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Introduction

I. Key Issues and an Outline of the Book

There has been a considerable amount of recent writing in civil society, in legal academia, among commercial lawyers and in UN agencies and the World Bank about the doctrine of odious debt.[1] The surge in interest

[1] P Adams, *Odious Debts: Loose Lending, Corruption, and the Third World's Environmental Legacy* (London: Earthscan, 1991); A Khalfan, J King and B Thomas, 'Advancing the Odious Debt Doctrine' (2003) CISDL Working Paper COM/RES/ESJ <www.cisdl.org/public/docs/pdf/Odious_Debt_Study.pdf>, accessed 22 July 2015; EF Mancina, 'Sinners in the Hands of an Angry God: Resurrecting the Odious Debt Doctrine in International Law' (2004) *George Washington Int'l Law Review* 1239; CG Paulus, 'Odious Debts vs. Debt Trap: A Realistic Help?' (2005) 31 *Brooklyn Journal of Int'l Law* 83; A Gelpern, 'What Iraq and Argentina Might Learn from Each Other' (2005) *Chi J Int'l L* 391. See most of the articles collected in the *North Carolina J of Int'l L and Comm Reg's* symposium of 10 February 2007 on 'Odious Debt: Exploring the Outer Limits of Sovereign Debt Relief' (2007) 32 *North Carolina J of Int'l L and Comm Reg* 605–840 and the two special issues on 'Odious Debts and State Corruption' (2007) 70 *Law & Contemporary Problems* (Issues 3 and 4). See also S Michalowski, *Unconstitutional Regimes and the Validity of Sovereign Debt: A Legal Perspective* (Hampshire: Ashgate, 2007); TH Cheng, *State Succession and Commercial Obligations* (Ardsley, NY: Transnational Publishers, 2007); LC Buchheit, GM Gulati and RB Thompson, 'The Dilemma of Odious Debts' (2007) 56 *Duke LJ* 1202; A Feibelman, 'Contract, Priority, and Odious Debt' (2007) 85 *North Carolina L Rev* 728; BN Lewis, 'Restructuring the Odious Debt Exception' (2007) 25 *BU Int'l L J* 297; LC Buchheit and GM Gulati, 'Odious Debts and Nation Building: When the Incubus Departs' (2008) 60 *Maine L Rev* 477; S Ludington and GM Gulati, 'A Convenient Untruth: Fact and Fantasy in the Doctrine of Odious Debts' (2008) 48 *Va J Int'l L* 545. The studies by UNCTAD and the World Bank include: R Howse, 'The Concept of Odious Debt in International Law' (July 2007) 185 *United Nations Conference on Trade and Development: Discussion Papers* <www.unctad.org/en/docs/osgdp20074_en.pdf>, accessed 22 July 2015; V Nehru and M Thomas, 'The Concept of Odious Debt: Some Considerations' (22 May 2008) World Bank Economic Policy and Debt Department Policy Paper, <elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-4676>, accessed 22 July 2015; O Lienau, 'Who Is the "Sovereign" in Sovereign Debt?: Reinterpreting a Rule-of-Law Framework from the Early Twentieth Century' (2008) 33 *Yale J Int'l L* 63; TS Wyler, 'Wiping the Slate: Maintaining Capital Markets while Addressing the Odious Debt Dilemma' (2007–2008) 29 *U. Pa. J. Int'l L.* 947; CG Paulus, 'The Evolution of the "Concept of Odious Debts"' (2008) 68 *ZaöRV* 391. Other, older and more recent work is also engaged with below.

arose after the fall of Saddam Hussein's Iraq in 2003, and the claims by senior members of US President George W. Bush's administration that Iraq's debt might be regarded as odious.[2] The core idea of the doctrine as traditionally presented is that some sovereign debt claims are not binding or enforceable on account of the creditor's awareness of the fact that the proceeds of the loan would be used to oppress the population of the debtor state, or would be used for personal enrichment rather than public purposes. As this book will show, there has also been a substantial degree of scepticism about the legal status of the doctrine. The precedents are regarded as meagre. Courts and tribunals have avoided ruling on its existence. Provisions on odious debt were deliberately omitted in the one relevant treaty on state succession to public debts. And the picture has been complicated by the existence of a widely diverging range of understandings of the doctrine, and especially of the putative requirement that public debts be for public purposes. In light of such difficulties, a number of sceptical writers have explored how other, more innovative legal or institutional approaches may be pursued to reduce odious lending without becoming mired in what they regard as a hopeless debate over the doctrine's legal status.[3] Although I express some reservations about one of those proposals in chapter 5, this book is in no way intended to cast general doubt on the value of those constructive projects.

[2] 'Iraq's Debt: The US Should Beware the Principle of Odious Lending', *The Financial Times*, 16 June 2003, p. 20; 'Those Odious Debts', *The Economist*, 16 October 2003 <www.economist.com/node/2137956>, accessed 29 July 2015; J King, 'Saddam's Evil Debts', *Financial Post*, 23 October 2003, FP 15; J Stiglitz 'Odious Rulers, Odious Debts', *The Atlantic*, November 2003, p. 39; P Adams, 'Iraq's Odious Debts', Cato Institute No. 526, 28 September 2004, pp. 1, 16–17; J Siegle, 'After Iraq Let's Forgive Some Other Debts', *Int'l Herald Tribune*, 19 February 2004, p. 6.

[3] Particularly notable contributions among these include M Kremer and S Jayachandran, 'Odious Debt' (2006) 96 *Am Econ Rev* 82; J Shafter, 'A Due Diligence Model: A New Approach to the Problem of Odious Debts' (2007) 21 *Ethics & Int'l Affairs* 49; A Feibelman, 'Contract, Priority, and Odious Debt' (2007) 85 *North Carolina L Rev* 728; C Ochoa, 'From Odious Debt to Odious Finance: Avoiding the Externalities of a Functional Odious Debt Doctrine' (2008) 49 *Harvard Int'l LJ* 109; O Ben-Shahar and GM Gulati, 'Partially Odious Debts? A Framework for an Optimal Liability Regime' (2008) 70 *Law & Contemporary Problems* 47; A Feibelman, 'Equitable Subordination, Fraudulent Transfer, and Sovereign Debt' (2008) 70 *Law & Contemporary Problems* 101; Y Wong, *Sovereign Finance and the Poverty of Nations: Odious Debt in International Law* (Edward Elgar, 2012). See also BN Lewis, 'Restructuring the Odious Debt Exception' (2007) 25 *BU Int'l L J* 297; CM Gentile, 'The Market for Odious Debt' (2010) 73 *Law & Contemporary Problems* 151; R Bajesky, 'Currency Cooperation and Sovereign Financial Obligations' (2012) 24 *Florida J Int'l L* 91; TH Cheng, 'Why New States Accept Old Obligations' (2011) *U Illinois L Rev* 1.

However, the aim of this book is nonetheless to re-examine the traditional question. It will be helpful at the outset to confront some of the scepticism by contemplating a thought experiment. Suppose a company, Clean Co., provides a regular shipment of cleaning chemicals to the state of Ruritania under a long-term supply agreement. Suppose further that Clean Co. discovers that such chemicals are being used to carry out genocide. Its board is shocked and mortified by the revelation. It resolves to terminate all shipments immediately, including those sitting on the docks and awaiting export. Ruritania sues in the state of New York (the choice of law and forum) to compel shipment (specific performance) or obtain damages, for the chemicals are not easily sourced elsewhere. It argues that the end use of the chemicals is its own business. Would a New York or English court compel Clean Co. to carry on with delivery? Would it award damages to Ruritania to help it find a suitable genocidal substitute? In other words, does the law of New York or similar jurisdictions compel a judge to give effect to a contract when it is common ground that it will facilitate crimes against humanity?[4] We may adjust the scenario to make it concern a supply of credit rather than chemicals. Suppose a bank extended a credit facility to Ruritania, and later learned it was being used to finance the construction of extermination camps in Ruritania, or was used to purchase weapons for use in campaigns of mass slaughter. Assuming the contract itself did not bar such conduct, would a court *prevent* the bank from shutting down the facility if Ruritania brought an action to compel payment? Would the judge force the bank to finance the slaughter, if the contract were sound in all aspects but for the end purpose of the proceeds?

If one's intuitions suggest that few judges, whether domestic or international, would find that the show must go on, one would be right. Yet if so, then what principle would the judge rely on in denying the claim? It must be that the contract is unenforceable, and it must be so not because of what the contract says but rather because of what it does. The agreement would be unenforceable due to its end purpose. The purpose would be unlawful because it violates public policy, and the contract itself would violate public policy if it were for the purpose of facilitating that unlawful end. It would not matter that the plaintiff

[4] Compare *Trial of Bruno Tesch and Two Others (The Zyklon B Gas Case)* (1947) 1 *Law Reports of Trials of War Criminals* 93, 93–104. The supply of Zyklon B Gas on commercial terms by civilians for use in various extermination camps was found to be a war crime punishable by death. See chapter 4 below, text to notes 90–91, for a different outcome in respect of whether a loan for financing extermination was a crime.

state could produce a duly enacted national law authorising the genocide. The breach in question violates international norms that are fundamental and cognisable as transnational public policy, as well as incompatible with the domestic public policy of the state in which the suit is brought. If one is inclined to agree with this line of argument, then one ought also to agree that certain odious debts, as defined in this book, are neither binding under international law nor enforceable in the national law of certain familiar jurisdictions. The underlying legal principles are largely the same.

No treatment of the subject of odious debt has yet fully explored the broad range of state practice in respect of the idea. Most focus on whether the words 'odious debt' have been cited in a state's refusal to honour a public debt, rather than the underlying idea of when it is that the hostile or non-beneficial purposes of a loan render it legally unsound. It would be a mistake to make the discussion turn on the label, treating the number of positive hits in legal databases as a proxy for the doctrine's soundness. The question is rather about the enforceability of such debts, whatever they are called, not of the currency of the label. Even the earliest precedents that all see as supporting the idea did not employ the terms as such. The answer to the traditional question depends on various factors, including whether the claim sounds in international or domestic law, whether it concerns state succession or rather change of government, and on the precise nature of the allegedly illicit activity. In chapter 2, each of these questions is considered, as well as the work of esteemed writers who considered the question prior to its modern renaissance. In chapter 3, I review the status of odious debts under international law and contend, departing from some of my previous work on the topic, that it is best to understand the idea of odious debts as comprising four distinct types, which are discernible in state practice: war debts, illegal occupation debts, corruption debts, and subjugation debts.[5]

War debts are debts arising out of transactions that helped or are presumed to have helped the defeated country in waging or preparing war against the successor state or its allies. Some also propose a newer category of illegal war debts, one whose validity is said to turn on the nature of the war rather than the antagonism between the warring

[5] The analysis in this book supersedes that put forward in my working paper, contained in A Khalfan, J King and B Thomas, 'Advancing the Odious Debt Doctrine' (2003) CISDL Working Paper, 11 March 2003 <http://cisdl.org/public/docs/pdf/Odious_Debt_Study.pdf>, accessed 22 July 2015. It develops the arguments put forward in J King, 'Odious Debt: The Terms of the Debate' (2007) 32 *North Carolina J of Int'l L and Comm Reg* 605.

parties. Illegal occupation debts are those contracted by an illegal occupying power and which the creditor purports to be binding on that occupied territory even after the occupation has ended. Corruption debts are those debts procured through bribery or corruption of a state representative, or those that are knowingly provided, in part or in whole, for the personal enrichment of public officials (indirect bribery). Subjugation debts, the most contentious of odious debts, have traditionally been defined as those loans that are 'hostile' or contrary to the 'major' interests of the population of a debtor state. Such a definition is admittedly nebulous. This book adopts nearly universally accepted legal principles of contemporary international law to define the nature and high threshold of the harm that such debts must finance to be considered odious. It is concluded that subjugation debts are those debts that are made for the purpose of facilitating the violation of *jus cogens* norms, or the commission of serious or flagrant violations of human rights, humanitarian law, or other fundamental international law principles in respect of the population of the debtor state. Some may think this is a redefinition of the idea of odious debt (or at least of subjugation debts). But that is not true – it is a continuation of the same idea inherent in the precedents by reference to the principles that have now achieved a recognition and status that was unthinkable in earlier times.

If we move with the times, however, then we must also acknowledge that the national law of certain important jurisdictions is what determines the enforceability of most modern loan agreements. Are these jurisdictions, we must ask, likely to enforce the types of debts just mentioned? The claims set out in chapter 4 of this book are that it is appropriate for domestic courts in New York and England to regard to international law when considering the content of domestic public policy, particularly when considering claims involving foreign sovereigns; that the act of state and justiciability doctrines do not bar the judicial consideration of foreign public acts of 'subjugation' as defined above; that lending funds for an unlawful purpose is a recognised ground for the refusal to enforce a loan agreement in the law of both jurisdictions, as are contracts procured through bribery or for the enrichment of public officials; that restitution on the ground of unjust enrichment will not normally be available to recover funds transferred under an illegal contract, where this would stultify the rule rendering the contract illegal or encourage future entry into similar contracts by the payer; and that woollier principles of good faith, abuse of rights and public fiduciary

obligations may play a supportive, if not decisive role in the analysis of public policy and the creditor's duties in respect of odious transactions.

II. The Law and Policy of External Sovereign Debt: A Primer

This book addresses a rather narrow legal question about the pedigree and current applicability of the doctrine of odious debt. However, it touches upon a much larger field of international finance and sovereign debt, one which benefits from a range of extraordinary scholarship by economists, practising and academic lawyers, and political scientists. Any examination of the legal doctrine of odious debt must begin by taking notice of that broader context. It is only within it that one can understand why states such as Iraq, Argentina, Ecuador, Nigeria, the Democratic People's Republic of the Congo and others might behave as they do in choosing to pay or avoid what some might regard as clear cases of odious debts.

Our focus will be on external (or foreign held) debt rather than domestically held debt. The latter is quite important, for it constitutes anywhere from 40 to 80 per cent of the total debt stock of all countries.[6] However, external debt is ordinarily governed by either or both international law and the domestic law of a foreign nation, while domestic debt is not (ordinarily). In practice it means that sovereigns have less latitude under the law to adjust their obligations on external debt, which gives special salience to the question of its legality. Another point of focus is the debt of developing countries, for it is there, again, that the doctrine finds its most prominent application. Figure 1.1 demonstrates the phenomenal growth of lending to developing nations since 1970.

Although the rising trend of such debt appears alarming, in fact the ratio of debt to gross national income (GNI) and debt to exports have remained relatively stable in recent years, meaning that overall economic growth and trade have to an extent grown in tandem with the growth of debt. Moreover, the vast majority of the world's overall public debt is owed by developed nations.[7] In that light, and as anyone who has sought a mortgage or student loan would know, borrowing can in fact be a powerful enabler – a good thing.

[6] CM Reinhart and K Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009), p. 41 and ch. 7.

[7] HS Scott and A Gelpern, *International Finance: Law and Regulation*, 3rd edition (Sweet & Maxwell 2012), p. 1041 (data from 2011).

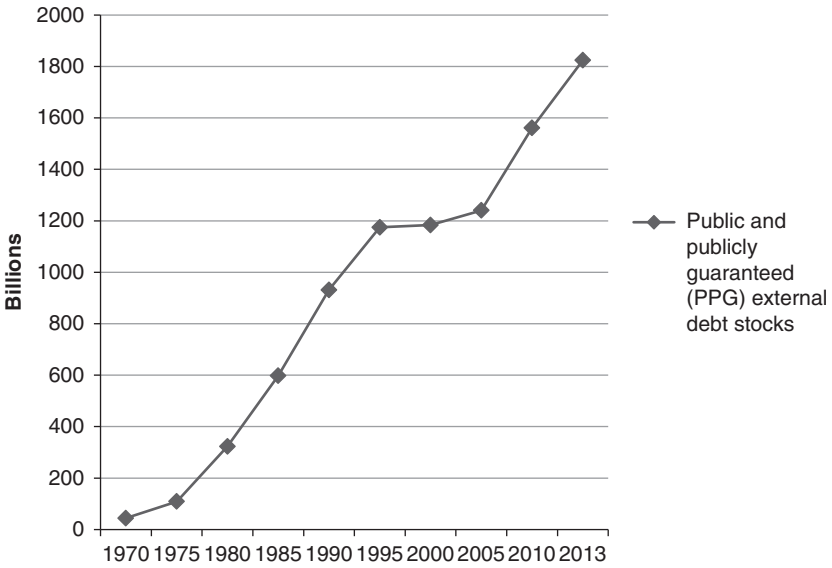

Figure 1.1 External debt of all developing countries since 1970.
Source: World Bank, *International Debt Statistics Database* (PPG, current US$)

A. Early History: Banks, Gunboats and Reputation

Though international sovereign finance dates to medieval times, the practice accelerated substantially over the nineteenth century, bringing with it an 'explosion in international defaults' throughout Europe and Latin America.[8] Most of this lending was from private creditors. In the early nineteenth century, London and, to a lesser extent, Paris were hives of the sovereign finance business (New York's time would come in the twentieth century).[9] Foreign sovereigns would seek out merchant banks in such cities to assist them in selling bonds to (hence borrowing from) investors. The merchant banks, the analogues of today's investment banks, would prepare, market and sell the bonds to a range of institutional and retail investors. They included some still familiar names: Barings, Rothschild, Hong Kong and Shanghai Banking Corporation (HSBC), among thirty to forty others.[10] They are now called 'financial

[8] Reinhart and Rogoff, *This Time Is Different*, pp. 69–71, 89–91.
[9] M Flandreau and others, 'Changing Role of Global Financial Brands in the Underwriting of Foreign Government Debt (1815–2010)' (2011) *International and Development Studies Working Paper*, p. 5ff.
[10] Flandreau and others, 'Changing Role of Global Financial Brands', pp. 8–9.

intermediaries'[11] because while they advised and structured the deal, and played a role in building markets for the bonds, they did not ordinarily become the final holder of the debt in any significant way.

Such nineteenth-century lending took place in a radically different legal and political world from the one we now know. There were no multilateral lending organisations. There was neither human rights nor humanitarian law, nor any UN Charter obligations proscribing the use of force in international law. The laws of 'conquest' were cemented parts of international law (divided then as now between the 'law of peace' and the 'law of war').[12] Britain and France had vast colonial empires, and even much of the relatively democratic United States was either slaveholding or segregated. Law and diplomacy also played a very different role in sovereign debt relationships. Contemporary political scientists now reckon with the so-called sovereign debt puzzle, which roughly concerns why sovereigns repay their debts when they can enlist neither law nor gunboats to compel payment on defaulted debt.[13] While historically sovereign immunity did tend to make contracts with states legally unenforceable, the European powers often used military might or direct administration of the local economy, typically under threat of force, to enforce the payment of debts. Some recent literature describes such measures as 'supersanctions' in the period of 1870–1913, namely, the use of direct military pressure or direct imposition of foreign political or financial control.[14] Far from being a remote risk, Mitchener and Weidenmier argue that 'all nations that defaulted on sovereign debt ran the risk of gunboats blockading their ports or creditor nations seizing fiscal control of their country' and that such sanctions were imposed in roughly one-third of cases of sovereign default.[15] Britain alone led debt-related military interventions or direct administration of the local economy in Mexico (1861), Egypt (1882), Greece (1887), Venezuela (1902), Serbia (1904) and

[11] Flandreau and others, 'Changing Role of Global Financial Brands', p. 9.

[12] A distinction reflected in the title of a great classic: Hugo Grotius, *De Jure Belli et Pacis Libris Tres* [On the Law of War and Peace], W Whewell (ed.), translation JW Parker (Clark, NJ: The Lawbook Exchange, 2011) [1625].

[13] M Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries* (Princeton: Princeton University Press, 2007), ch. 1; JI Bulow and K Rogoff, 'Sovereign Debt: Is to Forgive to Forget?' (1988) NBER Working Paper No. 2623.

[14] KJ Mitchener and MD Weidenmier, 'Supersanctions and Sovereign Debt Repayment' (2005) NBER Working Paper 11472 <www.nber.org/papers/w11472>, accessed 22 July 2015.

[15] Ibid at 2. But see Tomz, note 13 above and notes 26 and 27 below.

Guatemala (1913).[16] The Mexican incident occurred after the government of Benito Juárez declared a moratorium on debt repayments after the conclusion of the Mexican War of Reform.[17] This led to military intervention by the armies of Britain, France and Spain, and ultimately to the imposition of direct re-colonisation by France.[18] The Venezuelan affair, which involved shelling Venezuelan cities by British, German and Italian boats, was a flagrant violation of the Monroe Doctrine and led to a diplomatic intervention by the US president and ultimately to arbitration of the claims.[19]

The issue was acute enough at the time that it led to the formulation of the Calvo doctrine in 1868 and the Drago doctrine in 1902.[20] The Calvo doctrine was the assertion by an Argentinean jurist, Carlos Calvo, that there was no right in international law for one state to use military or even diplomatic intervention to collect private monetary claims against another state – such a right was not recognised between European nations and was a continuation of colonialism in Latin America. After the Venezuelan affair in December 1902, the Argentinean foreign minister, Luis M. Drago, sent a note to Washington in which he set out the narrower claim that came to be known as the Drago doctrine.[21] The claim was that the issuance of foreign debt is a sovereign act and that the use of military force to collect it was not justified in international law or the domestic law of nations such as the United States.[22] Though some authors found that the doctrine was discredited and rejected by creditor states,[23] other authors and the US President Theodore Roosevelt agreed with its validity.[24] It was in any event an important precursor to the Hague Convention (II) Respecting the Limitation of the Employment of Force for the Recovery of Contract Debts, signed at the Second Peace Conference

[16] See HB Samuel, *The French Default: An Analysis of the Problems Involved in the Debt Repudiation of the French Republic* (London: Effingham Wilson, 1930), p. 101.

[17] See JN Pomeroy, *Lectures on International Law in Time of Peace* (Boston, New York: Houghton Mifflin, 1886), p. 75. See also AN Sack, *Les effets des transformations des États sur leur dettes publiques et autres obligations financières* (Paris: Recueil Sirey, 1927), p. 158. For details on these events, see generally J Bazant, *Historia de la Deuda Exterior de México 1823–1946* (Mexico: El Colegio de Mexico, 1968), pp. 84–99.

[18] *See* Pomeroy, *Lectures on International Law*, p. 75; Bazant, *Historia*, pp. 89–99.

[19] AS Hershey, 'The Calvo and Drago Doctrines' (1907) 1 *AJIL* 26, 28–31 (describing the Drago doctrine and President Roosevelt's acceptance of it).

[20] Ibid. at 27–28. [21] Ibid. at 28–29. [22] Ibid. at 30–31.

[23] *See* Samuel, *The French Default*, p. 101.

[24] Hershey, 'The Calvo and Drago Doctrines' 43. At 30, Hershey mentions that President Roosevelt fully endorsed the doctrine in 1905.

in The Hague on October 18, 1907.[25] Article 1 of this convention stipulates that no military force may be used to collect a sovereign debt owed to a private person, unless the debtor refuses to submit to arbitration or comply with the award of an arbitrator. Its very existence suggests something about how the assertions of odious debt claims by emerging states against even private creditors might have been handled by wealthy creditor states.[26]

The other major though still disputed explanatory factor for why sovereigns repaid and still repay their debts was that their international reputation and hence access to fresh capital would be ruined if they defaulted. Michael Tomz supplies extensive quantitative and qualitative data both claiming to debunk the gunboats hypothesis and confirm the reputation hypothesis as explanations for why nations repaid their debts.[27] Others dispute this view. Bulow and Rogoff have argued in an influential paper that reputation will not play the role of enabling some less-developed countries to borrow.[28] The idea that reputation is blanched significantly by default is also put in question by the enormous data set provided by Reinhart and Rogoff, showing that the perennial assertion by borrowers that 'this time is different' has been believed routinely despite centuries of serial default.[29] Indeed, Bulow and Rogoff purport to show that strong creditor rights such as 'political rights . . . to threaten interests outside its borrowing relationships, or legal rights' may be required to stabilise lending

[25] Hague Convention (II) Respecting the Limitation of the Employment of Force for the Recovery of Contract Debts, The Hague, 18 October 1907, in force 26 January 1910, 36 Stat. 2241, 1 Bevans 607.

[26] In an extremely impressive study, Michael Tomz seeks to discredit this conventional understanding of gunboat diplomacy by presenting wide-ranging evidence that the use of gunboats accounts for less than 1 per cent of sovereign debt repayment in the period. He addresses not only direct threats and military action but subjective perceptions of both debtors and creditors to the possibility of action. However, he offers no adequate explanation for the perceived importance of the Drago doctrine or the existence of the Hague Convention. Without disputing the significance of Tomz's revisionist thesis and empirical findings, it appears nonetheless clear that gunboat diplomacy was a more than marginal concern for a significant number of states.

[27] Tomz, *Reputation and International Cooperation*. See also the seminal earlier work of J Eaton and M Gersovitz, 'Debt with Potential Repudiation: Theoretical and Empirical Analysis' (1981) 48 *The Review of Economic Studies* 289.

[28] Bulow and Rogoff, 'Sovereign Debt', 43. For a critique of some of the ideas in this paper, see Reinhart and Rogoff, *This Time Is Different*, pp. 56–59, and authors cited in Tomz, *Reputation and International Cooperation*, p. 6, note 11.

[29] Reinhart and Rogoff, *This Time Is Different*, esp. ch. 6. At pp. 55–59, Reinhart and Rogoff explore reputation and distance themselves somewhat from the conclusions of Bulow and Rogoff, 'Sovereign Debt'.