in equity. See N.Y. C.P.L.R. 103(a) (McKinney 2003); *Digiulio v. Robin*, No. 01 Civ. 1675 (CBM), 2003 WL 21018828, at *5 (S.D.N.Y. May 6, 2003). In *Byron v. Clay*, 867 F.2d 1049 (7th Cir. 1989), Judge Posner noted:

[W]ith the merger of law and equity, it is difficult to see why equitable defenses should be limited to equitable suits any more; and of course many are not so limited, and perhaps unclean hands should be one of these. Even before the merger there was a counterpart—in *pari delicto*—which forbade a plaintiff to recover damages if his fault was equal to the defendant’s.

Id. at 1052 (citations omitted).

115. *Adler*, 219 F.3d at 869.

116. *Id.* at 877.

miscreants, patriotic American judges should visit any financial losses only on the foreigners.

This argument met with a frosty reception at the appellate level. “[T]he fact that the defendants will receive a windfall,” the Ninth Circuit said, “is not an absolute bar to the unclean hands defense.”¹¹⁷ In addition, “public policy favors discouraging frauds such as the one perpetrated on Adler, but it also favors discouraging individuals such as Adler from voluntarily participating in such schemes and paying bribes to bring them to fruition.”¹¹⁸ Applying this doctrine to the Republic of Ruritania, a lender attempting to enforce in a U.S. court the Corrupt Loan (which involved, with the lender’s knowledge and acquiescence, corruption on the part of Ruritanian officials) could be met by a defense of unclean hands. The defense might even be available in the case of the Suspicious Loan, depending on how deliberately obtuse the lender may have been in its investigation of the use of proceeds of the loan.¹¹⁹ An unclean hands defense put forward by a successor Ruritanian government could relieve Ruritania from the obligation to repay the tainted loan.

Unclean hands is an equitable defense. In some states (but not in all), this equitable defense may be unavailable in an action at law for money damages. If sued in such a state for money damages, the defendant may have to rely on legal defenses that cover much the same ground, such as fraud, illegality,¹²⁰ or *in pari delicto*.¹²¹

3. *Agency Law*. The three hypothetical loans may also be analyzed under principles of agency law. For this purpose, Ruritania

117. *Id.*

118. *Id.*

119. See *infra* notes 131–33 and accompanying text. In *Alaska Cont'l Bank v. Anchorage Commercial Land Assocs.*, 781 P.2d 562 (Alaska 1989), for example, a bank lent money to a limited partnership knowing that the consent of the limited partners (and not just the general partner who signed the loan) was required for such a borrowing under the partnership agreement. *Id.* at 563–66. When the partnership subsequently sought a declaration that it was not obligated to repay the loan, the bank argued that the partnership was equitably estopped from contesting the validity of a loan whose proceeds it had received. *Id.* at 563, 565 n.6.

The trial court declined to permit the bank to invoke an equitable estoppel defense, citing the bank’s own lack of clean hands in the affair. *Id.* at 565 n.6. The appellate court affirmed this determination, quoting this description by the lower court of the nature of the lending bank’s unclean hands: “At worst, [the bank] knowingly chose to overlook the irregularities in this case or to decline to investigate further. At best, [the bank] was negligent in failing to seek information in the form of legal opinions and/or consultations with limited partners.” *Id.*

120. See 1 DAN B. DOBBS, DOBBS LAW OF REMEDIES 152 (2d ed. 1973).

121. *Id.* at 95 & n.6.

(meaning the country and its population over time) is in the position of the principal, and the individual members of the government or ruling regime in Ruritania (representative or despotic) at any particular time are the agents of that principal insofar as they enter into contracts on behalf of the Republic of Ruritania with third parties such as lenders.¹²²

Viewing the people of a country as the principal, and the government as the agent, is more than just a metaphor; it is how American political philosophy¹²³ and American legal theory¹²⁴ have frequently viewed the governmental relationship.¹²⁵ It does not matter that despotic regimes would contest this characterization. It is the very nature of despotic regimes that they regard themselves—like Nero (by the grace of the Praetorian Guard) or Louis XIV (by the grace of Divine Right)—as the rulers of the people, rather than their agent, much less their servant.¹²⁶ But the fundamental premise of the American political experiment is that ultimate sovereignty and political authority rests with the people, and it is this premise that

122. At least two other commentators in the modern odious debt literature look to principles of agency law to buttress their arguments. In both cases, however, the discussions are brief and tangential to the central point being made, which is to argue for recognition of a doctrine of odious debts under principles of international law. See HERTZ, *supra* note 62, at 197 (using the doctrine of actual authority from agency law to justify the first of the Sackian criteria, and arguing that democratic consent should, as a matter of international law, be a precondition to recognizing the authority of a regime to contract on behalf of its citizens); Khalfan et al., *supra* note 62, at 37–39 (pointing to common law principles of agency law, drawn from British and Canadian cases, that impose liability on third parties who willfully or knowingly assist in a breach of trust).

123. See THE FEDERALIST NO. 46, at 243 (James Madison) (George W. Carey & James McClellan eds., 2001) (“[G]overnments are in fact . . . agents and trustees of the people . . .”).

124. See Richard L. Pierce, Jr., *The Role of the Judiciary in Implementing an Agency Theory of Government*, 64 N.Y.U. L. REV. 1239, 1239 (1989) (“The Constitution is premised on the belief that government should act as the agent of the people.”); see also Steven G. Calabresi, *Political Parties as Mediating Institutions*, 61 U. CHI. L. REV. 1479, 1523–24 (1994) (finding a “noncontractual agency relationship” between voters and government officials); Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1095–1102 (2004) (finding assertions of fiduciary duties owed by government officials to citizens in Aristotle and Cicero).

125. The conceptualization of “the people” as the principal and the government (whether constituted by a monarch, an external colonizer, or democratically elected representatives) as the agent, has a history dating back at least to the thirteenth century. See Jedediah Purdy & Kimberly Fielding, *Trust, Agency, Wardship: Private Law Concepts in the Development of Sovereignty*, 70 LAW & CONTEMP. PROBS. (forthcoming Summer 2007).

126. See THOMAS HOBBS, LEVIATHAN 255 (C.B. MacPherson ed., Pelican Books 1968) (1651) (comparing the relationship between a despotic ruler and his citizens to that of a master over his servants).

likely would guide an American court in applying the law of agency to the legal relationships created by the hypothetical Ruritanian loans.¹²⁷ The argument, we suspect, is unlikely to find favor in other contemporary jurisdictions either.¹²⁸

The sovereign debt context raises a typical concern of agency law—that of faithless agents who purport to bind their principals to an obligation to third parties when the fruits received in return for the obligation accrue only to the agents. Who, as between the principal (the country and its citizens) and the third party (the lender) should bear this risk of the faithless agent? American agency law, using

127. A lack of consent can be argued to defeat an agency relationship because the common law bases its agency rules on a consensual relationship manifested by both the principal and agent. See RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006). (“Agency is the fiduciary relationship that arises when one person [a principal] manifests assent to another that the other [an agent] that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.”).

The consent of the governed sometimes slips insensibly into usurpation by the governors. Ferdinand Marcos was twice elected president of the Philippines until, legally banned from seeking reelection, he declared martial law and clung to power for another thirteen years. See KARNOW, *supra* note 40, at 356–57. If an agent, initially enjoying the consent of the principal, eventually overbears and controls the principal, has the agency relationship been destroyed? If so, this may not be apparent to the third parties who continue to deal with the agent as agent. The better way to analyze this situation is to see the principal as being temporarily deprived of its ability to instruct and control the agent.

128. *World Duty Free Co. v. Republic of Kenya* (ICSID Case No. Arb/00/7, 4 Oct. 2006) is illustrative. As noted, the plaintiff, a businessman, was attempting to justify a “donation” he paid to President Moi to obtain a contract with the Republic of Kenya. *Id.* ¶ 110. This donation was not a bribe paid to an agent of the state, the plaintiff argued in part, because the Kenyan President was one of the few “remaining ‘Big Men’ of Africa, who, under the one-party State Constitution was entitled to say, like Louis XIV, he *was* the state.” *Id.* ¶ 185. The arbitral panel was scornful of the argument. President Moi was no more than an agent for the state, no matter what his self-conception might have been. *Id.* We should note though that the Louis XIV argument has found sympathy in one recent instance. That was some months prior when the government of the United Kingdom, by its Attorney General, Lord Goldsmith, was trying to explain why it had dropped its corruption probe of a Saudi arms contract with a UK company. One argument that Lord Goldsmith gave for not pursuing the case was that it was going to be hard to argue that the payments made were corrupt when they were authorized by the Saudi monarchy. Implicit in his rationale appeared to be the point that the monarchy was the state; if it had authorized the taking of money in exchange for the grant of the contract, it was not a bribe. Put differently, the conception Goldsmith was using was that of the monarchy as the state, as opposed to as the agent of the state. See Christopher Adams, Michael Peel & Jimmy Adams, *Goldsmith’s Dilemma on Saudi Royals in BAE Case*, FIN. TIMES, Feb. 1, 2007, available at <http://www.ft.com/cms/s/dfd8abe6-b199-11db-b901-0000779e2340.html>. Query though whether Goldsmith was merely coming up with excuses to justify the UK government’s decision to avoid an ugly diplomatic incident that might result in a loss of a big arms contract. See *id.*; see also Chris Adams, Michael Peel & Nikki Tait, *Interview Transcript: Lord Goldsmith*, FIN. TIMES, Jan. 31, 2007, available at <http://www.ft.com/goldsmith> (questioning Lord Goldsmith’s assertion that “nobody is above the law”).

familiar concepts of authority, is clear that this risk usually lies at the feet of the principal. The reasons reflect both business expediency and some element of efficient risk-bearing.¹²⁹ Commerce would slow to a crawl if too severe a burden were put on creditors constantly to check back with a principal as to whether an agent had authority. As between the principal and the third party, the principal who puts the agent in a position to cause the harm ought normally to bear the risk.¹³⁰

But there are circumstances—out-of-the-ordinary and suspicious circumstances—in which U.S. agency law places the risk of a runaway agent, and the burden of unclocking such a runaway, on a third party such as a creditor. For instance, when a corporate officer signs a guaranty for a debt for which the corporation is not receiving any benefit, the “duty of diligence in ascertaining whether an agent is exceeding his authority devolves on those who deal with him, not on his principal.”¹³¹ In a well-known case in which the vice-president and treasurer of the Anaconda Corporation purported to act for Anaconda in guaranteeing the debt of another company, the court held that the third party, the recipient of the guaranty, could not rely on the asserted agency to bind Anaconda.¹³² What shifts to the third party the burden of verifying the agent’s fidelity to his principal in a particular transaction is the presence of visibly suspicious circumstances or behavior.¹³³

129. The commentary to the RESTATEMENT (SECOND) OF AGENCY observes that although a person relying on the appearance of agency knows that the apparent agent is not authorized to act except for the benefit of the principal, this is something that the third party normally cannot ascertain. RESTATEMENT (SECOND) OF AGENCY § 262 cmt. a (1958) (“[This is] something, therefore, for which it is rational to require the Principal, rather than the other party, to bear the risk. The underlying principle based on business expediency—the desire that third persons should be given reasonable protection in dealing with agents finds expression in many rules The line at which the principal’s liability ceases is a matter for judicial judgment.”).

130. *See id.*

131. *Strip Clean Floor Refinishing v. N.Y. Dist. Council No. 9*, 333 F. Supp. 385, 396 (E.D.N.Y. 1971).

132. *Gen. Overseas Films, Ltd. v. Robin Int’l, Inc.*, 542 F. Supp. 684, 690 (S.D.N.Y. 1982) (“Because the circumstances surrounding the transaction were such as to put Haggiag on notice of the need to inquire further into Kraft’s power and good faith, Anaconda cannot be bound.”).

133. Absent such suspicious circumstances or behavior, however, the law will not penalize innocent third parties if an agent—acting under color of authority—is subsequently exposed as faithless. The decision is made clear in *General Overseas Films* which found that “[h]ad Kraft [Anaconda’s vice president and treasurer, with apparent authority to bid for Anaconda] purported to borrow money for Anaconda [instead of guaranteeing the debts of an unrelated corporation], or in a credible manner for Anaconda’s benefit, he could have bound Anaconda

Such a shift usually shows up in the context of “apparent authority” when elements of the “actual authority” of the agent cannot be shown.¹³⁴ It is relatively easier in a sovereign debt context (as opposed to the normal corporate setting) for the agents to provide the instruments of authority typically taken to satisfy indicia of actual authority. The same upturned hand that receives a bribe can, when inverted, sign the decree authorizing the incurrence by the state of the obligation procured by that bribe. This is one of the reasons why the laws of many countries require the government to secure the approval of the legislature before undertaking any external borrowing. In countries where the legislature is a representative assembly, these requirements operate to force the third party (the lender) to seek the ratification of the principal (the people, acting through their elected representatives) for the actions of the agent (the government). Corruption by government officials is still possible, of course, but only when the legislature (acting on behalf of the principal—the people) fails to monitor the actions of the agent (the government) in carrying out the authorized borrowing. In practical terms, such monitoring would involve accounting for the full proceeds of the loan and ensuring that the terms of the borrowing are arm’s length and in line with prevailing market terms.

By way of comparison, American law does not usually regard directors as agents of the shareholders of a corporation,¹³⁵ but American law is willing to curb the power of a corporate governing body when the body is acting wrongfully, usually defined as breach of its fiduciary duty. A well-known example is the breadth of a board’s ability under corporate law to terminate a shareholder derivative suit instituted to challenge possible self-dealing conduct by directors. American courts are clear that a board has the power not to pursue litigation, but courts will not respect the wrongful exercise of that power. The Delaware Supreme Court put it this way:

[A] board has the power to choose not to pursue litigation when demand is made upon it, so long as the decision is not wrongful. . . .

even if he in fact intended and managed to steal the money involved.” *Id.* at 692 (emphasis added).

134. RESTATEMENT (THIRD) OF AGENCY § 2.01 cmt. b (2006) (distinguishing actual and apparent authority).

135. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(2) (2006) (“Directors’ powers originate as the legal consequence of their election and are not conferred or delegated by shareholders.”).

[T]he board entity remains empowered under § 141(a) to make decisions regarding corporate litigation. The problem is one of member disqualification, not the absence of power in the board.¹³⁶

Similarly, an American court faced with a governing authority that had purported to act in a self-dealing transaction will not accord respect to such wrongful action.

In addition, the validity of the delegation of actual authority from the governing authority to the agent who acted for the regime is constrained by several principles of agency law. The existence of actual authority of the agent to perform certain functions does not automatically mean that the agent has the apparent authority to bind the principal in all matters, nor does it always remove from the third party the responsibility for ensuring that the agent has not strayed into the realm of self-dealing. For example, the *Restatement of Agency* specifies that the authority to act as an agent includes only the authority to act for the benefit of the principal¹³⁷ and that agents owe a fiduciary duty to their principals.¹³⁸ When a third party is aware that the agent is acting for a personal purpose, the principal is not liable to the third party.¹³⁹ Indeed, agency law goes beyond merely voiding the contract between the principal and the third party in such situations; it declares that a third party who suborns a betrayal of trust by the

136. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785–86 (Del. 1981). The court also stated that “a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful.” *Id.* at 784.

137. See RESTATEMENT (SECOND) OF AGENCY § 39 cmt. a, reporter’s notes at 130 (1958) (“In business enterprises, an agent normally has no authority to seek personal advantage otherwise than through the faithful performance of his duties. . . .”); RESTATEMENT (THIRD) OF AGENCY § 2.02 cmt. e (2006) (explaining that an agent does not have actual authority if agent does not reasonably believe principal has consented, and adding that factors relevant to reasonableness of agent’s understanding include agent’s fiduciary obligation to act legally).

138. RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006).

139. RESTATEMENT (SECOND) OF AGENCY § 165, reporter’s notes at 389–92 (1958); RESTATEMENT (THIRD) OF AGENCY § 2.03 cmt. d (2006). An 1893 decision of the New York Court of Appeals expressed the rule in these terms:

It is an old doctrine, from which there has never been any departure, that an agent cannot bind his principal, even in matters touching his agency, where he is known to be acting for himself, or to have an adverse interest. . . . The plaintiff in such a case assumes the risk of the agent’s disloyalty to his trust, and has no occasion for surprise when he discovers that the agent has served himself more faithfully than his principal.

Manhattan Life Ins. Co. v. Forty-Second St. & Grand St. Ferry R.R., 139 N.Y. 146, 151–52 (Ct. App. 1893) (citations omitted). Nearly a century later, the Second Circuit reaffirmed the vitality of this “Faithless Servant Defense” but held, in that case, that the party asserting the defense offered no factual allegations in support of its claim that the agent was engaged in self-dealing. *Citibank. N.A. v. Nyland (CF8) Ltd.*, 878 F.2d 620, 624 (2d Cir. 1989).

agent is answerable in tort to the principal.¹⁴⁰ If the circumstances of the transaction raise reasonable doubts about whether the agent is faithfully representing the interests of the principal, these principles suggest that the third party is under a duty to investigate.¹⁴¹

The *Restatement (Third) of Agency*'s admonition should apply here: "A principal should not be held to assume the risk that an agent may act wrongfully in dealing with a third party who colludes with the agent in action that is adverse to the principal."¹⁴² That quote derives from a section specifying a rule against a third party being able to impute a faithless agent's knowledge to a principal, a discussion the *Restatement* puts squarely within a risk-assumption framework.¹⁴³ That is, the third party should not benefit from imputing the agent's knowledge to the principal when the third party itself acted wrongfully or otherwise in bad faith. The circumstances surrounding a transaction, including the magnitude of benefit it will confer on the agent who arranges it, may place a reasonable third party on notice that the agent will withhold material information from the principal.¹⁴⁴

140. 2 RESTATEMENT (SECOND) OF AGENCY § 312 cmt. d, reporter's notes at 52 (1958); RESTATEMENT (THIRD) OF AGENCY § 8.02 cmt. e (2006).

141. 1 RESTATEMENT (SECOND) OF AGENCY § 165 cmt. c, reporter's notes at 390 (1958) ("Whether or not the third person has reason to know of the agent's improper motive is a question of fact. If he knows that the agent is acting for the benefit of himself or a third person, the transaction is suspicious upon its face, and the principal is not bound unless the agent is authorized.").

Comment a to this provision says the agent's actions come under inherent agency authority. The RESTATEMENT (THIRD) OF AGENCY makes a similar point within the context of apparent authority (having abandoned inherent agency power as a distinctive label and incorporated it within the concept of manifestation under authority generally). See RESTATEMENT (THIRD) OF AGENCY § 2.03 cmt. d (2006) ("In a transactional context, the agent's position as a fiduciary should prompt doubt in the mind of the reasonable third party when the agent appears to be using authority to bind the principal to a transaction that will not benefit the principal.").

142. See *id.* § 5.04 cmt. c.

143. See *id.* ("It is more helpful to view questions about imputation from the perspective of risk assumption, taking into account the posture of the third party whose legal relations with the principal are at issue.").

144. See *id.*; see also *Invest Almaz v. Temple-Inland Forest Prods. Corp.*, 243 F.3d 57, 74 (1st Cir. 2001) (stating that "[i]n the majority of jurisdictions the law has evolved towards a recognition that information given to even a fraudulent agent should normally be imputed to the principal, unless the third party providing the information has notice that the agent is acting adversely or otherwise colludes with the faithless agent"); cf. *Lysee v. Marine Bank*, 703 N.W.2d 751, 755 (Wis. Ct. App. 2005) (discussing *Praefke v. Am. Life Ins. Co.*, 655 N.W.2d 456 (Wis. Ct. App. 2002) in which the principal, a widow, slipped into dementia during the course of an agency relationship and was unable to control the self serving actions of the agent in assigning certificates of deposit, which were held void).

The *Restatement* prescribes similar rules for other contexts. The adverse domination doctrine sometimes tolls the statute of limitations that otherwise would block, on timeliness grounds, a principal's suit.¹⁴⁵ The typical adverse domination case involves a self-dealing set of directors or managers who controlled (adversely dominated) a corporation for some period. When the self-dealing crowd exits the scene, a new set of directors may sue their predecessors for their misbehavior while in control of the company. But what if the malefactors argue that their alleged misdeeds took place years ago and that the statute of limitations on those misdeeds has elapsed? The doctrine of adverse domination solves that problem by tolling the statute of limitations clock for the period during which the self-dealing managers were in control; a period during which the corporation could not sue because the bad guys prevented it from doing so.

Application of agency law principles to an odious debt context should also include one further traditional agency issue: ratification. The general worry encompassed by ratification is that the principal will sit back and behave opportunistically as against the third party by, for example, accepting the benefit that the third party provided and, when time comes to pay back the loan, arguing that the agent lacked the authority to speak for the principal. The *Restatement (Third)* describes the general rule this way: "A person may ratify an act . . . by receiving or retaining benefits it generates if the person has knowledge of material facts, and no independent claim to the benefit."¹⁴⁶

A debt becomes odious in the eyes of the citizens of a country, however, in part because the proceeds of a borrowing do not benefit those people; the benefits flow to the governing regime that incurred the debt. Thus, the principals here (the people) are never given a chance to behave opportunistically vis-à-vis the third party lender. To use the terminology of the *Restatement*, there were never any "benefits" for the principals to retain.

Applying these principles to our three hypothetical Ruritanian loans yields these conclusions. The Corrupt Loan is voidable at the option of a successor government in Ruritania. The reason? The lender knew that the prior ruling regime (or officials in that regime)

145. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. d. reporter's notes at 386-87 (2006).

146. *Id.* § 4.01(g) cmt. g.

had breached its fiduciary duty to its principal—the country and the people of Ruritania—by committing Ruritania to repay money that was misappropriated by the government officials for their own purposes. Indeed, a successor regime in Ruritania may even have a claim against the lender for the damages—the money previously paid to service the loan while the old regime was in power—resulting from the lender’s bribery of the corrupt government officials involved.

Agency law would also say that the Suspicious Loan imposes an affirmative duty on the lender to investigate whether the governmental officials contracting the loan were indeed acting in the interests of Ruritania, as opposed to their own interests. It is here that the reputation of a corrupt governmental regime becomes relevant to the analysis. A loan will not be unenforceable merely because it was contracted by a corrupt regime. But that regime’s reputation for corruption may place upon the lender, as a matter of agency law, a higher burden to satisfy itself that the proceeds of the borrowing are benefiting the principal (the country) and not just the agent (the government officers signing the loan agreement).

It is conceivable in a private-actor setting that a principal might countenance a degree of self-interested behavior on the part of an agent—much like the old Roman custom of appointing provincial “tax farmers” who would remit a specified amount of tax revenue back to Rome but were then free to retain for themselves any excess contributions they could exact from the unhappy taxpayers. But it is fanciful to believe that the principal involved in this case—the millions of dispersed Ruritanian citizens—would ever have condoned the theft by government officials of money borrowed in their name and repayable out of their (or their posterity’s) taxes.

The Utterly Fatuous Loan, however, untainted by the fact or even the suspicion of corruption, binds the principal—the country and citizens of Ruritania. At least under American law, the cupidity of government officials in borrowing money may give rise to a defense to repayment of the debt; the stupidity of government officials does not.

4. *Disregarding Entity Separateness in Corporate Law.* We have been speaking in this Article about the circumstances in which principles of private (domestic) law in the United States might permit a successor government legally to disavow a debt obligation incurred by its predecessor. The common theme running through these possible defenses is that when a third party suborns a government to

betray its duty to the country on whose behalf it purports to act, or when a third party consciously turns a Nelsonian blind eye to such a betrayal, the resulting contract between that third party and the traduced sovereign state is voidable at the option of a successor government.

An additional way to analyze these legal relationships draws upon the legal fiction known as the corporation. On several levels, the legal analysis of a sovereign state parallels that of a corporation. Both are artificial persons recognized by law as separate persons from their constituent members—a state has citizens;¹⁴⁷ a corporation has shareholders.¹⁴⁸ A state is managed by a government; a corporation is managed by officers and directors. Both may have creditors or other contractual counterparties.

This recognition of entity separateness creates benefits in terms of streamlining collective action and permitting the entity an enduring life beyond the death of any one participant. The corporation achieves this status as a creature of positive law in the jurisdiction in which it is incorporated. A sovereign state, however, achieves this status only by being recognized as such by other sovereign states, much like a stray wolf who follows a new pack at a distance for some period of time until—after being appropriately sniffed, pawed, and bitten by the incumbents—it is admitted to full membership in the pack.¹⁴⁹

The law normally disregards the ever-changing cast of these individual stakeholders and treats the rights and obligations of the entity as belonging to the continuing legal fiction—the state or the corporation. But there are limits beyond which American law will not respect the legal fiction if doing so would injure innocent parties.

147. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 201 cmt. c (1987).

148. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 124–27 (9th ed. 2004).

149. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 201 cmt. h (1987) (observing that “[w]hether an entity satisfies the requirements for statehood is ordinarily determined by other states when they decide whether to treat that entity as a state”); *see id.* § 203(1) (“A state is not required to accord formal recognition to the government of another state, but is required to treat as the government of another state a regime that is in effective control of that state, except as set forth [in this section under the rules governing the use of force under the United Nations charter].”).

One prominent exception in corporate law is the doctrine known as “piercing the corporate veil” (PCV).¹⁵⁰ Indeed, it is the most litigated issue in corporate law.¹⁵¹ In the garden-variety PCV case, creditors of the corporation will seek a court’s permission to disregard the separate entity of the corporation and to look through (to pierce) the limited liability veil of the corporation, with the goal of recovering their claims from a controlling shareholder that abused the corporate form by treating the corporation as its alter ego. In the typical fact pattern, a shareholder inserts a separate corporate entity with no assets between the richer shareholder and a third-party creditor, with the creditor having no realistic source of recovery for future payment obligations of the company. A court, if it finds that the shareholder and the corporation have abused the normal limited liability characteristic of a corporation to harm the third-party creditor, will disregard the separate entity and pierce the veil so that the creditor can recover directly from the controlling shareholder.¹⁵² In other examples of disregarding the entity, courts will pierce the veil to block the shareholder from using the separate entity to avoid a government regulation or for other nefarious purposes.¹⁵³

The PCV doctrine in American law has thus evolved in a flexible manner to address the many different ways in which insiders abuse legal fictions such as corporations. The law has an interest in seeing that any entity carrying the suffix “Inc.” or one of its substitutes operates in a manner consistent with the legal requirements and expectations that the legislature had in mind when it authorized these legal fictions. “Abuse of the corporation” therefore is a shorthand way of saying that one or more of the stakeholders in the enterprise acted outside of the range of the rights and duties anticipated by the legislature when it authorized the creation of limited liability

150. For discussions of the subject, see STEPHEN B. PRESSER, *PIERCING THE CORPORATE VEIL* (1991 ed. & Supp. 2004), and Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479 (2001).

151. Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1036 (1991).

152. *See, e.g.*, *Van Dorn Co. v. Future Chem. and Oil Corp.*, 753 F.2d 565, 569–70 (7th Cir. 1985) (observing that the veil may be pierced where maintenance of the legal fiction would “sanction a fraud or promote injustice”).

153. PRESSER, *supra* note 150 § 1:5; *see also id.* § 1:13 (discussing the need to disregard the corporate form when it is used “to defraud creditors, to evade existing obligation, to circumvent a statute, to achieve or perpetuate a monopoly, or to protect knavery and crime”).

entities.¹⁵⁴ In effect, the wrongdoer will have taken advantage of the unspoken expectations of the other stakeholders (that they are all playing by these rules) as the camouflage to conceal the misbehavior. This is probably a workable definition for the concept of cheating in any rules-based game, with the possible exception of solitaire.

Sovereign debt may involve a similar misuse of separate entity status. The same triangular relationship is present in a sovereign borrowing: a third party (a lender) has advanced funds to a legal entity (a country) acting through agents (government officials) who in turn have succeeded in appropriating the proceeds for their own use. The equivalent *dramatis personae* in a corporate borrowing are a third party who has advanced funds to a legal entity (a corporation) acting through a controlling shareholder who similarly has secured the benefit of the funds advanced to the entity. The malefactor's ability to make the scheme work in each case turns on the law's willingness to recognize the separate legal status of the entity. But there are important differences between the abuse of a corporation and the abuse of a sovereign because of the relative cash position of the entity. To see these differences, follow the money and keep your eye on the malefactor operating behind the entity.

In a typical corporate veil-piercing case, the abuse involves a controlling shareholder who sets up an under-capitalized corporation for the purpose of incurring an obligation to a third party. By one means or another, the controlling shareholder then siphons off the proceeds of the corporation's borrowing from that third party. When the time comes for the corporation to repay the debt, the corporation lacks the means to do so and the controlling shareholder asserts the entity's separate legal personality and the corollary of shareholders' limited liability to block the third party's efforts to recover from the shareholder. The result is that the third party ends up bearing the risk of the non-payment.

Compare this to a sovereign borrowing situation. The controlling parties, here the government officials, cause the entity (the country) to incur an obligation for future payment. Again the proceeds find their way through the entity to the ostensible agent. But, unlike the corporate shareholder, the citizens do not enjoy limited liability. Indeed, under international law, one consequence of the legal

154. See, e.g., *Sea-Land Servs., Inc. v. Pepper Source*, 941 F.2d 519, 521 (7th Cir. 1991) (applying the *Van Dorn* analysis in observing that the defendant was using the corporate form as his "plaything[]").

personality of the state is that it imposes *unlimited* liability upon the principal; the citizens are theoretically subject to taxation to pay all of the state's debts.

In summary, abuse of legal entity status in the corporate context usually involves an attempt by a controlling shareholder to exploit a fundamental feature of that legal personality—limited liability. Abuse of legal entity status in the sovereign context typically involves an attempt by an agent (the government official) to exploit a fundamental feature of that legal personality—unlimited liability of the principal for obligations incurred by its agents.

The remedy in both situations requires a court to look though whatever feature of the separate legal entity status has caused or has camouflaged the mischief. In corporate settings, that feature is the normal rule about the limited liability of shareholders. In the sovereign context, it is the normal rule about the unlimited liability of citizens to repay debts incurred by agents who prove faithless.

As U.S. courts have tried to fashion remedies in veil-piercing cases, they regularly allow the third party to recover from a controlling shareholder. Courts describe this remedy as expanding the potential sources of relief to include the controlling shareholder without depriving the lender of its cause of action against the corporation itself.¹⁵⁵ In some circumstances, this dual remedy of allowing a third party lender to retain its rights against the corporation would only expand the list of victims of the abuse by adding to that list the innocent creditors of the corporation as well as any other innocent shareholders. If the third party lender can recover in full from the corporation on a simple claim for money due but not paid, it will have no financial incentive to pursue a necessarily more difficult veil-piercing claim against a controlling shareholder who has benefited from the inappropriate transfer of the original proceeds. That leaves, however, the other creditors and innocent shareholders of the corporation holding claims (debt or equity) against a weakened entity.

Courts applying the piercing the corporate veil doctrine have had little reason to explore this concern, however, because piercing usually arises when the corporation lacks the funds to pay anyone.

155. *In re Tex. Am. Express Inc.*, 190 S.W.3d 720, 726 (Tex. App. 2005) (noting that a piercing claim is “purely remedial,” expanding the “scope of potential sources of relief by extending to individual shareholders or other business entities what is otherwise only a corporate liability”).

Yet, in parallel settings where this condition of an insolvent entity is removed, courts are very willing to consider other possible victims in deciding whether a remedy for misuse of the corporate entity is appropriate. Thus, in so called “reverse veil piercing” cases (where a creditor of the controlling shareholder is allowed to ignore the separateness of the corporation and its shareholder to pursue a recovery against the corporation for the shareholder’s obligation), courts have been careful not to create “friendly fire” victims among other innocent stakeholders.¹⁵⁶ Similar concerns motivate courts applying agency principles discussed in an earlier section.

Applying the corporate veil-piercing precedents from the contexts in which the entity has no money to the odious debt scenario in which the entity has money and/or taxing authority therefore produces an unsatisfying result similar to the traditional rule of strict state/governmental succession. An innocent lender to the sovereign may be allowed to pursue an absconding dictator to the south of France, but it will retain its claim against the Republic of Ruritania as well.¹⁵⁷ The proponents of an odious debt exception to the doctrine of state succession would object to this outcome on the grounds that this only substitutes another victim (the citizens of Ruritania) in place of the original victim (the lender) and sanctions a misuse of the legal entity.

And maybe it does. But our research suggests that this is precisely where U.S. courts typically come out in comparable situations involving abuses of corporate entities and agency authority. The status of “fellow victim” is, by itself, insufficient to shield one

156. “Reverse piercing is ordinarily possible only in one-man corporations, since if there is more than one shareholder the seizing of the corporation’s assets to pay a shareholder’s debts would be a wrong to the other shareholders.” *Scholes v. Lehmann*, 56 F.3d 750, 758 (7th Cir. 1995); *In re Phillips*, 139 P.3d 639 (Colo. 2006) (en banc) (answering certified question that reverse piercing exists in Colorado but subject to equitable limitations focusing on whether innocent shareholders or creditors would be prejudiced).

157. Allowing a creditor of a sovereign borrower to pursue a recovery against an absconding dictator, unless it is also accompanied by a bar on suing the sovereign, is in practice likely to be just eyewash. The record of successor governments (much less creditors of successor governments) attempting to recover misappropriated funds from fleeing despots (Marcos, Duvalier, Abacha, and so forth) is poor. Even when the authorities know that the scoundrel can be found at 4 p.m. each afternoon sipping an absinthe at a particular café in Cap Ferrat, a combination of bank secrecy laws, convoluted corporate structures and clever lawyers can usually forestall any disgorgement of the funds for generations. Cf. *Missing Millions: Need to Track Down Hidden Treasure*, THE STATESMAN (Calcutta, India), May 16, 1999 (describing the thicket of laws and political barriers that have to be negotiated if one is attempting to pursue an absconding dictator’s assets), available at 1999 WLNR 4612339.

from monetary liability. Yet there are times when courts will put the risk of entity abuse on the third party as opposed to the principal. When that occurs, it likely reflects an unspoken hierarchy of moral blame. An innocent creditor of a corporation can recover against the corporation, even at the cost of making victims of innocent (non-controlling) shareholders, because the former is more innocent than the latter. The innocent shareholders are more closely connected to the villain of the drama than the innocent creditors.¹⁵⁸ Being innocent is not like being dead; there are gradations of innocence.

In sovereign lending, the argument goes, the citizens of Ruritania—by their willingness to endure a corrupt regime—have in effect earned the decoration of “innocence, second class.” A truly innocent lender to the Republic trumps them on the scale of moral rectitude and this gives the creditor a legal claim for recovery of its loan that is higher than the legal claim of the citizens not to be burdened by debts for which they received no benefit.

By contrast, when the creditor is not truly innocent, that fact can also operate to shift the risk of nonpayment to the creditor as opposed to the citizens or the shareholders. One consequence of shaving these fine distinctions between villains and victims, of course, is that any reproach of the “known or should have known” variety that can be laid at the feet of the lender will significantly affect the lender’s position on the totem pole of moral righteousness. Interestingly, this was the instinctive conclusion of Alexander Sack and the other traditional odious debt theorists—the lender’s awareness of the irregularity is an essential element in voiding the lender’s claim for recovery.

B. Possible Problems

1. *The Problem of Proof.* Challenging the enforceability of the Suspicious Loan extended to a predecessor regime in a court of law places upon the sovereign defendant a burden of proving the “irregular” (to use Chief Justice Taft’s adjective in the *Tinoco Arbitration*)¹⁵⁹ circumstances surrounding the incurrence of the loan.

158. The priorities in a corporate bankruptcy are consistent with this idea. Innocent creditors take in priority to innocent shareholders in a bankruptcy because the latter received a different package of benefits and risks when they acquired their equity stake in the company. One of those risks was the risk of being victimized by a fellow shareholder.

159. *Tinoco (Gr. Brit. v. Costa Rica)*, 1 R.I.A.A. 371, 394 (1923).

This may not be an easy task. By their very nature, fraud and corruption can be notoriously difficult to prove. Cross-border corruption is even more difficult to substantiate, and cross-border corruption that occurred years or decades earlier is exceptionally difficult. In the twenty-seven years (through 2004) that followed the passage of the U.S. Foreign Corrupt Practices Act (FCPA), for example, the U.S. Department of Justice brought only thirty-nine criminal prosecutions and seven civil enforcement actions under the anti-bribery provisions of the FCPA.¹⁶⁰ In nearly three decades, there were probably many other transgressions that went undetected, unproven, and unpunished.

We believe that governmental corruption in some countries at certain times is so suffocatingly ubiquitous that a U.S. court could legitimately shift onto the plaintiff the burden of showing that a particular transaction was *not* tainted by corruption. A reputation for corrupt behavior is no longer, as it once was, just a matter of the accumulated sediment of hundreds or thousands of personal anecdotes recounted by those on the receiving end of what Mexicans charmingly call “the bite.” Several independent groups have devised methods to assess the extent of governmental corruption in a particular country and even rank them in a comparative matrix with other countries.¹⁶¹ Against a showing of pervasive corruption, is it unreasonable to ask the plaintiff/lender to explain how it alone had managed to preserve its virtue in dealing with the corrupt regime?

In a variety of contexts, U.S. courts are called upon to acknowledge the existence of widespread corruption in foreign countries and to draw reasonable inferences about the conduct of persons who do business with governmental agencies in those countries. The original version of the FCPA passed in 1977, for example, criminalized payments to foreign government officials, or to an intermediary for such an official, when the payor knew or “had reason to know” that the purpose of the payment was to influence a

160. U.S. Dep’t of Commerce, Int’l Trade Admin., *Addressing the Challenges of International Bribery and Fair Competition 2004* (July 2004), available at http://tcc.export.gov/static/exp_000951.pdf (last visited Mar. 22, 2007).

161. See e.g., Press Release, Transparency Int’l, *Transparency International Corruptions Perceptions 2004* (Oct. 20, 2004), available at http://ww1.transparency.org/pressreleases_archive/2004/2004.10.20.cpi.en.html; Press Release, Transparency International, *Transparency International Releases New Bribe Payers Index (BPI) 2002* (May 14, 2002), available at http://ww1.transparency.org/pressreleases_archive/2002/2002.05.14.bpi.en.html.

foreign governmental action or to obtain business.¹⁶² The phrase “had reason to know” was widely criticized by American businesspeople.¹⁶³ In many cross-border transactions, exporters find it useful to retain the services of a local agent or intermediary. How can the exporter be sure that some of the compensation paid to a local agent will not find its way into the hands of government officials?

In response to complaints that the phrase “had reason to know” was so imprecise that it inhibited legitimate competition by American exporters, Congress amended the FCPA in 1988 to delete this phrase.¹⁶⁴ The 1988 amendments limited the bribery prohibition of the FCPA to payments made with “knowledge” that all or part of the money would be used for bribery.¹⁶⁵ Drawing from the Model Penal Code, however, the 1988 amendments defined a person’s knowledge with respect to conduct or circumstance or a result (in this context, a bribe) as that person’s being aware of a “high probability” of the occurrence of the conduct or circumstance, or being “substantially certain” of the result.¹⁶⁶ The Conference Report for the 1988 amendments said the conferees intended that the requisite state of mind for this offense include a “conscious purpose to avoid learning the truth,”¹⁶⁷ and used phrases such as “willful blindness,” “deliberate ignorance,” “conscious disregard,” and “a head in the sand,”¹⁶⁸ to explain when a party can be held to “know” that illicit conduct is afoot.¹⁶⁹

American judges will take judicial notice of foreign governmental corruption in other contexts as well. One of the grounds for nonrecognition in the United States of a foreign court

162. Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78dd-1, 78dd-2 (amended 1988).

163. See, e.g., Peter D. Trooboff, Current Development: *Proposed Amendment of the Foreign Corrupt Practices Act of 1977*, 77 AM. J. INT’L L. 340, 341 (1983).

164. Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107, 1419 (1988).

165. H.R. REP. NO. 100-576, at 920 (1988) (Conf. Rep.), as reprinted in 1988 U.S.C.C.A.N. 1547.

166. Foreign Corrupt Practices Act of 1977, 15 U.S.C. § 78 dd-2(h)(3) (amended 1988).

167. H.R. REP. NO. 100-576, at 919 (1988) (Conf. Rep.), as reprinted in 1988 U.S.C.C.A.N. 1547.

168. *Id.*; see also John E. Impert, *A Program for Compliance with the Foreign Corrupt Practices Act and Foreign Law Restrictions on the Use of Sales Agents*, 24 INT’L LAW. 1009, 1014 (1990) (summarizing the terminology used by the 1988 amendments to indicate the presence of “willful disregard”).

169. H.R. REP. NO. 100-576, at 919 (1988) (Conf. Rep.), as reprinted in 1988 U.S.C.C.A.N. 1547.

judgment, for example, is the absence of impartial tribunals or fair procedures in the country in which the judgment was handed down. This determination must be made by the U.S. court that is asked to recognize the foreign judgment. “The recognizing court may make this determination without formal proof or argument, on the basis of general knowledge and judicial notice.”¹⁷⁰

In *Bridgeway Corp. v. Citibank*,¹⁷¹ a Liberian corporation (Bridgeway) sought to enforce in a U.S. federal court a money judgment it had obtained against Citibank in Liberia.¹⁷² The U.S. federal district court granted summary judgment in favor of Citibank on the ground that Liberia’s courts did not constitute “a system of jurisprudence likely to secure an impartial administration of justice.”¹⁷³ On appeal, the parties quarreled over who bore the ultimate burden of proof with respect to the fairness of the Liberian judicial system.¹⁷⁴ The appeals court declined to express an opinion on this issue, but held that even if the burden of proof rested with Citibank, the production of affidavit evidence and an unflattering U.S. State Department report about the Liberian judiciary carried that burden.¹⁷⁵ Although the Second Circuit’s opinion does not say so explicitly, Citibank’s evidence about the generally bleak state of the Liberian judicial system shifted the burden onto Bridgeway to contradict Citibank’s characterization. Bridgeway failed to do so. The court therefore affirmed the dismissal of Bridgeway’s action for recognition of the Liberian judgment.¹⁷⁶

In motions for dismissal on *forum non conveniens* grounds, U.S. judges are occasionally asked to take judicial notice of the fact that the courts of a proposed alternative forum are so corrupt, or so inefficient, that they do not meet even a minimally acceptable standard for an adequate alternative forum for the action. In *Eastman*

170. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 482 cmt. b (1987).

171. *Bridgeway Corp. v. Citibank*, 201 F.3d 134 (2d Cir. 1999).

172. *Id.* at 137.

173. *Id.* at 139.

174. *Id.* at 141–42.

175. *Id.*

176. *Id.* at 144; *see also* *Koplik v. Bank Mandiri*, No. 05-01136, 2006 WL 3017346 (Bankr. S.D.N.Y. Oct. 23, 2006) (citing *Bridgeway*, the court refused to give effect to a decision of an Indonesian court in light of evidence—principally a State Department report—regarding the pervasive corruption of the Indonesian judicial system).

Kodak Co. v. Kavlin,¹⁷⁷ a federal district court denied a motion by Bolivian defendants to dismiss the case on *forum non conveniens* grounds.¹⁷⁸ The plaintiffs developed an extensive record showing that the Bolivian judicial system was corrupt at all levels. The court reached this conclusion despite its recognition that “[t]he ‘alternative forum is too corrupt to be adequate’ argument does not enjoy a particularly impressive track record.”¹⁷⁹

More directly on point in the area of foreign governmental corruption is *Republic of Haiti v. Duvalier*.¹⁸⁰ In that case, the Republic of Haiti brought an action in a New York state court against the wife of the deposed Haitian dictator (Jean-Claude “Baby Doc” Duvalier) for embezzlement and conversion of public assets.¹⁸¹ The trial court granted Mrs. Duvalier’s motion for summary judgment and an appeal followed.¹⁸²

The appellate division noted the evidence produced by the Haitian government at trial concerning the widespread corruption of the Duvalier regime, including circumstantial evidence suggesting that the Duvaliers had pilfered substantial amounts of public funds. “This combination of direct and circumstantial evidence,” the appeals court ruled, “is sufficient to establish [Haiti’s] conversion claim, *prima facie*.”¹⁸³ The court held that the burden had thus shifted to Mrs. Duvalier to produce evidence that would establish a “triable issue of fact” on the corruption allegation.¹⁸⁴ She failed to do so, and the trial court’s summary judgment in her favor was reversed.

There is, in short, no reason to believe that Ruritania would have to produce “smoking gun” evidence of a lender’s collusion with corrupt officials of the prior regime for Ruritania to prevail in one or more of the defenses discussed in this Part. Nor could a lender escape a compelling, if circumstantial, inference of corruption merely by turning a Nelsonian blind eye to those circumstances.¹⁸⁵ There is

177. *Eastman Kodak Co. v. Kavlin*, 978 F. Supp. 1078 (S.D. Fla. 1997).

178. *Id.* at 1082.

179. *Id.* at 1084, 1080–82 (reviewing the track record).

180. *Republic of Haiti v. Duvalier*, 626 N.Y.S.2d 472 (App. Div. 1995).

181. *Id.* at 473.

182. *Id.*

183. *Id.* at 476.

184. *Id.*

185. In an appeal of a criminal conviction brought under the mail fraud statute, for example, the First Circuit approved jury instructions that allowed the required element of knowledge of the fraud to be proved by circumstances showing the defendant’s “deliberately clos[ing] his eyes

indeed a price to be paid for dealing with a notoriously corrupt regime and that price, at the very least, is a higher standard of vigilance and investigation.

2. *In Pari Delicto*. This discussion has assumed a litigation scenario in which a successor government of Ruritania appears in a lawsuit in a U.S. court to contest the enforcement of a loan extended to the prior ruling regime. Our hypotheticals have assumed that the loan was incurred in the name of the Republic of Ruritania. The government that borrowed the money did so as agent for the Republic, and the government that now appears to defend the lawsuit also does so as agent for the Republic.

In the Ruritanian Corrupt Loan example, the corrupt government that stole the proceeds of the loan would be awkwardly placed to construct a legal defense based on its own misconduct or the misconduct of the lender that bribed it. Like the *Adler* case discussed in Part IV.A.2,¹⁸⁶ all the parties appearing before the trial court under these circumstances would share a degree of culpability. But following a regime change in Ruritania, the new (blameless) government may well try to mount defenses to enforcement of the loan along the lines of those suggested in Part IV.A. This may in turn prompt the lender to argue that the defendant Republic of Ruritania—ignoring the interim change of government—was at the very least *in pari delicto* (of equal fault) with the lender in the whole affair. The equitable doctrine of *in pari delicto* precludes one wrongdoer from asserting claims against a confederate who is equally at fault. This is precisely the argument on which Adler relied in his (unsuccessful) attempt to disarm Nigeria's unclean hands defense.¹⁸⁷

The question then is whether the new Ruritanian government, when it inherited the debt of its predecessor, also inherited the disability of that predecessor to resist legal enforcement of the debt based on the predecessor's own misconduct in the affair.

There are parallels in the corporate field. A trustee or a receiver in the bankruptcy of a corporation similarly "steps into the shoes" of the bankrupt enterprise.¹⁸⁸ In a derivative suit, shareholders assert the

to what otherwise would have been obvious to him," "[r]efusing to investigate something that cries out for investigation . . ." United States v. Kaplan, 832 F.2d 676, 682 (1st Cir. 1987).

186. See *supra* note 111 and accompanying text.

187. See *Adler v. Federal Republic of Nigeria*, 219 F.3d 869, 877 (9th Cir. 2000).

188. KLEIN & COFFEE, *supra* note 148, at 258–59.

rights of the corporation to redress injuries to the corporation.¹⁸⁹ In each of these situations, a similar question can arise: will the successor (the trustee, the receiver, or the shareholder in a derivative action) be entitled to assert the claims of the enterprise against third parties, and if so, will that successor be subject to any equitable defenses (such as unclean hands or *in pari delicto*) that those third parties may have had against the enterprise itself?

In the case of a trustee in bankruptcy, U.S. courts have generally interpreted section 541 of the Bankruptcy Code to limit a trustee's rights to those of the corporation as they existed at the time of the commencement of the bankruptcy proceeding.¹⁹⁰ Accordingly, if the bankrupt corporation had participated in the wrongdoing, it would on the date of commencement of the bankruptcy have been disabled from pursuing claims against confederate wrongdoers on *in pari delicto* grounds. The trustee, stepping into those shoes, suffers that same disability.¹⁹¹

Court-appointed receivers, however, are a different matter. Receivers are not limited by section 541 of the Bankruptcy Code, and in pursuing claims of the corporation against other wrongdoers, receivers are generally not hampered by the *in pari delicto* defenses raised by those third parties.¹⁹² In *Scholes v. Lehmann*,¹⁹³ for example, the Seventh Circuit in 1995 confronted these facts: Michael Douglas had set up several corporations and caused those corporations in turn to create limited partnerships for the ostensible purpose of investing in commodity trades.¹⁹⁴ Prospective investors in the limited partnerships were lured by promises of a return of 10 to 20 percent *a month* on their original investments.¹⁹⁵

189. *Id.* at 205.

190. Bankruptcy Act, 11 U.S.C. § 541 (amended 2005).

191. *See, e.g.*, Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 357 (3d. Cir. 2001); *see also* Reynolds B. Brissenden, IV, *In Pari Delicto Doctrine May Bar Receiver's Third-Party Claims*, 3 DEPAUL BUS. & COM. L.J. 169, 171–73 (2005) (“The court concluded that the plain language of section 541 . . . [rendered] the *in pari delicto* doctrine . . . applicable to the third-party claims asserted by the Committee.”). This rule may soon be changed by legislation. *See* the discussion of the draft bill captioned “Bankruptcy Reform Technical Amendments Act of 2005” in Steven P. Caley, *In Pari Delicto in the Bankruptcy Courts—Big Changes in the Offering?*, METROPOLITAN CORP. COUNSEL, June 2006, at 20, 21.

192. 11 U.S.C. § 541 (amended 2005).

193. *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995).

194. *Id.* at 752–53.

195. *Id.* at 752.

The entire arrangement was a Ponzi scheme. Douglas himself stole most of the money. The balance was strategically paid out to early investors to establish the track record that Ponzi operators need to prime the pump for future victims. Within two years, the scheme collapsed. Douglas went (more precisely, went back) to jail.¹⁹⁶

The U.S. Securities and Exchange Commission brought a civil suit against Douglas's corporations and asked a federal court for the appointment of a receiver for both Douglas and the corporations.¹⁹⁷ That receiver, Steven Scholes, set about recovering as fraudulent conveyances money that Douglas had siphoned from the corporations and transferred to his wife (ex-wife by the time of the lawsuit), one of the investors, and several charitable organizations. These transferees argued that Douglas and his three corporations were integral components of the Ponzi scheme.¹⁹⁸ How then, the transferees asked, could a receiver stepping into the shoes of Douglas and his three corporations pursue fraudulent conveyance claims against third parties in the face of the *in pari delicto* doctrine?

In a masterful opinion by Judge Posner, the Seventh Circuit articulated a displacement theory. The rationale behind the *in pari delicto* doctrine is that wrongdoers should not be allowed to benefit from their own wrongdoing. That rationale, the court concluded, is inapplicable to a receiver. Once Douglas had been displaced by the court-appointed receiver, Douglas no longer stood to benefit from the recovery of the fraudulently conveyed funds. Thus, the *in pari delicto* doctrine did not bar a recovery by a successor administrator (the receiver) once the wrongdoer (Douglas) had been ousted from control of, and beneficial interest in, the corporations.¹⁹⁹ In language that a successor government of Ruritania might easily adapt to its own situation in the corrupt Ruritanian loan cases, the Seventh Circuit held that after the appointment of the receiver:

The corporations were no more Douglas's evil zombies. Freed from his spell they became entitled to the return of the moneys—for the benefit not of Douglas but of innocent investors—that Douglas had made the corporations divert to unauthorized purposes. . . . Put

196. *Id.* at 752–53.

197. *Id.*

198. *Id.* at 753.

199. *Id.* at 754–55.

differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated.²⁰⁰

This leaves the interesting question of whether the analogy between a receiver and a successor Ruritanian government is sound.²⁰¹ Given a situation in which the prior regime was ousted from dictatorial control over the country, the successor government truly is, to use the words of one U.S. court in describing court-appointed receivers, “thrust into [the] shoes” of its predecessor.²⁰² By definition, that new government was not complicit in the misdeeds of the prior regime. Disabling the successor government from pursuing third parties that assisted the previous regime in perpetrating those misdeeds—or in the Ruritanian Corrupt Loan cases, depriving the successor regime of a legal defense to the enforcement of a corrupt loan—would only convey a benefit to the wrongdoers at the expense of the citizens and innocent creditors of Ruritania. The rationale of the *Scholes* case should logically apply by analogy to this situation: once the corporation (acting through its receiver) or the sovereign state (acting through its new government) liberates itself from the control of the wrongdoer, the *in pari delicto* doctrine should not disable the innocent successor from pursuing claims or asserting defenses against those who knowingly participated in the misbehavior of the recently-departed regime.²⁰³

200. *Id.* at 754; *see also* FDIC v. O’Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) (holding that the FDIC, as receiver for a failed bank, was not subject to defenses based on unclean hands or inequitable conduct that may have been raised against the bank itself). *But see* Knauer v. Heartland Fin. Servs., Inc., 348 F.3d 230, 236 (7th Cir. 2003) (employing an “equitable balancing” test to reach the conclusion that a receiver *was* subject to an *in pari delicto* defense by third parties).

201. It is, of course, no more than an analogy. Receivers, like trustees in bankruptcy, are appointed pursuant to specific statutory authority. Regime changes in sovereign states, whether constitutional or extra-constitutional, are not the subject of any U.S. law or regulation.

202. *O’Melveny & Myers*, 61 F.3d at 19.

203. In *Republic of Haiti v. Duvalier*, 626 N.Y.S.2d 472 (App. Div. 1995), a New York appeals court allowed a successor government in Haiti to pursue monies that had been embezzled by the prior Duvalier regime. *Id.* at 473. The defendant in the case, the wife of Jean-Claude “Baby Doc” Duvalier, did not raise an *in pari delicto* defense to the successor government’s claims, nor did the court mention the issue. The court’s decision assumed a sufficient separation between the new Haitian government and the Duvalier regime. *Id.* at 474–75.

CONCLUSION

It would never have occurred to Alexander Sack to suggest that successor governmental regimes should rely exclusively on municipal courts of law to invalidate the infamous debts incurred by their predecessors. There was a good reason for this. At the time Sack was writing in the 1920s, most countries recognized an “absolute” theory of sovereign immunity: sovereigns could not be sued in foreign courts without their consent.²⁰⁴ Commercial creditors were therefore compelled to seek the diplomatic assistance of their own governments in protesting debt defaults by foreign sovereign borrowers.²⁰⁵ If commercial loans could not become the subject of lawsuits in municipal courts, there was no reason to spend much time speculating about what defenses the sovereign defendants might have run in such cases.

All of that changed dramatically in the middle of the last century. The prevailing notion of absolute sovereign immunity gave way to a “restrictive” theory under which sovereigns could be held accountable in municipal courts for their commercial activities abroad.²⁰⁶ This restrictive theory was eventually codified into law in the late 1970s in both the United States and the United Kingdom.²⁰⁷

For Alexander Sack and for all other interested commentators in the fifty years following him, therefore, the only possible countermeasure to the mandatory inheritance of debts incurred by a despotic regime lay in achieving an international consensus that such obligations should not, as a matter of international law, continue to burden the citizens of the country once the despot had been removed. But lenders now have legal remedies in municipal courts to pursue their debt recovery efforts. For the last thirty years in the United States, the legal enforcement of foreign sovereign debt obligations has been the province of U.S. federal judges applying conventional doctrines of state contract law. In those lawsuits, the sovereign defendants are perfectly at liberty to assert defenses based on principles of that same contract law or on U.S. public policy generally.

204. JOSEPH W. DELLAPENNA, *SUING FOREIGN GOVERNMENTS AND THEIR CORPORATIONS* § 1.2 (2d ed. 2003).

205. See Lee C. Buchheit, *The Role of the Official Sector in Sovereign Debt Workouts*, 6 *CHI. J. INT'L L.* 333, 333 (2005) (“Inevitably, these lenders have looked to their own governments for succor and protection against defaulting sovereign lenders.”).

206. *Id.* at 338.

207. *Id.* at 338–39.

In short, the dream of Alexander Sack and many others since—to achieve an international consensus about what constitutes an odious sovereign debt—has been overtaken by events. This is probably just as well. As a putative doctrine of public international law, it faced an El Capitan of definitional obstacles. Had it flown at all (which we doubt), it probably would have flown very low, far beneath the level of near-universal consensus required to make it a binding norm of international law.

The prospect of yoking innocent generations of citizens to the repayment of *any* Profligate Debt causes an audible grinding of the moral teeth; the prospect of forcing this result on people already victimized by a corrupt and despotic regime is even more distasteful. This sense of moral outrage fueled the attempt over all these years to enshrine a public international law doctrine of odious debts. Strong moral imperatives, however, have a way of embodying themselves in principles of domestic law as well as public international law. We have suggested that the entrenched hostility of American law to bribery, litigants with unclean hands, faithless agents, and public officials embezzling state funds under the cover of what we have called the “governmental veil,” is adequate to allow a sovereign defendant to defend itself in an American court against the attempted enforcement of what Alexander Sack would have recognized as an odious debt.

Establishing legal defenses on a loan-by-loan basis will achieve some, but certainly not all, of the objectives that modern champions of a doctrine of odious debt are seeking to promote. This approach will certainly have an *in terrorem* effect on prospective lenders that are toying with the idea of lending to disreputable regimes. It will not, however, provide a legal pretext for wholesale debt cancellation for emerging market countries previously ruled by kleptomaniacal regimes, nor will it permit a legal repudiation of Profligate Debts incurred for hare-brained projects.

A country weighed down by a history of imprudent borrowings is not, however, wholly without recourse. It is not necessary to repudiate (in a legal sense) every loan whose payments the country can no longer afford. Even in the absence of a transnational bankruptcy code applicable to sovereign debtors, overindebted countries have been able to approach their creditors (bilateral and commercial) for consensual debt relief when the accumulated debt burden becomes unsustainable, or is sustainable only at the cost of diverting all public financial resources away from other necessary

expenditures. The sovereign debt restructuring process as it has evolved over the last twenty-five years is often not pleasant—indeed, it is frequently exasperating, contentious, and attenuated—but it is a recognized feature of the international financial system.