ODIOUS, ILLEGITIMATE, ILLEGAL, OR LEGAL DEBTS—WHAT DIFFERENCE DOES IT MAKE FOR INTERNATIONAL CHAPTER 9 DEBT ARBITRATION?

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I

INTRODUCTION

Once upon a time, sovereign debts were just that—debts or the entitlement to be repaid fully, including interest. During the 1970s it was thought unnecessary to make any distinctions between debts, based on the assumption that sovereigns might possibly become illiquid, but could never become insolvent. Commercial banks disregarded the most elementary rules of prudent banking, including their duty of due diligence as lenders, laboring on the assumption that whatever flowed into developing countries would eventually flow back with fees and interest. A substantial misallocation of resources resulted, both directly within borrowing countries and indirectly by preventing otherwise viable investments elsewhere. Commercial banks did not act irrationally, though. Convincing evidence exists that they had reason to assume that their claims would be protected against the market by governments that are members of the Organization for Economic Cooperation and Development (OECD).[1] Not bothering about economic fundamentals was thus explicable and—from a business-administration point of view—rational.

This cozy understanding that neither legal principles enforced elsewhere nor economic facts would affect sovereign debts was supported by the Bretton Woods Institutions (BWIs), the International Bank for Reconstruction and Development (IBRD), and the International Monetary Fund (IMF). They promoted such attitudes, encouraging developing countries to borrow. Even after the debt disaster had been recognized by others, the BWIs continued to assert very vocally that financial markets worked, completely failing to realize how serious the situation was—that indeed there was a crisis. It took them an embarrassingly long time to acknowledge the nature and the dimension of the

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1. *Cf.* KUNIBERT RAFFER & H.W. SINGER, THE ECONOMIC NORTH-SOUTH DIVIDE: SIX DECADES OF UNEQUAL DEVELOPMENT 161–62 (2001) (discussing how the United States bailed out commercial banks during the Indonesian Pertamina debt crisis).

debt problem, as a host of evidence from their own publications proves. Even after Mexico's default in August 1982, the BWIs thought the money market functioned well, seeing no signs of liquidity bottlenecks or of restrictions regarding the capital base of private banks limiting lending to sovereign developing countries, which was supposed to continue on a large scale.[2] Naturally, after 1982, banks continued to assume all sovereign debts to be legitimate, legal, and payable.

Eventually forced to admit at least a liquidity crisis, the BWIs became the most ardent advocates of the "illiquidity theory." Debt management after 1982 was based on the assumption that there was no fundamental crisis, only an inconvenient but temporary inability to pay. Countries would "grow out of debts." Debt reduction would therefore not be needed. No one saw a need to qualify debts because they were expected to be fully repaid. Economist William R. Cline, U.S. Treasury Secretary James Baker, as well as the BWIs were firm defenders of this thesis. Based on optimistic assumptions—for instance, regarding debtors' export volumes and prices or relatively high growth in OECD countries—Cline claimed just before the 1985 IMF–IBRD meeting that by the late 1980s, debt–export ratios would be back to levels previously associated with creditworthiness. Optimistically, he concluded, "The emerging evidence in 1983–84 has tended to confirm the analysis that the debt problem is one of illiquidity and subject to improvement as international recovery takes place."[3] Public funds poured in, allowing commercial banks to receive higher (re)payments than otherwise possible and producing a remarkable change in debt structures. It took quite some time to realize that a substantial percentage of sovereign debts was indeed unpayable, although the problem had been recognized well before August 1982, and insolvency procedures for sovereigns were proposed soon after Mexico's default.[4]

It took even longer until standards absolutely usual and mandatory in the case of any debtors other than sovereigns were acknowledged, such as checking the legal basis of claims. Although Costa Rica had saved almost ten percent of interest in arrears by verifying past-due interest claimed by banks loan-by-loan,[5] no need was perceived for systematic and routine checks of the legality of claims. The first request that all debts of insolvent sovereigns should be routinely assessed, as in the case of all other insolvent debtors, met with

2. *See, e.g.*, Eugene L. Versluysen, *Der Kapitaltransfer in Entwicklungsländer zu Marktbedingungen*, 19 FINANZIERUNG & ENTWICKLUNG, no. 4, 33 (1982); for more details see RAFFER & SINGER, *supra* note 1, at 165.

3. William R. Cline, *International Debt: From Crisis to Recovery?*, 75 AMERICAN ECON. REV. (PAPERS & PROC.) 185, 187 (1985).

4. *See* C. G. Oechsli, *Procedural Guidelines for Renegotiating LDC Debts: An Analogy to Chapter 11 of the US Bankruptcy Reform Act*, 21 VA. J. INT'L L. 305, 317–18 (1981) (proposing sovereign insolvency well before 1982); *see also* RAFFER & SINGER, *supra* note 1, at 163–64.

5. Christine A. Bogdanowicz-Bindert, *Debt and Development Crisis: The Case of Small- and Medium-Sized Debtors*, *in* THE LINGERING DEBT CRISIS 141, 145 (Khadija Haq ed., 1985).

disdain.[6] It was not considered necessary to verify the legality of claims against sovereigns. Even claims that were known to have no legal basis were treated as perfectly legal and legitimate debts. According to the IBRD, "governments in many of these countries were forced to assume the losses suffered as a result of the external debts of private banks and corporations, which further worsened the burden on the budget."[7] Neither the BWIs nor creditor governments criticized this practice. Although such ex post "socialization" under pressure made debt management more difficult, the BWIs and creditor-OECD governments insisted on punctual service of these illegal debts as well—all the while busily preaching the rule of law to debtors whose basic right to honor contracts freely and voluntarily entered into they were aiding to breach.

After denying first the need and even the possibility of registering and assessing debts in the way usual in any domestic insolvency procedure, the IMF meanwhile demands specific checks regarding, "for example, the authority of an official to borrow on behalf of the debtor,"[8] echoing what I first demanded in 1990, nearly using my wording.[9]

The platform of Jubilee 2000 U.K., a British movement founded in 1996, demanded the cancellation of unpayable debts. Which debts were to be considered payable, or the capacity of debtors to pay, was to be determined by an independent arbitration panel. The movement described my insolvency proposal emulating Chapter 9 U.S. municipal bankruptcy[10] without using the word insolvency, which was still considered too revolutionary by quite a few participating nongovernmental organizations (NGOs). This fair and transparent arbitration process later became the acronym FTAP, a solution for which many NGOs have campaigned worldwide. Soon, NGOs started to look into the legal and moral bases of debts. They propagated the idea that some claims were unfounded or should not be honored. This was not always done with utmost legal and logical rigor. Politically, however, it prepared the way for present differentiations. Patricia Adams drew attention to the largely forgotten U.S. concept of odious debts some fifteen years ago, a concept that was revived by the U.S. administration when demanding debt cancellation for post-invasion Iraq.[11] Once the United States realized what it had done by reviving its own odious debt doctrine, the administration started to back-pedal vigorously. The

6. Kunibert Raffer, *Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face*, 18 WORLD DEV. 301, 309 (1990).

7. WORLD BANK**,** WORLD DEBT TABLES, vol.1, at xx (1988).

8. IMF, THE DESIGN OF THE SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS 68 (2002), http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf.

9. Kunibert Raffer, *What's Good for the United States Must Be Good for the World: Advocating an International Chapter 9 Insolvency*, *in* FROM CANCÚN TO VIENNA, INTERNATIONAL DEVELOPMENT IN A NEW WORLD 68 (Bruno Kreisky Forum for International Dialogue ed., 1993), *available at* http://homepage.univie.ac.at/Kunibert.Raffer/kreisky.pdf.

10. *See* Raffer, *supra* note 6.

11. *See* PATRICIA ADAMS, ODIOUS DEBTS: LOOSE LENDING, CORRUPTION, AND THE THIRD WORLD'S ENVIRONMENTAL LEGACY (1991).

damage of giving credibility to the doctrine was done, though. It could be limited only by shunning the very word odious.

Meanwhile, NGOs advocating solutions to the debt problem have brought forward an array of reasons why certain types of debts should not be honored, as well as an equally impressive array of expressions and concepts. In 2005, the new Norwegian government explicitly expressed the intention to support arbitration on illegitimate debts and to "adopt an even more offensive position in the international work to reduce the debt burden of poor countries. The UN must establish criteria for what can be characterized as illegitimate debt, and such debt must be cancelled."[12] The government firmly opposes undue conditionality regarding privatization, thus economically unfounded links between debt relief and policy actions. Norway "will support the work to set up an international debt settlement court that will hear matters concerning illegitimate debt."[13] As "debt settlement" can also be understood as payment, it should be mentioned that the Norwegian original clearly refers to a court (of arbitration or otherwise) to tackle debts. This and the clear demand for canceling illegitimate debts make the government's intentions absolutely clear. Norway has adopted a highly proactive role in international efforts to reduce the debt burden of poor countries.

On October 2, 2006, Norway declared that she would cancel claims of 520 million crowns to five countries, deriving from her Ship Export Campaign (1976–1980), which the government classified as a "development policy failure."[14] Cancellation is unilateral and, according to the government's press release, unconditional, although the annex specifies conditions in some cases.[15] As a creditor, Norway recognizes a shared responsibility for these debts.[16] Unlike other OECD "donors," Norway will not record this money as official development assistance. It is additional to normal aid.[17] For the first time a creditor government explicitly recognized part of its claims as improper (the government does not use the word "illegitimate") and acted upon that conclusion.

12. NOR. GOV'T, *The Soria Moria Declaration on International Policy* (English version) (2005), http://www.sv.no/partiet/regjering/regjeringsplattform/kap2engelsk/ (last visited Jan. 19, 2007).

13. In the original: "*opprettelsen av en gjeldsdomstol for behandling av spørsmål om illegitim gjeld*," NOR. GOV'T, *Kapittel 2: Internasjonal politikk*, http://www.sv.no/partiet/regjering/regjeringsplattform/kap2/ (last visited Jan. 19, 2007).

14. Press Release, Utenriksdepartementet (Ministry of Foreign Affairs), Cancellation Of Debts Resulting From The Norwegian Ship Export Campaign (1976–80) (Oct. 2, 2006) (Nor.), *available at* http://www.odin.dep.no/ud/english/news/news/032171-070886/dok-bn.html.

15. Press Release Fact Sheet, Utenriksdepartementet (Ministry of Foreign Affairs), Cancellation Of Debts Resulting From The Norwegian Ship Export Campaign (1976–80) (Oct. 2, 2006) (Nor.), *available at* http://www.regjeringen.no/en/dep/ud/Documents/Reports-programmes-of-action-and-plans/Reports/2006/Cancellation-of-debts-incurred-as-a-result-of-the-Norwegian-Ship-Export-Campaign-1976-80.html?id=420457.

16. Press Release, *supra* note 14.

17. *Id.*

Nevertheless, and although it has been taken up by many NGOs, "illegitimate debt" is not yet a well-defined and generally accepted term. It must therefore be elaborated and defined. Differences between illegitimate and other types of debts, such as odious or legal debts, must be clarified. Finally, the relation of these different types of debts with my international debt arbitration based upon Chapter 9 in the U.S. bankruptcy code[18] is examined.

II

DEFINING ILLEGITIMATE DEBT

Considering the use of the word "illegitimate" by campaigning NGOs, the Norwegian government had quite understandably a problem when surveying how illegitimate debts had been defined. The Ministry of Foreign Affairs summarizes the problem of several and differing definitions used:

> Non-governmental organizations usually define debt as being "illegitimate" when []
>
> 1. the debt was incurred by an undemocratic regime[,]
>
> 2. the borrowed funds have been used for what are regarded as morally reprehensible purposes (such as the purchase of landmines or the financing of suppressive regimes)[,]
>
> 3. repayment is a threat to fundamental human rights[,]
>
> 4. the debt has grown to unmanageable proportions as a result of external factors over which the country has no control (e.g. higher market interest rates), and when
>
> 5. debt that was originally commercial is taken over by the government of a debtor country (through the triggering of government guarantees).[19]

It then concludes,

> The sum of these criteria for "illegitimacy" is a very finely-meshed net, in fact it is so finely meshed that it appears to catch all debt. If all these criteria are accepted (including items 4 and 5 above), to advocate canceling "illegitimate debt" may easily be seen as a recommendation to *cancel all developing countries' debt*. This can hardly be regarded as either appropriate or desirable.[20]

This conclusion is perfectly right. There is a need to define the term in a meaningful way, to determine what, precisely, is to be understood by illegitimate debts in order to see how such debts should be treated if accepted legal norms prevailed—as they have not done so far in the case of southern sovereign debts.[21]

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18. 11 U.S.C. §§ 901–946 (2000).

19. MINISTRY OF FOREIGN AFFAIRS, DEBT RELIEF FOR DEVELOPMENT, A PLAN OF ACTION 19 (2004) (Nor.) (emphasis in original), *available at* http://www.regjeringen.no/upload/kilde/ud/rap/2004/0225/ddd/pdfv/217380-debtplan.pdf.

20. *Id.*

21. The problem of defining odiousness has brought about a tendency to use national legal principles as the measuring rod for evaluating the legal quality of sovereign debts in recent literature. *See* Lee C. Buchheit, G. Mitu Gulati & Robert B. Thompson, *The Dilemma of Odious Debts*, 56 DUKE L.J. 1201 (2007); Kunibert Raffer, *Risks of Lending and Liability of Lenders*, 21 ETHICS & INT'L AFFAIRS 85 (March 2007).

Apparently the first to attempt a definition, Joseph Hanlon rightly points out that the "term 'illegitimate debt' seems almost never to have been used in legislation or court judgments."[22] Hanlon's own very broad definition reflects the Ministry's problem that "illegitimate" threatens to cover virtually any sovereign developing country debt. He subsumes odious debts, as well as lending "[w]here [l]ender [m]isbehavior [m]akes [l]oans [i]llegitimate."[23] His illustrative examples include debts that could be categorized as odious (lending to oppressive or self-enriching regimes),[24] but also the increases in interest rates of the 1970s,[25] and generally loans made illegitimate by illegitimate conditions "even if the purpose of the loan is acceptable and proper."[26] Hanlon extends his definition to "loans given where grants would have been more correct."[27] Whereas "indicated" could at least be explained by economists, the word "correct" remains opaque at best. Unacceptable conditions making a loan illegitimate would be conditions that "ultimately increase the cost of the debt, such as dollar convertibility in Argentina, even if they are accepted by the elected government."[28] Strictly applied, Hanlon's criteria would make a loan that is not illegitimate a rare bird indeed.[29]

I agree with Hanlon that dictionaries are a good starting point for defining this term. Whereas "illegitimate" cannot be found in connection with contracts or debts in legal dictionaries, *The Oxford English Dictionary* defines "illegitimate" as "not authorized by law; improper" or "wrongly inferred."[30] According to *Webster's* it means "against the law, illegal," but also "illogical."[31] Finally, *Collins Cobuild* describes illegitimate as "not allowed or approved by law or social customs."[32] Briefly put, all three nonspecialist dictionaries subsume two kinds of debts under "illegitimate"—illegal debts and debts that violate social norms.

A. Illegal Debts

These debts (which we may call Type A debts) are debts whose existence violates the law or basic legal principles or debts that are legally null and void. These would comprise debts incurred in violation of national laws, of international law, such as in breach of legal obligations or statutes of

22. Joseph Hanlon, *Defining "Illegitimate Debt": When Creditors Should Be Liable for Improper Loans*, *in* SOVEREIGN DEBT AT THE CROSSROADS 109, 112 (Chris Jochnick & Fraser A. Preston eds., 2006).

23. *Id*. at 118.

24. *Id.* at 120–24.

25. *Id*. at 118–20.

26. *Id.* at 125.

27. *Id.* at 126.

28. *Id.*

29. Hanlon argues more carefully on other occasions. *See* JOSEPH HANLON, *'Illegitimate' Loans: Lenders, Not Borrowers, Are Responsible*, 27 THIRD WORLD Q. 211 (2006).

30. CONCISE OXFORD ENGLISH DICTIONARY 603 (5th ed. 1964).

31. MERRIAM-WEBSTER DICTIONARY 360 (1974).

32. COLLINS COBUILD ENGLISH DICTIONARY 721 (1990).

International Financial Institutions (IFIs), or of universally accepted legal principles, especially debts whose servicing violates human rights. What Jeffrey Winters called "criminal debts"[33] would also be illegal. These are debts originating from loans IFIs disbursed to corrupt governments, such as Suharto's in Indonesia, knowing that large parts of these loans would be embezzled. There is no doubt that debts that can be serviced *only* if human rights are violated are illegal and thus illegitimate, as quite a few NGOs posit.[34]

One principle of law is that debts assumed under pressure—obligations not freely entered into—are null and void. No creditor government or IFI has ever exercised any pressure when governments in many developing countries had been forced to "assume retroactively" losses of private banks and corporations. It should be emphasized that these were not initially commercial debts voluntarily guaranteed by the government whose guarantees were eventually triggered, but debts for which there had never been any government guarantee in the first place.

If such creditor behavior is a criminal act in a creditor country, the criminal code would have to be applied. Yet, creditor governments and IFIs have insisted that these illegal debts be "honored." U.S. legislators were more concerned. A bill introduced by Representatives B.A. Morrison and S. Levin demanded investigation on the amount of such forced debts and "the extent to which the assumption of liability for private loans by such countries was a condition imposed by any such banking organization for entering into a rescheduling agreement."[35] The bill did not become law.

B. Debts That Might Be Legal by Strictly Formal Standards, yet Whose Existence or Servicing Violates Socially Established Norms

Often, servicing such debts—that may be called Type B debts for the sake of simplicity—cannot be enforced or even expected—it would be somehow "illogical" to honor them—unless the debtor is a developing country sovereign. To give an illustration: In some European legal systems gambling debts are legally existing (if paid they extinguish an obligation and repayment cannot be demanded later) but nevertheless not enforceable (payment cannot be enforced by the winner-creditor) due to moral considerations reflecting societal disapproval of the underlying reason for such debts. By contrast, official creditors of sovereign debt have never singled out claims as unenforceable or

33. *See Combating Corruption in the Multilateral Development Banks: Hearing Before the S. Comm. on Foreign Relations*, 108th Cong. (2004) (statement of Jeffery Winters, Assoicate Professor of Politcal Economy, Northwestern University), *available at* http://foreign.senate.gov/testimony/2004/WintersTestimony040513.pdf; *see also* Kunibert Raffer, *International Financial Institutions and Financial Accountability*, ETHICS & INT'L AFF. (Summer 2004), at 61, 64–65, *available at* http://www.cceia.org/resources/journal/18_2/articles/5019.html/_res/id=sa_File1/5019_EIA_18.2_Raffer_Article.pdf.

34. *See, e.g.*, Jostein Hole Kobbeltvedt, *Illegitim å Betale . . .*, GJELDSBREVET (Sept. 30, 2001) (Nor.), *available at* http://www.slettgjelda.no/v_bibliotek/1.pdf.

35. H.R. Res. 1435 § 4(c)(1)(B), 100th Cong. (1987).

void on comparable grounds until Norway's action. The principle of barring the claims of those with unclean hands, *ex turpi causa non oritur actio,* was turned on its head in the case of sovereign developing country debts.

The distinction between illegal debts and Type B debts is not always very clear. The British Money Lenders Act of 1900 enabled courts to reopen any money-lending transaction when interest or charges were excessive—the transaction harsh and unconscionable or otherwise so unfair that courts of equity would give relief. Debtors needed not pay more than what the court thought to be fairly due. This Act was replaced by the Consumer Credit Act in 1974, which made resistance to demands for debt repayment much more difficult.[36] Nevertheless, in 2005 a couple whose initial debt of £5,750 had spiraled to over £380,000 had their debt "wiped out" because the loan agreement was unenforceable under this Act. Upholding the county court's decision, the court of appeal declined to say whether it agreed with the judge that the loan at an annual percentage rate of 34.9 percent was "extortionate."[37] Such changes of contracts are generally accepted and universally applied—basically because of moral standards of what constitutes fairness in debtor–creditor relations—unless debtors are "Developing Countries."

Obviously, odious debts can be subsumed under "illegitimate," as Hanlon and many NGOs have done, although one might discuss in specific cases whether as Type A or Type B debts. Lobbying the government—specifically, campaigning against debt service originating from ship exports and propagating illegitimacy—the Norwegian NGO SLUG perceives "odious debts" as "an old term that is not unlike illegitimate debts."[38] The evolution of the doctrine of odious debts in international law and its recent acknowledgement and corroboration in the case of Iraq would suggest subsuming it under illegal debts.

Norway's reasons for debt relief deserve closer analysis. The government's press release explicitly referred to the evaluation of the Ship Export Campaign by the Brundtland administration in 1988–1989, "in which the campaign was criticized for inadequate needs analyses and risk assessments."[39] The Minister of International Development, Erik Solheim, declared, "This campaign represented a development policy failure. As a creditor country Norway has a shared responsibility for the debts that followed. In canceling these claims Norway takes the responsibility for allowing these five countries to terminate their remaining repayments on these debts."[40] The press release referred to Norway's Debt Relief Strategy, which—as the then-Minister of International Development, Hilde F. Johnson, declared—was

36. *Cf.* Raffer, *supra* note 6, at 310 n.3.

37. PHILIP INMAN, *Court Cancels Debt That Grew From £6,000 To £380,000*, GUARDIAN (London), July 28, 2005, at 19, *available at* http://www.guardian.co.uk/business/story/0,,1537428,00.html (last visited Jan. 19, 2007).

38. Kjetil G. Abildsnes, *Legitime Lover Om Illegitime Lån*, GJELDSBREVET, Oct. 2001 (Nor.), *available at* http://www.slettgjelda.no/v_bibliotek/1.pdf.

39. Press Release Fact Sheet, *supra* note 15.

40. Press Release, *supra* note 14.

> in many ways a reaction to the Norwegian Ship Export Campaign of the 1970s and 1980s, during which Norwegian business interests overshadowed and dominated development policy considerations. I have myself called this campaign a disgrace. I stand by what I said. One of my goals is to cancel the debt that was incurred as a result of this campaign."[41]

This statement shows Norway's continuity, as well as Norway's conviction that creditor coresponsibility for—undiplomatically put—credit pushing, is the reason for cancellation. This very laudable attitude is sadly missing with all other official creditors that have steadfastly refused to apply even generally recognized legal standards and principles to developing countries so far. The wording "remaining repayments" shows that debt service already paid remains unaffected. This recalls the definition of "illegal contract" by the Oxford Dictionary of Law as "totally void, but neither party (unless innocent of the illegality) can recover back any money paid . . . under it."[42] On the other hand, though, no Norwegian or borrower-country law seems to have been breached—at least this was not mentioned nor claimed as the reason for cancellation. The word "inadequate" used by Norway may, but does not necessarily mean, needs analyses done negligently. Thus Norway's claims clearly fall into Type B, unless lack of due diligence by Norway could be raised. Only remaining payments are waived on ethical grounds. Economically, creditor and lender thus share the financial consequences of these loans—both face their responsibilities.

Legally and economically, coresponsibility, as understood by Norway, reduces these debts but does not cancel them totally. This may contradict the demands of quite a few NGOs, but is perfectly in line with Norway's own debt strategy stating that "rich countries clearly have a responsibility for helping to relieve the debt burden, but the critics have often omitted to point out the responsibility of governments and elites in poor countries for their own populations."[43] This may be understood in the way that debtor governments, too, have to shoulder their part of responsibility.

If these debts were recognized as illegal, however, there would be no need for canceling, as these remaining debts would be void. Even if they were seen to be precisely like gambling debts, debt service could just stop. Logically, no conditions could be attached in either case. But Norway attaches conditions, although not for all countries. Norway's ship-export debt will not be canceled in Myanmar and Sudan until these countries become eligible for multilateral debt-relief operations.[44] Sierra Leone will not benefit until the country has completed its heavily indebted-poor-countries treatment.[45] One has to look at the precise

41. Hilde F. Johnson, *Foreword* to MINISTRY OF FOREIGN AFFAIRS, DEBT RELIEF FOR DEVELOPMENT, A PLAN OF ACTION 4 (2004) (Nor.), *available at* http://www.dep.no/filarkiv/217380/Debtplan.pdf.

42. OXFORD DICTIONARY OF LAW (6th ed. Elizabeth A. Martin & Jonathan Law eds., 2006), *available at* http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=49.e1510 (last visited Jan. 19, 2007).

43. MINISTRY OF FOREIGN AFFAIRS, *supra* note 19, at 17.

44. Press Release Fact Sheet, *supra* note 15.

45. *Id.*

wording. Norway did not condition relief on a return to democracy, the respect of human rights, or a guarantee that money released from debt service would benefit the poor, but on the seal of approval of the BWIs. Recalling the cozy relationship between the BWIs and fascist military juntas such as in Chile or dictators such as Mobutu and "Baby Doc," one might conclude that the former is definitely different from the latter. Given Norway's overall policies, it may well be that this incongruity was simply not seen and that this formulation was meant as a proxy for furthering democracy or protecting human rights.

The statement that Norway's unilateral reduction is an act outside the cooperative framework of the Paris Club and Norway's own independent initiative would support the interpretation of a certain dissociation from multilateral restrictions. However, Norway's government declared that the "unilateral forgiveness of debt in 2007 will be a one-off debt-relief policy measure. All future debt forgiveness will be effected through multilaterally coordinated debt-relief operations."[46] Thus, no definite step away from Norway's earlier position in her *Debtplan* occurred: "Efforts will be made to cancel the rest in a way that ensures the greatest possible development effect, insofar as this is possible within internationally recognized rules."[47]

Obviously, Norway does not plan to exercise the basic right of any creditor simply to renounce all rights to debt service because the claim is uniquely her property. Future decisions will again depend on whether the BWIs and the Paris Club condone such reductions. This makes it difficult to argue that Norway's move may set a precedent. The return to multilateralism is unfortunate: both the BWIs and the Paris Club have a sad record of arbitrary decisions and have shown a profound disrespect for the rule of law over decades, not least by forcing countries to honor "socialized" debts assumed under pressure.

Norway rightly observes, though, that due to "delimitation problems, it is extremely difficult to use 'illegitimacy' as a reasonable and fair guideline for debt relief. If one implication of the illegitimacy debate is that developing countries have no responsibility for having taken up loans for 'illegitimate' purposes, this is a very problematic premise."[48] Naturally, if debts can be defined as illegitimate later on the basis of evolutions impossible to predict when loans were signed, "this in itself would mean less access to financing and more expensive loans, especially for the poorest countries."[49] It would also be blatantly unfair to bona fide creditors. Whereas it is well known, not least from credit relations, that any legal system protects contracts only if both sides have complied with their legal duties, the risk that perfectly legal and legitimate contracts might suddenly turn illegitimate is wholly different. A duty of care is imposed on lenders. They have to observe professional standards, or investigate

46. Press Release Fact Sheet, *supra* note 15.
47. MINISTRY OF FOREIGN AFFAIRS, *supra* note 19, at 13.
48. *Id.* at 20.
49. *Id.*

facts, such as whether persons signing for legal entities have the authority to do so. Tortious or illegal behavior makes creditors liable to compensate damages and may void contracts. Human rights might make perfectly legal claims unenforceable, *pacta sunt servanda* (contracts must be honored), is overruled—except when it comes to developing countries. But there are limits to creditor duties and risks as well. Not all risk can or should simply be shifted onto creditors.

Several NGOs, notably Jubilee South, stretch the concept of illegitimacy to cover the bulk of or all of southern sovereign debts. Two assertions in particular are problematic, namely, defining debts for projects that failed to deliver expected benefits as illegitimate or simply claiming that the principal had been repaid already, even several times over, because over time repayments had been higher than loans.[50] Both are legally and economically untenable.

By definition, debt service (amortization plus interest) must always be greater than the amount borrowed, unless the rate of interest is zero. As interest is the capital-market equivalent of rent, whatever amount of interest is paid can never be construed to be a repayment. Someone renting a car over many months may well end up paying more than the car's value, and yet the car still belongs to the rental agency. Claiming that the principal had been repaid already is thus patently invalid. What could be legally convincing is the argument of usury, which would justify appropriate reductions in debt service.

There is no question that illegal debts must not be serviced. No logical defense is possible against requesting the application of commonly recognized legal principles and the demand of equal treatment of people, whatever their passports might be. It is equally impossible to speak in favor of debts violating laws, especially laws within creditor countries, including those jurisdictions that have usually been stipulated in waivers of immunity.

It is more difficult when it comes to Type B debts. This does not mean that the legitimacy of these debts should not be questioned. Norway's debt relief may eventually bring such a change of attitude about, although chances are slim at present, not least due to Norway's explicit statement that future decisions will be made within multilaterally coordinated debt-relief operations. Doing so would, however, be much easier and less contentious once illegal debts were recognized as such and properly reduced or deleted.

III

ODIOUS DEBTS

Although far from not being contentious, odious debts are arguably the one type of debt for which international law accepts that they need or should not be honored. Declaring debts as odious has already led to nonpayment in very concrete, practical cases. The United States introduced this concept around

50. *Cf.* Soren Ambrose, *Social Movements and the Policies of Debt Cancellation*, 6 CHI. J. OF INT'L L. 267, 276–77 (2005) (discussing Jubliee South's demands).

1900. During the peace negotiations after Cuba's war against her colonial ruler, won with strong U.S. support, the United States argued that these debts were not only incurred by Spain without Cuban consent, but indeed against the very interest and will of Cubans in order to finance repression: such odious debts must not be repaid.[51] This may be seen as having been influenced by the opinion widely held during the nineteenth century, including international tribunals, that states were not bound by contracts made by someone without proper authority, so-called ultra vires ("beyond powers") contracts. When Venezuela's President Páez had his consul improperly enter into contracts that fell within the legislature's authority, claims under these contracts were rejected. In the typology of the preceding section, these would be illegal debts. After the 1970s, such basic legal principles were no longer applied in relations between developing nations and OECD-creditor governments, as Argentina's example in particular illustrates. Arguably, official creditors have been too busy preaching the rule of law to their debtors to be able to apply it themselves.

When the Soviet Union repudiated tsarist debts, A.N. Sack wrote his seminal work[52] on the doctrine of odious debt. In 1922 Costa Rica refused to honor a contract between the former dictator Federico Tinoco and a British oil company, a concession granted by him and approved by the Chamber of Deputies. The new government repudiated the contract on the grounds that those who had entered it had acted ultra vires. It also challenged as odious the debts entered into between Tinoco and the Royal Bank of Canada, passing a law to renounce them. Arbitration was invoked by Great Britain. Chief Justice Taft, of the U.S. Supreme Court, was the sole arbitrator. While finding that Tinoco's government was a legitimate de facto government capable of binding the state to international obligations, he determined that the Royal Bank of Canada "knew" that the funds in question were to be used for the personal expenses of the retiring ruler and his brother. Thus, the bank could not be expected to be repaid by Costa Rica.[53] If the Royal Bank of Canada had been able to prove that its funds had been used for a legitimate government purpose, its claim would have been upheld. Comparing this decision with present debt management, one cannot help noting differences.

Costa Rica would have had to honor this obligation if the money had been used for state purposes, such as building roads or infrastructure or if the creditor could not possibly have known that the money would be embezzled. Taft's decision is in stark contrast to present practice applying neither this consideration nor ultra vires. More pithily expressed, sovereign developing country borrowers were once treated like any other debtor. Creditors were

51. *See* David C. Gray, *Devilry, Complicity, and Greed: Transitional Justice and Odious Debt*, 70 LAW & CONTEMP. PROBS. 137 (Summer 2007); Adam Feibelman, *Equitable Subordination, Fraudulent Transfer, and Sovereign Debt*, 70 LAW & CONTEMP. PROBS. 171 (Autumn 2007).

52. A.N. SACK, LES EFFETS DES TRANSFORMATIONS DES ÉTATS SUR LEURS DETTES PUBLIQUES ET AUTRES OBLIGATIONS FINANCIÈRES (1927), *available at* http://www.odiousdebts.org/odiousdebts/publications/dettes_publiques.html (last visited Jan. 19, 2007).

53. ADAMS, *supra* note 11, at 167–69.

supposed to exercise due diligence. By these normal standards quite a substantial part of present debts would not have become a binding obligation on sovereigns. International Financial Institutions financing Mobutu or Suharto, fully knowing that large parts of the loans would disappear, would not have received full repayments including interest, let alone have been allowed to pass as de facto "preferred creditors."

After Costa Rica, the notion of odiousness fell into oblivion. It was taken up again by the United States after overthrowing Saddam Hussein. Obviously by coincidence, Cuba and Iraq were characterized by strong political U.S. interests and very low, if any, U.S. claims. The enthusiastic reception of this proposal by NGOs apparently made the U.S. government see its argument for debt reduction in Iraq in a different light. The word odious is shunned. The Paris Club does not use it, which renders the generosity of debt reduction a bit difficult to explain. The term cannot be found on the Paris Club's homepage.[54] Officially, Iraq's debts were not reduced because of odiousness. A Congressional Research Service (CRS) Report does not mention odiousness as the reason for U.S. efforts to achieve debt reduction for Iraq, painting a fairly misleading picture.[55] It introduces odious debts in the following way:

> Proponents of a doctrine of 'odious' debt assert that some of Iraq's debt's could potentially be classified as non-legitimate under international law since they were undertaken during the Hussein regime and that international law should be able to expunge these debts. The concept of 'odious' debt does not appear to be well established in international law.[56]

Very clear statements by leading officials of the U.S. administration, such as Treasury Secretary John Snow,[57] that the Iraqi people "shouldn't be saddled with . . . debts incurred through the regime of the dictator who is now gone" have apparently escaped the CRS author's attention. Nevertheless, he remarks, "Under traditional Paris Club guidelines, Iraq's petroleum and gas reserves would render it ineligible for debt relief."[58]

Conspicuously, the pertinent footnotes to the CRS Report quote demand applying "Iraqi [t]erms" to other debtors, for instance, a Miami Herald story about African pressure to "[r]educe [o]ur [d]ebt [l]ike Iraq's."[59] In the report, the U.S. government's forceful advocating of odiousness goes completely and notably unmentioned as though it had never occurred. Instead, the author claims, "the U.S. government has made clear its intention to restructure its Iraqi

54. *See* The Paris Club Home Page, http://www.clubdeparis.org/en/ (last visited Jan. 20, 2007).

55. MARTIN A. WEISS, CRS REPORT FOR CONGRESS, IRAQ: PARIS CLUB DEBT RELIEF (2005), *available at* http://fpc.state.gov/documents/organization/44019.pdf.

56. *Id. at* 6.

57. *See* Hanlon, *supra* note 22, at 211 (citing interview on *Your World with Neil Cavuto* with John Snow, U.S. Treasury Secretary (Fox News broadcast Apr. 11, 2003)).

58. WEISS, *supra* note 55, at CRS-4.

59. *Id.* at 16 n.19 (quoting Sudarson Raghavan, *African Advocates to U.S.: Reduce Our Debt Like Iraq's*, MIAMI HERALD, Feb. 20, 2004, at 19A).

debt through the Paris Club process, and parallel negotiations with non-Paris Club countries in the Middle East and Asia, and Iraq's private creditors."[60]

Debts have thus been classified as "odious" for two reasons: the money had been used to repress people (as in Cuba), or the lender had given loans knowing that they would be improperly used. The latter type of odiousness is not unknown to national laws obliging creditors not to foster embezzlement and unlawful practices. The professional duty of care to their clients would require them not to make such loans. Taft thus only applied generally recognized domestic principles to a developing country.

Lending under such conditions might not only have consequences pursuant to civil law. The *Oxford Dictionary in Law*, for instance, defines "aiders," as a specific type of accessory, as "assist[ing] in the performance of a crime either before or during . . . its commission."[61] There is a need to "prove that the defendant had knowledge that he was assisting the principal in the commission of the crime."[62] Providing loans to corrupt officials while knowing that the money would disappear would be worth examining in this respect.

As the debt problem has been with us for so long, statute-of-limitation periods might restrict the possibility of civil actions. But there is another big problem. Over the decades, loans have been rolled over, and present creditors are quite often not the ones that granted the initial and illegal or void loan. When defining illegitimate debts, Hanlon tries to get around this problem by coining the expression "loan laundering"[63] in linguistic association with money laundering. He argues that loans "issued for the sole or main purpose of paying off an illegitimate debt" are also illegitimate.[64] He has a point in observing that this would pose no difficulty if loans are simply rolled over by the same creditor. He mentions the BWIs, whose rolling-over of loans can indeed be traced, and one may argue that the BWIs knew why their new loans were issued. One might also argue that bilateral creditors knowingly granted credits in order to allow rolling-over. There were, in fact, real financial merry-go-rounds orchestrated to allow countries to repay IFIs "in time." In all other cases it is much more difficult if not impossible to prove that the new creditor knew (or should have known) what the money was used for. Hanlon tries to get around this problem by using fungibility: although loans are given for one specific purpose, they release funds that would otherwise have been used for this clearly defined purpose. Hanlon thus argues that "because of fungibility, all loans to odious regimes and dictators can be classified as odious, even if the ostensible purpose was permissible."[65] Obviously, Hanlon advocates no longer lending to such

60. *Id.* at 6.

61. OXFORD DICTIONARY OF LAW (Elizabeth A. Martin & Jonathan Law eds., 2006), *available at* http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=t49.e161 (last visited Nov. 5, 2007) (defining "aid and abet").

62. *Id.*

63. Hanlon, *supra* note 22, at 117.

64. *Id.*

65. *Id.* at 118.

regimes, even if loans were demonstrably used for investments in favor of the poor.[66]

This is a simple but untenable way out. First, what if a regime turns odious after borrowing? Would loans be lost? How recognize precisely when that change happens? Jayachandran and Kremer offer a solution by proposing to empower an independent institution to assess regimes and declare any sovereign debt subsequently incurred odious.[67] The authors propose various options, such as the United Nations' Security Council, an international judicial body, or even the United States alone. If this proposal were adopted—its authors seem to harbor doubts about its political implementability—the problem of odious debts would cease to exist in practice. Credit markets would simply stop lending. Jayachandran and Kremer rightly observe that this could restrict dictators' ability to loot, thus limiting the debt burden on the poor. But it does not solve the problem of presently existing debts.

Applying Hanlon's proposal to present private creditors would be both unfair and unnecessary. Especially small bondholders—say, Italian pensioners having bought Argentine bonds on the advice of their banks—have hardly the means to check all the legal history of the country's debts in order to judge whether their new money rolls over old, "odious" loans. If they buy bonds from their banks or otherwise on the secondary market, their money does not go to Argentina, but they are holding the instrument when payment is refused. Practically, though, this problem is defused. These investors were compensated by the banks that had advised them to invest in Argentine bonds because these banks did not provide advice with due diligence.

IV

CREDITOR DUTIES, LEGITIMACY, AND THE OBLIGATION TO REPAY

That inappropriate creditor behavior should or might lead to reducing creditor claims has come up repeatedly during the debate on legitimacy. Arguably, this is more confusing than helpful. All legal systems already establish duties creditors must comply with in order to enjoy full legal protection of their contractual rights. Not complying with such duties may give rise to damage-compensation payments, which can be effected in the simplest way by deducting them from outstanding debt obligations. Establishing and enforcing these principles is the duty of governments, regarding both domestic and international laws. Whereas the private sector has no further duty but to abide by laws passed by others, governments also have the obligation to preserve the foundation of the rule of law, including international law, and to

66. *Id.*

67. Seema Jayachandran & Michael Kremer, *Odious Debts, in* SOVEREIGN DEBT AT THE CROSSROADS 215 (Chris Jochnick & Fraser A. Preston eds., 2006). In their early, preliminary paper of April 2002, the authors used "illegitimate" and "odious" interchangeably, making no distinction. *See* Seema Jayachandran & Michael Kremer, *Odious Debt* (working paper 2002), *available at* http://www.imf.org/external/np/res/seminars/2002/poverty/mksj.pdf.

safeguard human rights. Creditor governments have not done so, but have aided and abetted unlawful practices, such as the violation of membership rights of debtor countries by IFIs—with consequences such as increased infant mortality. So far, fundamental legal principles have not mattered when it has come to developing countries and the poorest of the globe.

What seems particularly worrying is that courts, too, have accommodated political wishes, as the U.S judiciary illustrated: after Costa Rica had prevailed in a lawsuit, based in part on the assumption that this was consistent with U.S. policy,[68] the Second Circuit reheard the matter and reversed itself when the executive branch, as amicus curiae, clarified that supporting Costa Rica was not U.S. policy.[69] This reversal occurred despite the court's own reasoning, based on what it had called "principles recognized by all civilized nations."[70] Logically, the court's holding subordinated legal principles to administrative whim: executive wishes may change court judgments. Although it was always explicitly acknowledged that Costa Rica's capital controls were effected "in response to escalating economic problems," the court specifically named U.S. "interest in maintaining New York's status as one of the foremost commercial centers in the world" as one reason for the final judgment.[71] Grave economic problems were subordinated to this commercial interest, even though it seems unlikely that a different judgment would have done perceptible harm to New York's standing as a financial center. On the contrary, given that judgment, one wonders why New York is so frequently the jurisdiction of choice. Whereas it is perfectly understandable that creditors wish to avoid national courts, fearing that these might not be really independent from their governments and that they would prefer courts weighing interests in the way this court did, it is difficult to understand why debtors do not insist on neutral jurisdictions where courts are not inclined to accommodate their government's wishes so fully.

I argue that it is important to differentiate between official and private creditors.[72] Official creditors largely pushed aside the most essential economic principles and the rule of law in sovereign lending after 1970. They established a framework violating human rights, destabilizing credit markets, and inflicting damage on the poor in particular, but also on private creditors. Delaying a solution of the problem of sovereign overindebtedness, official creditors have reaped political and economic gains at the cost of human rights and the rule of law. The sovereign-debt-restructuring mechanism (SDRM) proves that strong

68. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440, 1443–44 (S.D.N.Y. 1983).

69. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 519–520 (2nd Cir. 1985); *see also* UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD), TRADE AND DEVELOPMENT REPORT 1986 142 (1986); Kunibert Raffer, *Internationalizing US Municipal Insolvency: A Fair, Equitable, and Efficient Way to Overcome a Debt Overhang*, 6 CHI. J.INT'L L. 361, 364–65 & nn.10, 19 (2005).

70. UNCTAD, *supra* note 69, at 142.

71. *Allied Bank Int'l,* 757 F.2d at 519, 521.

72. *See* Kunibert Raffer, *Risks of Lending and Liability of Lenders*, 21 ETHICS & INT'L AFFAIRS 85 (March 2007) (arguing this point).

forces within the IMF want to continue as before, even to increase the weight of wrong incentives.[73] It is a highly self-serving scheme that would confer further privileges on the IMF and other IFIs, such as legal exemption for IFI claims, which would have a considerable ratchet effect protecting IFIs against the market and the rule of law. It would have cost both debtors and the private sector dearly. Fortunately, it was voted down.

All IFIs claim the privilege of absolute immunity from any financial responsibility for their own actions, decisions, and omissions. Moreover, in contrast to developing countries that feel the economic consequences of inadequate implementation of projects and programs, external financial agencies have benefited economically from the very disasters they have helped create or even created themselves. Claiming the status of preferred creditors—although they know that they do not have that status, as one can learn at the IMF's own homepage[74]—and benefiting from the total absence of any financial accountability for their decisions, IFIs profit from their own errors and negligence at their clients' expense. IFIs have even profited from violating their own statutes and overriding the membership rights of weaker members.[75] This impunity and gains from crises can be strong incentives to make incorrect choices. Developing countries and the poor have remained totally unprotected against negligently or even willfully inflicted damage. Even worse, errors and negligently done damage tend to increase the importance of IFIs, since damages caused by one project or adjustment program call for a new loan to repair them, thus increasing IFI income. In other words, there is an automaticity of "IFI-flops securing IFI-jobs."[76]

Such perverse outcomes are economically and legally unjustifiable. The principle that anyone suffering or alleging to suffer damages due to another's fault or because of another's failure to observe a purely equitable duty must be able to seek redress is firmly established in all OECD countries and indeed is one cornerstone of functioning market economies. Knowing that one must pay for the damage done by sloppy work or wrong advice if that damage could have been avoided by following professional standards serves as a strong incentive to improve the quality of products and services. The success of market economies

73. For details, see Kunibert Raffer, *The Present State of the Discussion on Restructuring Sovereign Debts: Which Specific Sovereign Insolvency Procedure?*, *in* PROCEEDINGS OF THE FOURTH INTER-REGIONAL DEBT MANAGEMENT CONFERENCE AND WADMO CONFERENCE 10–12 NOVEMBER 2003 69 (UNCTAD ed., 2005), *available at* http://r0.unctad.org/dmfas/pdfs/raffer.pdf; Kunibert Raffer, *The IMF's SDRM—Simply Disastrous Rescheduling Management?*, *in* SOVEREIGN DEBT AT THE CROSSROAD 246 (Chris Jochnick & Fraser A. Preston eds., 2006).

74. *See* JAMES M. BOUGHTON, SILENT REVOLUTION: THE INTERNATIONAL MONETARY FUND 1979–1989 820–21 (2001) (noting this fact); *see also* Raffer, *supra* note 39, at 61.

75. *See generally* Kunibert Raffer, *The IMF'S SDRM—Simply Disastrous Rescheduling Management?*, SOVEREIGN DEBT AT THE CROSSROADS 246 (Chris Jochnick & Fraser A. Preston eds., 2006); Raffer, *supra* note 69; Raffer, *supra* note 72.

76. Kunibert Raffer, *International Financial Institutions and Accountability*: *The Need for Drastic Change*, *in* TRADE, TRANSFERS AND DEVELOPMENT, PROBLEMS AND PROSPECTS FOR THE TWENTY-FIRST CENTURY 151, 158 (S.M. Murshed & Kunibert Raffer eds., 1993), *available at* http://homepage.univie.ac.at/kunibert.raffer/ifiacc.pdf

is based on linking decisions and risks. The absence of such risks triggers unjustifiable and wrong behavior. A large amount of multilateral debts has been the effect of (grave) negligence by IFIs, but IFIs are not forced to pay for the damage their negligence has caused. May one example of many suffice, uniquely illustrated by quoting from an official IMF document, the IMF's Independent Evaluation Office's (IEO) findings on the Fund's role in Argentina, which shows many clear cases of, at best, grave negligence. The September 2001 "program was also based on policies that were either known to be counterproductive . . . or that had proved to be 'ineffective and unsustainable everywhere they had been tried.'"[77] The Fund's IEO makes it clear that this had been known before the program started because this view had been "expressed by FAD [the IMF's Fiscal Affairs Department] at the time."[78] Another "critical error" was the lack of "a clearer understanding of an exit strategy in case the chosen strategy did not work."[79] The Fund's Board of Directors supported "a program that Directors viewed as deeply flawed" mainly because "no one has proposed a different strategy that, risk adjusted, promises a less costly alternative."[80] The "September 2001 augmentation suffered from a number of weaknesses in program design, which were evident at the time. If the debt were indeed unsustainable, as by then well recognized by IMF staff, the program offered no solution to that problem."[81] Any consultant or creditor but an IFI would be liable to face appropriate consequences. Any other client's lawyer would have a feast.

Overwhelming evidence, provided not least by IFIs themselves, shows that IFIs force policies on debtors, thus making far-reaching decisions. However, even if IFIs only provided consultancy services, there is no reason why the liability and financial accountability standards of consultants should not apply. Introducing normal professional standards, and equal treatment compared with private consultants, would appropriately expose IFIs to the risks involved, while preference for IFIs is inequitable and unfair. International Financial Institutions do not deny that they give advice as part and parcel of services paid for by clients. The IBRD even calls itself the "knowledge bank."

Official creditors differ from the private sector when it comes to projects that failed to deliver expected benefits. Whereas all creditors are subject to the rule of due diligence, public creditors have done more than lend by designing and implementing such projects. It should be made clear that the risk that projects may fail to deliver expected benefits even though professional standards were meticulously observed remains with the borrower or country. Whereas private lenders would face problems if fully aware that they were

77. INDEP. EVALUATION OFFICE OF THE INT'L MONETARY FUND, THE IMF AND ARGENTINA, 1991–2001 55, *available at* http://www.imf.org/External/NP/ieo/2004/arg/eng/pdf/report.pdf.

78. *Id.* at n.66.

79. *Id.* at 41.

80. *Id.* at 46.

81. *Id.* at 89.

financing a debacle, public lenders acting as consultants in addition to lending are allowed to profit from their own grave negligence.

If consultants fail to respect professional standards or to work properly, they can be taken to court. If governments or their agents cause damage by negligence, by failing to exercise their duty of care, by not obeying professional standards, or by acting unlawfully, governments can be sued by individuals. As a general principle, victims have a right to compensation. International Financial Institutions, however, can inflict damage with impunity and with financial gain. Developing countries and the poor remain unprotected against negligently or willfully inflicted damage.

Worse still, errors and negligent damage tend to increase the importance and income of IFIs. No multilateral-debt problem would exist if normal accountability, liability standards, and tort laws applied to southern countries. But IFI clients have to pay for their consultants' negligence, which increases unpayable debts. They have to carry the costs of decades of negligent debt management, of continuously "overoptimistic" forecasts and estimates that "proved" initially that no debt overhang existed and served later as the justification for insufficient debt reductions prolonging catastrophe. Introducing the rule of law and economic sense to IFIs—as intended by their founders—would reduce sovereign developing country debt drastically. This would also be fair to private bona fide creditors. Rather than "bailing in" the private sector, as IFIs presently demand, although the private sector has granted more relief than IFIs so far, IFIs themselves must eventually face the consequences of their actions.

Most Multilateral Development Banks (MDBs) have a statutory obligation to grant debt relief, but they chose to violate their own Articles of Agreement. Article IV § 7 of the International Bank for Reconstruction and Development's (IBRD) Articles of Agreement, for instance, stipulates the obligation to reduce claims in the case of default.[82] By contrast, other creditors, notably the private sector, have no similar obligation to grant debt relief. Logically, this supports the view that the IBRD and other IFIs are meant to grant relief well before others, that their statutes legally subordinate multilateral claims. Their task of fostering development would explain this decision of their founders. Under pressure from private business, the IBRD waived the negative-pledge clause in its loans in 1993, which would have guaranteed that no creditor's claims could have preference over the Bank's.[83] If the IBRD had been de jure preferred, there would have been no need for such clause, indeed no point in waiving it, as legal norms always prevail. By waiving this right, the IBRD acknowledged that

82. International Bank for Reconstruction and Development Articles of Agreement art. IV, § 7, *available at* http://siteresources.worldbank.org/EXTABOUTUS/Resources/ibrd-articlesof agreement.pdf.

83. CATHERINE CAUFIELD, MASTERS OF ILLUSION 323 (1996); *see also* Kunibert Raffer, *Delivering Greater Information and Transparency in Debt Management* (June 2005) (paper presented at the 5th UNCTAD Inter-Regional Debt Management Conference), *available at* http://r0.unctad.org/dmfas/pdfs/raffer2.pdf.

its claims should not be treated in the same way as private claims, but should be subordinated to them.

A very thorough analysis of IFI-preference in international law by J. Martha Rutsel Silvestre concludes that "general international law contains no compulsory standard of conduct requiring the preferential treatment of any external creditor, including the Fund."[84] She argues that the IMF's Articles of Agreement "contained a provision suggesting that others would have preference on the Fund"[85] before the Second Amendment of the IMF's statutes. The author refers to Schedule B, paragraph 3, on the calculation of monetary reserves on which repurchase obligations were based. It can be argued that the exclusion of holdings "transferred or set aside for repayments of loans during the subsequent year" from this calculation was done "to give preference in repayment to lenders other than the Fund."[86] Silvestre argues that the intent of deleting this calculation, and with it schedule B, paragraph 3, from the statutes by the Second Amendment "was not to repudiate the underlying thought that it was beneficial to encourage bank lending by giving banks and others a preference in repayment."[87] Her conclusion is corroborated by the statutes of MDBs, as well as by the IMF's attempts to gain legal preferred creditor status via the SDRM.

Official creditors have inflicted damage on debtors, flouted contractual rights and obligations, and even ignored human rights, gaining politically and financially from their behavior and using these catastrophes to exert leverage with debtor countries. Obviously, *pacta non sunt servanda* (contracts must not be honored) when it comes to the rights of developing countries, an asymmetry destroying the foundations of markets and the rule of law. Eventually, official creditor behavior has also increased the losses of the private sector.

Norway's Ministry of Foreign Affairs listed "higher market interest rates" around 1980 as one NGO argument for illegitimacy of contracts. Clearly, this is wrong. But is this usury? It is at least difficult to base the argument of usury on the increase of interest levels brought about by the United States around 1980. Banks themselves had to pay more as borrowers, passing costs on to their borrowers with a spread. This was quickly felt by developing countries because variable interest rates had been widely introduced during the 1970s. By stipulating a spread over the London Interbank Offer Rate or prime as the rate charged to countries, lenders shifted interest-volatility risks onto borrowers. In functioning markets, the difference between fixed and variable interest rates agreed on in contracts is simply the cost of this risk. Accepting such risk is not necessarily against borrowers' interest. If fixed interest rates had been stipulated, lender charges would have had to include specific volatility risks. If

84. J. Martha Rutsel Silvestre, *Preferred Creditor Status Under International Law: The Case of the International Monetary Fund*, 39 INT'L & COMP. L.Q. 801, 825 (1990).

85. *Id.*

86. *Id.*

87. *Id.*

the stipulated variable rate is reduced by the costs of providing for interest-rate variability (the difference vis-à-vis the fixed interest rate otherwise charged equals or is larger than the expectation value of volatility costs), borrowers are not worse off. In cash-flow terms they are even more liquid. Whether developing countries actually benefited from comparatively lower rates would have to be answered by analyzing historical data. A functioning credit market, as opposed to sovereign lending, limits the amount of risk creditors can shift onto debtors. If interest hikes are too large, debtors are driven insolvent. Creditors lose money in spite of shifting risk. This also applies to punitive interest rates. If too high, they push debtors into insolvency.

One may try to argue that spreads might have been too high. But this would not be easy. One may agree with the Senate Committee on Foreign Relations that the intervention of creditor governments to bail out commercial banks "calls into question the justification—the high degree of risk involved . . . for the high rate of interest banks charge to developing countries. Thus it is the creditor governments, not the banks, which are really bearing the risk."[88] But the losses commercial banks eventually had to take after 1989 may in the end have justified higher spreads. These losses were compounded by unjustified de facto preference IFIs were able to get.

Creditor duties might go quite far. In order to extract common principles from national, domestic laws to transform the theory of the responsibility for abusive granting of credit into a general principle of international law, Juan Pablo Bohoslavsky surveyed laws and judicial practice in eight countries establishing creditor liabilities for loose lending.[89] He argues that such "abusive credits" should also have consequences in international law and thus be applicable in cases of sovereign insolvency. This concept holds lenders liable for damages inflicted on other creditors by lending with disregard for the most basic principles of risk evaluation, thus hiding the debtor's real situation and postponing the insolvent lender's crash, thereby increasing other creditors' losses. French, Belgian, and Italian jurisprudence, in particular, have developed this concept. Loans granted without following the most elementary prudential guidelines in the analysis of credit risk, attempting by such means to obtain an unfair advantage over previously existing creditors, should be subordinated to those not classified as abusive. Subsequent creditors, in particular those harmed by having been induced to make loans because of abusive lending to a party that could not or would not repay them, could file claims against the abusive lenders generating such false appearance. However, this concept is in a very early stage at present. It still needs to be made applicable to cases of sovereign insolvency.

88. S. REP. NO. 95-603, at 29 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 2530, 2559.

89. Juan Pablo Bohoslavsky, Consecuencias Jurídicas Y Económicas Del Crédito Abusivo (Especial Referencia Al Endeudamiento Soberano) (2006) (Ph.D thesis, University of Salamanca) (on file with author).

V

PERFECTLY LEGAL AND LEGITIMATE DEBTS

Finally, there are claims that are perfectly legal and legitimate, such as debt contracts voluntarily entered into by both parties without any overreaching, however subtle. Obviously these debts must be honored. They are the prime example of the sanctity of contracts, so often quoted by creditors.

Even such debts are normally subject to risk. Risk and liability are necessary systemic elements of the framework on which markets need to function. Risk is the hazard of losing money, even without any fault of the lender. It cannot be avoided and exists for both sovereigns and other debtors. External shocks, individual catastrophes, or unforeseeable events can change the debtor's circumstances drastically, resulting in losses in spite of every possible precaution and state-of-the-art analysis of creditworthiness. Even model creditors may lose money if external shocks, such as natural disasters, render debtors insolvent. Without any fault of the parties, the terms of the initial contract are changed; total repayment becomes unenforceable. On the other hand, wrong creditor decisions may increase risk. Economically, risk serves as an incentive carefully to assess debtors' ability to service debts. Errors and negligence in assessment bring about losses.

Usually, debtors have rights too, unless they are sovereigns. Liability is the right of victims to receive compensation contingent upon conditions stipulated in law, such as negligent actions creating unlawful damage. Domestic liability and tort laws serve the purpose of compensating those suffering such damages and of deterring such behavior. Internationally, this legal principle that victims of unlawfully inflicted damage must be compensated applies equally, and it is the duty of governments to safeguard it, not least for economic reasons. Official creditors have done the very opposite, totally obstructing it. One may argue that liability does not change the terms of contract, but creates a new counterclaim of debtors unlawfully hurt by lenders. Economically, though, creditors get less than originally stipulated. Net claims diminish. Shifting all responsibilities onto debtors—as done in sovereign lending—encourages economically and ethically wrong behavior. Over decades public creditors attempted to eliminate any lender responsibility.

Losing money is part and parcel of lending, just as grocers have to face the fact that some apples rot before they can be sold. Fees and prices charged to clients must accommodate these costs. This is both economically and ethically justified. Well-managed lenders will, of course, lose relatively little. Lenders unfit for the market may be wiped out by losses.

Some risk can be avoided. Conscientious scrutiny of borrowers, lending limits, or checks on how prior loans were used (stopping further loans if wasted) reduce total risk in the lender's very own interest. Additionally, these mechanisms perform important allocative tasks, assuring that money is put to good use. Risk makes creditors cautious. It is the main incentive against loose lending.

This useful role was eliminated in sovereign lending, producing massive misallocations of funds. In the context of sovereign syndicated lending, it was assumed that countries would always exist, and thus always repay. This idea does not, of course, stand scrutiny. The history of sovereign lending from countries to U.S. states (which are quasi-sovereign regarding debts, pursuant to the U.S. Constitution's Eleventh Amendment) had proved it wrong well before the 1970s. One might note parenthetically that the Eleventh Amendment and court decisions based upon it do not preclude the federal government or other U.S. states from filing a suit. Foreigners, though, are explicitly barred from suing U.S. states. Foreign bondholders circumventing this by suing in state courts, such as in Arkansas and Mississippi, won their cases. The states, however, simply refused to obey their own courts' orders to pay.[90]

Unfortunately, the effects of wrong perceptions of risk were compounded by regulatory authorities in some countries that chose to destabilize international credit markets by unhelpful regulations. Tax-deductible, loan-loss provisioning, a very efficient stabilizer with negligible costs to taxpayers,[91] was not allowed to play its useful role outside Western Europe. This fueled the crisis in the early 1980s when many U.S. money-center banks were on the brink of collapsing while European banks had been able to provision against the crisis. Furthermore, this U.S. practice taxes illusory profits. It appears a paradox that otherwise anti-tax U.S. corporations have put up with this.

Even without the slightest fault of bona fide creditors, laws compound losses brought about by unavoidable risk. When a debt overhang exists, the right of creditors to repayment collides with the principle recognized universally and unconditionally (not only in the case of loans) by all civilized legal systems that no one must be forced to fulfill contracts if doing so leads to inhumane distress, endangers one's life or health, or violates human dignity. Briefly put: debtors cannot be forced to starve their children to be able to pay. Although creditor claims are recognized as perfectly legitimate, insolvency exempts resources from being seized by bona fide creditors. All decent legal systems make a clear choice: human rights, human dignity, and the debtor's "fresh start" enjoy unconditional priority.

Insolvency procedures deal with claims based on solid and proper legal foundations. No insolvency is needed for illegal debts. These are null and void, whether the debtor is liquid or insolvent. Demands for canceling apartheid debts were therefore based on the odious debt doctrine. Insolvency relief is not an act of mercy but of justice and economic reason. This is evident down to negligible details such as that "forgive" is not commonly used when insolvency procedures reduce debts. It is reserved for developing country debts and sins. Debt reduction is a right of all other insolvent debtors—even if they are not "deserving, good boys." Only developing countries have to beg for

90. William B. English, *Understanding the Costs of Sovereign Default: American State Debts in the 1840s*, 86 AM. ECON. REV. 259, 261 (Mar. 1996).

91. *See* Raffer, *supra* note 72; Raffer, *supra* note 69, at 377–79.

"forgiveness" and are required to prove that they are "good children." Whereas very ancient Roman law literally allowed creditors to cut debtors into easily transportable pieces—although only judges, not creditors themselves, had the authority to decide—decent and civilized legal systems have not only opted against physical dismembering, but also for exempting a certain amount of resources to safeguard the human dignity of debtors.

Insolvency changes contracts substantially. In the United States, general unsecured creditors can expect to receive nothing in four out of five bankruptcy cases, and they will receive only four to five percent on average, if they get anything at all.[92] Argentina's initial offer to her bondholders, paying twenty-five percent of face value, though five percentage points below the country's secondary market rate, compares quite favorably. The final terms were a little more generous to creditors. Meeting President Bush in January 2004, Argentina's President Kirchner compared its offer to Enron's paying its investors only "[fourteen] cents on the dollar."[93] In both cases the principle that contracts must be honored was overruled. Argentina's offer caused an angry outcry. Enron's payment did not, but this was considered a matter of course.

Laws may terminate, modify, or permit a party to terminate or modify contracts, explicitly allowing unilateral changes of contractual rights. Thus, 11 U.S.C. § 365(a) empowers the trustee (subject to the court's approval) to "assume or reject any executory contract or unexpired lease of the debtor." Pursuant to § 365(g) this "constitutes a breach of such contract," but it is a perfectly legalized breach. Injured entities are given a prepetition claim for any resulting damages and are treated as prepetition creditors with respect to this claim. Considering the statistical distribution of unsecured creditor receipts renders an expectation value of about 0.01.[94] The law itself annihilates perfectly legal claims. In the case of railroad reorganization, 11 U.S.C. § 1165 protects public interest "in addition to the interests of the debtor, creditors, and equity security holders."[95] Section 1170(a)(2) permits courts to abandon railway lines if this is "consistent with the public interest."[96] A public interest in the preservation of rail transportation mandates finding a balance between various interests, which in economic terms means that creditors may have to lose more than without such balancing. By contrast, no creditor government has shown a similar public interest in avoiding debt service that increases infant mortality within developing countries.

One fundamental misunderstanding must be clarified, though. Debt reduction based on the concept of insolvency is not charity but justice. It means

92. S*ee* Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 997 n.239 (2000).

93. Eric Helleiner, *The Strange Story of Bush and the Argentine Debt Crisis*, 26 THIRD WORLD Q. 951, 956 (2005).

94. This calculation is based on Schwarcz's figures. *See* Schwarcz, *supra* note 92.

95. 11 U.S.C. § 1165 (2006).

96. 11 U.S.C § 1170(a)(2) (2006). *See also* 11 U.S.C § 1173(a)(4) (2006) (permitting confirmation of railroad reorganization plan only when "consistent with the public interest").

equal treatment of debtors irrespective of passports, nationality, or color. Canceling unpayable debts is not "limited to the 'deserving poor,'" and it is definitely not comparable to "Victorian charity," as Hanlon states for no understandable reason.[97] Insolvency protection is a right. This is a fundamental difference to which Hanlon is oblivious when accusing the international Jubilee campaign of a Victorian "charity consciousness." To illustrate this with a simple example: Even a debtor hitting the insolvency judge in the face would be entitled to full debtor protection and his human rights would remain sacred, although one should hope that she sends him to jail for quite some time for contempt of court.

VI

AN ECONOMIST'S CONCLUSION

Bringing the rule of law to relations between developing countries and creditor-OECD governments and abolishing the present discrimination against developing countries and their inhabitants is mandatory. Opposing it may carry the risks of being accused of accepting or defending the legal equivalent of apartheid. Economically, equal treatment of all debtors would abolish a market imperfection that has caused huge damages, misallocation of resources, and human misery. Acknowledging basic legal principles as well as economic sense would avoid the catastrophes present debt management has brought about. Introducing universally accepted legal principles would reduce developing countries' debts substantially and improve the functioning of international credit markets. Those debts called illegal above (Type A) could and should be dealt with immediately. This would reduce the debt burden substantially in many cases. Encouraged by the Norwegian example, which is a first step, one could also elaborate a closer definition of what precisely constitutes Type B debts. Some form of creditor co-responsibility, as argued by Norway, can serve as the basis to elaborate a more precise definition. Equity considerations, which are well established in Anglo-Saxon legal thinking, may be another starting point. Equity is a field of jurisdiction that enables the judiciary to apply principles or morals. Once a meaningful international insolvency procedure for sovereigns exists, this would no longer be as urgent a task as at present.

Allowing basic legal principles and economic sense to prevail by differentiating debts and introducing creditor liability is also in the interest of bona fide creditors, who would lose less or nothing if all debtors were equal before the law. As economic facts eventually assert themselves, it must be recognized at last that large shares of debts exist merely on paper and cannot be recouped. Economically, they are no longer claims but phantoms. If legally unfounded claims were eliminated and damage compensation paid in those cases in which creditors caused unlawful damages, acting without due diligence,

97. Hanlon, *supra* note 22, at 110.

bona fide creditors would recoup larger shares of their claims from insolvent debtors.

Let us assume that country A has total debts of 100, but is able to service a debt stock of only 50. Country A gets insolvency protection—no doubt a heroic assumption, still, when it comes to the debts of developing countries. In this case the "haircut" would be 50. If 40 were null and void, A would only have a remaining debt stock of 60, of which 10 would still have to go in order to align A's capacity to pay to debt service due. For A this would not really matter: 50 would go one way or another, although based on very different legal titles. For A's creditors, though, the results differ strongly. In the former case, every creditor would receive half her claims. In the latter case, those whose claims are voided would receive nothing, while recognized creditors would receive eighty-three percent of their claims.

As economic facts eventually assert themselves—what cannot be paid goes unpaid—denying the rule of law to debtors has considerable effects on creditors, both bona fide creditors, who are unduly discriminated against, and other, unduly protected creditors, such as IFIs. Public creditors enforcing or supporting the violation of the rule of law also trigger substantial negative effects for bona fide creditors. Grave injustice is inflicted if perfectly legal and legitimate debts are treated like debts lacking such solid foundation. Classifying and differentiating debts may thus arguably be seen as more in the interest of bona fide creditors, even though the application of universally recognized legal principals would have avoided substantial damage to debtor countries and their people.

If official creditors had not blocked a quick and fair solution over decades, total debts would be much lower. Creditors as a group will now have to accept larger losses in order to make debtor economies sustainable than would have been necessary some twenty-five years ago. As the structure of creditors has changed dramatically over the last two decades, each single creditor need not necessarily be worse off. Bondholders, practically non-existent in 1982, are now an important creditor class in quite a few cases, while banks have been able to reduce their exposure, although not without considerable costs, as debt reductions of thirty-five or forty-five percent under the "Brady Deals" document. Formulations such as "bailing-in the private sector" used by the unduly preferred therefore add insult to injury.

Quite noteworthy distributional effects are exacerbated by IFIs having been able to secure a privileged treatment of de facto preferred creditors for themselves, mostly in breach of their own constitutions. This undue privilege is especially problematic in the case of the poorest countries where multilateral claims are substantial percentages of sovereign debts and IFIs have influenced economic policies substantially. Unfortunately, official creditors have repeatedly attached conditions to debt relief that are not necessarily connected to economic necessities and have quite often worsened the crisis.

At present, any cancellation is based on arbitrariness; there is no right to it, nor are there any rules. It is granted to some countries, not to others, for some types of debts, but not for others. Reductions should, of course, be accepted if and when granted because getting quickly rid of the debt overhang must have priority for debtors. But a new transparent method is needed, based on objective, transparent criteria, not on creditors' whims. It must respect the very foundation of the rule of law that one must not be the judge in one's own cause. Debt reduction must be available to any technically insolvent country. Equal treatment of all debtors must be secured.

Determining whether a country is technically insolvent is a thorny problem, which can be solved by emulating the solution found domestically. National laws give neutral actors the authority to determine whether a debtor's situation warrants starting formal procedures of debt reduction. In domestic cases, courts are disinterested actors—neither creditors nor debtors. Internationally, an independent body is mandatory, too. My proposal of arbitration based on U.S. Chapter 9 (municipal insolvency),[98] also called Fair and Transparent Arbitration Process by many NGOs, perfectly accommodates this demand. An ad hoc arbitration panel established by creditors and debtors in the way usual in international law would either have to endorse or reject a debtor's demand immediately on being formed. It would have to reject the debtor's demand if clearly unfounded, denying this debtor any advantage from starting the procedure. A neutral entity, not creditors, would and must decide, respecting the very foundation of the rule of law. Decisions must be taken in a transparent way. Allowing procedures to start would recognize that there is a need to discuss debt reduction. Debt sustainability, and thus the specific amount of debt reduction needed, or whether any reduction is needed, would emerge from the proceedings as in the case of domestic debt reduction procedures.

If clearly illegal debts, no longer unduly harassed debtors, and the principles of tort law were applied, reducing multilateral debts in particular—if my sovereign insolvency model were used as the solution to sovereign insolvency—both bona fide creditors and debtors would be perceptibly better off than at present. Identifying such claims and dealing with them properly would make solutions much easier. Abolishing unjustified de facto privileges of those official creditors that substantially contributed to making crises worse would meaningfully contribute to an acceptable and sustainable outcome. Multilateral claims, whose very existence violates basic legal principles, would have to go. After abolishing the undue discrimination of developing countries and bona fide creditors, reinstalled economic mechanisms would again be allowed to play their useful and welcome role.

98. *See, e.g.*, Raffer, *supra* note 6; Raffer, *supra* note 69.