

THE DILEMMA OF ODIOUS DEBTS

Lee C. Buchheit
G. Mitu Gulati
Robert B. Thompson

TABLE OF CONTENTS

I.	The Intergenerational Tension in Sovereign Borrowing	1
II.	A Taxonomy of Sovereign Debt.....	6
A.	Virtuous Debts	7
B.	Profligate Debts	8
1.	War Debts	9
2.	Hostile Debts.....	11
3.	Odious Debts.....	13
C.	The Rebirth of the Odious Debt Debate	18
III.	Do We Need a Doctrine of Odious Debts?.....	22
A.	What Is the Objective?.....	24
B.	Is There Now a “Doctrine” of Odious Debts?	26
IV.	The Alternative: Principles of Private Law	29
A.	Possible Defenses.....	31
1.	Considerations of Public Policy.....	31
2.	Unclean Hands	34
3.	Agency Law	36
4.	Piercing the Governmental Veil.....	44
B.	Possible Problems	47
1.	The Problem of Proof.....	47
2.	<i>In Pari Delicto</i>	51
V.	Conclusion	55

DRAFT
08/091/06

THE DILEMMA OF ODIIOUS DEBTS

Lee C. Buchheit
G. Mitu Gulati
Robert B. Thompson

Abstract

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

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

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

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

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

THE DILEMMA OF ODIIOUS DEBTS

Lee C. Buchheit^{*}

G. Mitu Gulati^{**}

Robert B. Thompson^{***}

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

I. The Intergenerational Tension in Sovereign Borrowing

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

^{*} Partner, Cleary Gottlieb Steen & Hamilton LLP (New York).

^{**} Professor, Duke Law School.

^{***} New York Alumni Chancellor’s Chair in Law & Professor of Management, Vanderbilt University.

Thanks to Jai Damle, Josh Kaye, and Erin Shively for excellent research assistance. Thanks to Adam Feibelman, Anna Gelpern, William Klein, Kimberly Krawiec, Robert Scott, David Skeel, Paul Stephan, George Triantis, Jed Purdy and participants in seminars at the Centre for Development Studies in Trivandrum, India, and at the law schools of the University of Alabama, the University of California at Los Angeles, the University of North Carolina at Chapel Hill, Vanderbilt University and the University of Pennsylvania for comments. Special thanks to Deborah DeMott for the numerous occasions on which she discussed agency law concepts with us. Finally, thanks to Joy Hanson of the Duke Law Library for her untiring willingness to track down every source that we asked for, no matter how obscure.

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

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

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

Under such a system, debts, once incurred, would be carried by each generation in the bloodline and passed on to each succeeding generation like a bucket brigade at a house fire. Naturally, each generation would be sorely tempted to defer the repayment of their inherited debts for as long as possible in the hopes that final payment could be delayed to a date, *any* date, falling after they have managed to shuffle off this mortal coil. Whenever and wherever feasible, bucket-carriers might also be tempted to top-up the bucket with their own new liabilities before passing it on.

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

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

This may not be the system we have adopted for the transmission of personal debts, but it is precisely the system that public international law imposes with respect

² See 23 Am. Jur. 2d §§ 1-20. (2006) .

³ WILLIAM SHAKESPEARE, THE TEMPEST act 2, sc. 2, ln. 137.

to sovereign debts. Under the public international law doctrine of “state succession”⁴, a government automatically inherits the debts of its predecessor governments, regardless of how dissimilar the forms of government may be.⁵ The state, together with its rights and obligations, continues; its governments come and go.

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

The doctrine also applies, although in a more checkered way, to situations in which the state itself undergoes a major change.⁷ This occurs both in cases of

⁴ The leading treatises are Ernst Feilchenfeld, PUBLIC DEBTS AND STATE SUCCESSION (1931) (hereinafter “*Feilchenfeld*”), and Daniel Patrick O’Connell, STATE SUCCESSION IN MUNICIPAL LAW AND INTERNATIONAL LAW, Vol. I, 369-453 (1967). More recently, see Tai Heng Cheng, STATE SUCCESSION AND COMMERCIAL OBLIGATIONS (2006).

⁵ Aristotle asked, but famously did not answer, this question in Book III of his *Politics*: “. . . whether it is right or wrong for a state to repudiate public obligations when it changes its constitution into another form.” ARISTOTLE, THE POLITICS OF ARISTOTLE, (E. Barker ed. 1969), bk III, chapt. III, § 7. See generally 1 RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 208, rept. note. 2; BARRY CARTER, PHILLIP R. TRIMBLE, & CURTIS BRADLEY, INTERNATIONAL LAW, 449–55, 459–58 (4th ed. 2003) (discussing the international rights and obligations that transfer from preceding governments upon recognition of a new government).

⁶ See 1 RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES, § 208, rept. note 2 (“International law sharply distinguishes the succession of states, which may create a discontinuity in statehood, from a succession of governments, which leaves statehood unaffected”).

⁷ See *id.* at § 209.

cession of territory, as well as in cases of secession or the disintegration of a state.⁸ When the Republic of Texas joined the United States in 1845, for example, the United States inherited (and had to settle) the debts of Texas.⁹ When the USSR disintegrated in 1991, the international community pressured the dominant successor state, Russia, to assume all of the debts of the former Soviet Union.¹⁰ A squabble over the appropriate division of the assets and liabilities of the former Yugoslavia among its various provinces is only now being resolved.¹¹

In the sovereign context, therefore, debts are congenital (in that each generation of citizens inherits a responsibility to contribute toward repayment of the old debts merely by being born in the state) and astonishingly adhesive. The obligations will remain legally glued to the territory notwithstanding changes of government (constitutional or extra-constitutional), a churning population or even the disintegration of the state itself.¹²

Contrast this to corporate debts. Acme Corporation borrows money. Over the years, the management and the board of directors of Acme may change many times. Over a long enough period of time, the entire corpus of Acme shareholders will change. But the debt remains.¹³ In that sense, corporate debts are also adhesive.

There are two important differences, however, between corporate debts and sovereign debts. If Acme Corporation becomes indebted beyond its capacity to repay, it may seek to have its obligations legally reduced or expunged in a bankruptcy proceeding. Moreover, the corporate planners of Acme are relying on the venerable corporate law principle of limited liability to block creditors' efforts to collect their claims, absent unusual circumstances, from Acme's shareholders.¹⁴ So, in the final extremity, the debts of an individual and the debts of a corporation are

⁸ See generally, FEILCHENFELD, *supra* note 4, at 69-75.

⁹ *Id.* at 271-286.

¹⁰ See Paul Williams & Jennifer Harris, *State Succession to Debts and Assets: the Modern Law and Policy*, 42 HARV. J. INT'L L. 355, 369-370 (2001).

¹¹ See, e.g., Carsten Stahn, *The Agreement on Succession Issues of the Former Socialist Federal Republic of Yugoslavia*, 96 AM. J. INT'L L. 379, 382 (2002); Milena Sterio, *Implications of the Altmann Decision on Former Yugoslav States*, 20 CONN. J. INT'L L. 39, 39, 47 (2004).

¹² RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 209(2) (1987).

¹³ WILLIAM A. KLEIN AND JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 108 (9th ed. 2004).

¹⁴ *Id.* at 145.

treated similarly: the debts do not pass involuntarily to those surviving the demise of the individual or the company.

Not so sovereign debts. Sovereigns cannot look to death, dissolution or bankruptcy for liberation from the consequences of imprudent borrowing. Sovereign debts devolve involuntarily on subsequent generations of citizens, long after the people who borrowed the money have departed and, in many cases, long after anyone can even remember why the debts were incurred in the first place. When a sovereign sins in this context, it therefore does so without hope of absolution or redemption, apart from whatever debt relief the sovereign may be able to negotiate or impose on its creditors down the road.¹⁵

Under a strict application of the doctrine of state succession, sovereign debt is thus congenital, adhesive *and* ineradicable.¹⁶ It is the combination of these three attributes that sets the stage for intergenerational conflict. The incumbent government of a country may incur debts that successor governments will be obliged to pay off. By the very nature of things, those successor governments and the citizens they represent are not consulted when the money is borrowed. They lie somewhere in offing -- mute, disenfranchised and wholly reliant on the forbearance of their ancestors. They are, in fact, perfect victims of the linear progression of time.

When these new citizens finally do appear on the scene, they will inherit many things: a territory, a history and the infrastructure of a society. They may also inherit a stock of unpaid debts; debts that public international law requires them to assume as their own obligations.¹⁷ The obvious question is whether there are any circumstances in which such a bequest can legally be declined, with the consequence that the old debts will not bind successor generations of citizens. Stated differently, are there any exceptions to the strict rule of state succession?

¹⁵ If a state borrows in its own currency, of course, it has one other possible avenue of escape -- inflation. But inflating one's way out of a sovereign debt problem (as tempting as it sometimes seems), is just another way of taxing the citizens and stakeholders in the country to pay for the debt.

¹⁶ *See, e.g.*, GEOFFREY WATSON, THE LAW OF STATE SUCCESSION, in CONTEMPORARY PRACTICE OF PUBLIC INTERNATIONAL LAW 115–27 (Ellen Schaffer and Randall J. Snyder eds. 1997).

¹⁷ RESTATEMENT (THIRD) FOREIGN RELATIONS LAW, § 209 (1987).

II. A Taxonomy of Sovereign Debt

Of all the people who have pondered the intergenerational conflict inherent in sovereign borrowing, only one has ever offered a truly crisp solution, Thomas Jefferson. On September 6, 1789, Jefferson wrote a letter to his friend James Madison in which he declared:

“[T]he earth belongs in usufruct to the living; . . . the dead have neither powers nor rights over it.”¹⁸

Jefferson was then ending his stint as the American Minister in France and was poised to return home soon to become the nation’s first Secretary of State. He had been in France long enough to see the early ravages of the French Revolution. This sentence was written with particular reference to what Jefferson had come to see as the pernicious practice of sovereigns incurring debts that had to be repaid by succeeding generations. He called this principle -- that the earth belongs in usufruct to the living -- a principle of natural law. He described it as “self-evidently” correct (a phrase with which he had some success earlier in his career).¹⁹

The solution he proposed was splendidly Jeffersonian. After studying life expectancy tables, Jefferson had determined that if a person of his time reached the age of 21, that person was likely to live another 34 years. Jefferson’s conclusion was that each generation may contract debts or, for that matter, may pass laws or enact constitutions, that must automatically expire within that generation’s 34-year average tenure. Thus, when a generation comes into its majority, it may legitimately contract a debt in the first year having a duration of no more than 34 years, and in the second year, 33 years, and so forth. In this way, one generation can never burden a successive generation with its own debts, its own laws or its own constitutions.²⁰

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

If we abandon the hope for a solution that absolves each succeeding generation of liability for *all* previously-contracted debts, the task becomes one of

¹⁸ Letter from Thomas Jefferson to James Madison (September 6, 1789) (available at <http://odur.let.rug.nl/~usa/P/tj3/writings/brf/jefl81.htm>)

¹⁹ *Id.*

²⁰ *See generally*, HERBERT SLOAN, PRINCIPLE & INTEREST 50-53 (1995).

deciding which types of inherited debts, if any, are candidates for repudiation by the involuntary heirs.

A. Virtuous Debts

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

Similarly, the Republic of Ruritania, a fictional country we use in this article to develop the argument in a more tangible context, may borrow money to defend itself against aggression.²² Future citizens of Ruritania, as evidenced by the fact that they can still claim the honor of being called Ruritanians, are the remote beneficiaries of the debt. Or a government may attempt to jump-start a national economy out of a depression, as Franklin Roosevelt did in the United States in the 1930s, through deficit financing of public works projects.²³

For purposes of this article, we shall call debts incurred for purposes such as financing durable infrastructure improvements and the waging of defensive wars, “Virtuous Debts”. Opinions may differ about whether a particular use of proceeds is indeed virtuous, but it is enough for present purposes to conclude that certain types of sovereign borrowing will benefit the people expected to repay the debt, even if that benefit is temporally remote.

²¹ SAMUEL PUFENDORF, *THE LAW OF NATURE AND NATIONS*, bk VII, ch.10, ¶ 8, in 2 *THE CLASSICS OF INTERNATIONAL LAW* 1345–6 (James Brown Scott ed., 1964). *See also* HUGO GROTIUS, *OF THE RIGHTS OF WAR AND PEACE* 221-22, 229-30 (J. Morice trans., 1715); ARTHUR KEITH, *THE THEORY OF STATE SUCCESSION* 2-3 (1907).

²² Access to loans “in time of public danger, especially from foreign war”, said Secretary of the Treasury, Alexander Hamilton, are an “indispensable resource”, even to the wealthiest of nations. Alexander Hamilton, *First Report on the Public Credit*, Jan. 14, 1790, in 2 *THE WORKS OF ALEXANDER HAMILTON* 227–28 (N.C. Lodge, ed., 1904).

²³ *See* John Steele Gordon, *HAMILTON’S BLESSING* 122-24 (1997).

B. Profligate Debts

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

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

The other side of this debate portrays most financing of current budget deficits as being driven by simple political expediency.²⁵ The argument runs along

²⁴ For a recent example of this argument, see Joshua Bolten, *Budget for the Future*, N.Y. TIMES (Feb. 6, 2006) at A19.

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

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

DAVID HUME, *Of Public Credit*, in ESSAYS, MORAL, POLITICAL, AND LITERARY, pt. II, essay IX, ¶ 5 (Eugene F. Miller, ed., Liberty Fund, 1987) (available at <http://www.econlib.org/library/LFBooks/Hume/hmMPL32.html>).

these lines: Elected politicians like to spend money but they don't like to tax the electorate to the point of losing votes. The solution? Borrow the money. You can spend it now without taxing the current electorate. Naturally, some poor taxpayer/voter will someday have to pay it back, but when that happens you will be quietly contemplating your dignity (and your pension) as an *ex*-congressman.²⁶

It is not our intention here to express a view on the relative merits or demerits of deficit financing. It is enough to agree that certain types of sovereign debts -- to which we will give the term "Profligate Debts" -- convey little or no benefit to the people expected to repay those debts.

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

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

1. War Debts

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

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

This doctrine²⁷ is usually traced back to the behavior of Great Britain in 1900 following the Boer War in South Africa. The victorious British announced that they would voluntarily assume the debts of the South African Republics contracted *prior* to the commencement of hostilities, but none incurred following the commencement of the hostilities that we know as the Boer War.²⁸ The British Government did not at the time articulate the rationale for this policy. Perhaps it believed the justification to be obvious.²⁹ Paying the debts of a former adversary is one thing, particularly when victory brings sovereignty over the disputed territory and resources. But paying off the very loans that both delayed and added to the cost of that victory is quite another thing.³⁰

²⁷ This area of the law is far murkier than the following description suggests. Public international law is derived both from what sovereign states say and from what states do. But what a state says at any particular time may not comport with what it says at another time. What it says may not correspond to how it acts, then or thereafter. And how it acts on one occasion may not constrain its later behavior when its interests have changed. Multiply this pandemonium by the 190 or so sovereign states on the planet and the aspirational element in the phrase “doctrine of public international law” becomes apparent.

²⁸ See FEILCHENFELD, *supra* note 4, at 393-95. It later became apparent that the British Government did not believe this policy of recognizing the pre-belligerency debts of a vanquished enemy was a requirement of international law. See *West Rand Central Gold Mining Co. Ltd. v. The King*, Law Reports, 1905, 2 K.B. 391, 394 (submission of S.R. Finlay and Sir E. Carson for the Crown).

²⁹ Feilchenfeld concludes that the British position was based entirely on what Britain regarded as a “natural demand of justice”. *Id.* at 394.

³⁰ The Fourteenth Amendment to the Constitution of the United States (enacted in 1868 after the Union victory in the American Civil War) reflects a similar approach to the debts incurred by the rebellious Confederate States of America. Section 4 of the Fourteenth Amendment begins by reaffirming the validity of the public debt of the United States. It then goes on to decree that:

“. . . neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States . . . but all such debts, obligations and claims shall be held illegal and void.”

U.S. CONST. amend. XIV.

Moreover, anyone lending to a belligerent power after hostilities have begun is placing an obvious bet -- an “all or nothing” bet -- on the outcome of the war.³¹ This aspect of the war debt limitation to the doctrine of state succession is significant because it introduces into the debate the reasonable expectations of the creditor when extending the loan.

State succession to debt obligations traditionally concerned itself with the allocation of debts in cases of territorial cession, annexation, secession, dismemberment and so forth.³² The validity and enforceability of the debts themselves, however, were rarely an issue; it was mostly just a matter of pinning the debts to one part or the other of a map. The unspoken premise was that lenders had a justifiable expectation under international law to be repaid, even if they could not always be sure who would ultimately be held responsible for making the payment.

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

2. Hostile Debts

At about the same time as the Boer War, an even broader qualification to the strict doctrine of state succession was articulated by the United States of America following the Spanish American War of 1898. When that war ended, the belligerent powers met in Paris to hammer out a peace treaty. Under the terms of that treaty, Spain ceded to the United States its sovereignty over Cuba, the Philippines, Puerto Rico and certain other territories. As Spain saw things, along with sovereignty came the responsibility for repaying the debts of the territory being transferred.³³

³¹ “A creditor who advances money to a belligerent during a war to some extent adventures his money on the faith of the borrower’s success.” John Fisher Williams, *International Law and International Financial Obligations Arising from Contract*, BIBLIOTHECA VISSERIANA DISSERTATIONVM IVS INTERNATIONALE ILLVSTRANTIVM, Vol II, at 55 (1924) (hereinafter “*Williams*”).

³² See WATSON, *supra* note 13.

³³ JAMES BASSETT MOORE, 1 DIGEST OF INTERNATIONAL LAW ISSUED BY PRESIDENTS AND SECRETARIES OF STATE OF THE UNITED STATES OF AMERICA, OPINIONS AND DECISIONS OF COURTS FEDERAL AND STATE 352-385 (1906).

A particular point of controversy centered on certain loans that the Crown of Spain had incurred in its own name but for which Cuban revenue streams had been pledged.³⁴ Spain wanted the United States to assume responsibility for these debts in its capacity as the new sovereign power in Cuba; the United States was disinclined to do so.³⁵

Each side advanced arguments for its position, citing both juristic opinion and state practice. Spain based its case on the traditional rules of state succession. If a debt exists at the time of a transfer of territory, responsibility for that debt must be allocated between the transferor and the transferee, with a strong presumption in favor of the transferee (in this case, the United States). The Spanish delegation went so far as to assert that its position was in accordance with rules “observed by all cultured nations that are unwilling to trample upon the eternal principles of justice.”³⁶

For their part, the Americans -- uncultured trampers that they were -- put forward three justifications for the United States’ reluctance to honor these loans. First, the Americans argued that the loans had not been contracted for the benefit of Cuba; indeed, a portion of the proceeds of the loans had been spent in Spain’s campaign to suppress rebellions in the island.³⁷ Second, Cuba (meaning, presumably, the Cuban people) had not consented to these debts. The loans had been imposed on those people by Spain.³⁸ Finally, the creditors knew that the pledges of Cuban revenues to secure the loans had been given in the context of efforts to suppress a people struggling for freedom from Spanish rule. The creditors therefore “took the obvious chances of their investment on so precarious a security.”³⁹

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

³⁴ See FEILCHENFELD, *supra* note 4, at 329-343.

³⁵ MOORE, *supra* note 33, at 352-385.

³⁶ *Id.* at 353; See also FEILCHENFELD, *supra* note 4, at 335.

³⁷ MOORE, *supra* note 33, at 358-359.

³⁸ *Id.*

³⁹ FEILCHENFELD, *supra* note 4, at 341.

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

The third argument advanced by the Americans in Paris -- creditors holding the disputed loans knew or should have known that the debts would not be recoverable if Spanish sovereignty over the island were to end -- was similar to one of the predicates of the war debt exception. Under certain circumstances, sovereign lending does not reflect a judgment on the part of the investor about whether the country can or will repay the debt; it rather reflects a wager by the lender about whether the incumbent regime will remain in power long enough to repay the debt. Back the wrong horse, to use the racing metaphor, and the money is uncollectible. Only a disingenuous lender pretends otherwise. The important shift of emphasis here involves characterizing the debt as personal to a ruling regime, as opposed to assuming that any governing power -- by virtue only of the fact that it *is* governing -- is legally free to contract debts that bind the state.⁴⁰

3. Odious Debts

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

Both of these ideas received an important boost as a result of a 1923 arbitration involving Great Britain and Costa Rica. William Howard Taft (a former

⁴⁰ In the end, neither Cuba nor the United States assumed these debts in the Treaty of Paris, although Spain never formally abandoned its position on the matter. *Id.* at 343.

Yale law professor, colonial administrator of the Philippines, President of the United States and then Chief Justice of the United States Supreme Court) served as the sole arbitrator.⁴¹ The facts were these: In January 1917, the Government of Costa Rica was overthrown by Frederico Tinoco and his brother. His government lasted two years.⁴² Before he left the country, however, Tinoco managed to borrow some money from the Royal Bank of Canada. That money also left the country . . . in the company of Messrs. Tinoco.⁴³

In a subsequent arbitration of Great Britain's claim that the successor government of Costa Rica was bound to honor the loans extended by the Royal Bank of Canada. Costa Rica argued that the Tinoco Government was neither the *de facto* nor the *de jure* government of Costa Rica and thus could not, under international law, bind successor Costa Rican governments.⁴⁴ Mr. Taft disagreed. Citing various commentators, Taft held that under general principles of international law, a change of government has no effect upon the international obligations of the state.⁴⁵

That said, however, Taft refused to order Costa Rica to repay the Tinoco loans. These were, Taft said, not transactions of "an ordinary nature" but were "full of irregularities".⁴⁶ Mr. Taft ruled that the bank "must make out its case of actual furnishing of money to the government for its legitimate use. It has not done so. The bank knew that this money was to be used by the retiring president, F. Tinoco, for his

⁴¹ Great Britain and Costa Rica jointly chose Taft for this assignment. *See Choose Taft as Arbitrator*, N.Y. TIMES, Nov. 2, 1922. From Great Britain's perspective, however, Taft was an unhappy choice as sole arbitrator. Taft's experience as the colonial administrator of the Philippines left him with an acute distaste for political corruption in what we would today call third world countries. *See* STANLEY KARNOW, IN OUR IMAGE: AMERICA'S EMPIRE IN THE PHILIPPINES 231 (1989) ("...Taft deplored the pervasive 'tyranny' of Filipino officials who never understood that 'office is not solely for private emolument'").

⁴² *Arbitration Between Great Britain and Costa Rica* (1923) 1 U.N. REP. INT'L ARB. AWARDS 369, reprinted in 18 AM. J. INT'L L. 147, 148 (1924) (hereinafter "Tinoco Arbitration").

⁴³ *Id.* at 149. *See also* Anna Gelpern, *Sovereign Debt Restructuring: What Iraq and Argentina Might Learn from Each Other*, 6 CHI. J. INT'L L. 391, 411 (2005).

⁴⁴ Tinoco Arbitration, reprinted *supra* note 42, at 149.

⁴⁵ *Id.* at 150–152.

⁴⁶ *Id.* at 168.

personal support after he had taken refuge in a foreign country. It could not hold his own government for the money paid to him for this purpose.”⁴⁷

Costa Rica’s ability to disown responsibility for the Royal Bank of Canada loans therefore had nothing to do with the questionable legal status or legitimacy of the Tinoco Government. Taft expressly rejected this line of argument as being inconsistent with the doctrine of state succession.⁴⁸ Costa Rica *could* avoid responsibility for repaying the debts, Taft held, because the Royal Bank of Canada knew that the proceeds of its loans would benefit only Tinoco himself, not the state or the people of Costa Rica.⁴⁹

The lessons of Cuba, the Boer War settlement and the Tinoco Arbitration were not lost on the international lawyers of this era. Lenders were repeatedly warned about extending loans that might, following a regime change in the debtor country, be portrayed as hostile to the citizens of that country, personal to a departing dictator, or otherwise lacking the consent of the people ultimately bound to repay the loans.⁵⁰

In 1927, a Russian jurist, Alexander Sack, stirred this cauldron once again and defined a class of what he called “odious” debts.⁵¹ In Sack’s formulation, a sovereign debt is presumptively odious if:

⁴⁷ *Id.*

⁴⁸ *Id.* at 169.

⁴⁹ *Id.*

⁵⁰ “[The lender] must, at the present day, anticipate dangers in imposing on communities having no voice in negotiation fiscal burdens lacking local approval, unless the benefits of the loan through the expenditure of proceeds are confined to the territory burdened with service.” Charles C. Hyde, *The Negotiation of External Loans With Foreign Governments*, 16 AM. J. INT’L L. 523, 531 (1922). See also *Williams*, supra note 31 at 55 (“A creditor who claims for money lent to satisfy the personal whims of a despot or dictator has not so good a claim for money as one who advanced his money for the economic development of the country on the faith of the legislative act of a representative assembly.”)

⁵¹ ALEXANDER N. SACK, LES EFFETS DES TRANSFORMATIONS DES ETATS SUR LEURS DETTES PUBLIQUES ET AUTRES OBLIGATIONS FINANCIERES [THE EFFECTS OF STATE TRANSFORMATIONS ON THEIR PUBLIC DEBTS AND OTHER FINANCIAL OBLIGATIONS] 157–84 (1927).

- the debt is contracted by a “despotic” power,⁵²
- for a purpose that is not in the general interests or needs of the state, and
- the lender knows that the proceeds of the debt will not benefit the nation as a whole.⁵³

Under Sack’s theory, the consequence of tarring a debt with the label “odious” is that the debt is deemed to be personal to the despotic regime that contracted it and can only be collected from that regime.⁵⁴ It follows that successor governments of the country can legally repudiate the debt once the despot is removed.

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

Under this definition, therefore, a Virtuous Debt (one that benefits, however remotely, the people obliged to repay the debt), even if incurred by a tyrannical regime, cannot be branded odious. A Profligate Debt, no matter how hare-brained the intended use of proceeds, is not odious if it is contracted by a representative government. Finally, a Profligate Debt borrowed by a detestable regime is not odious if the lender genuinely believes that the proceeds will be used for a purpose that benefits the country.

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

⁵² *Id.* at 157. The implication here seems to be that the people of a country do not consent to the incurrence of debts by a despot.

⁵³ *Id.*

⁵⁴ *Id.*

odious debt into more gauzy factual situations reveals its limits as a legal diagnostic tool.

For example, the Tinoco case was remarkable only to the extent that Tinoco appears to have appropriated for his own use the *entire* proceeds of the Royal Bank of Canada loans.⁵⁵ Modern dictators do not behave in this way, and even the most indulgent lender might nowadays balk at a credit proposal whose “use of proceeds” line reads “corruption -- high, wide and handsome”. The modern technique is to steal only part of a loan, not the whole of it. So, the construction of a new hospital for children with terminal diseases requires financing of \$50 million. The dictator *du jour* demands (indirectly, of course) a modest 5% commission; perhaps a level just below what an open-eyed lender would be forced to confront in its due diligence investigation. Is the loan odious? Partially odious (a new concept)? Does the overwhelmingly virtuous purpose of the loan justify, in a moral sense, a small blemish of transactional corruption? How would the terminally-ill children vote on that question?

Most of the elements of the odious debt idea were already in play before Alexander Sack added his contribution in 1927.⁵⁶ Among these was the notion that if a country (meaning the population of the country over time) must assume the burden of repaying a debt, it should have realized some benefit from the loan when the debt was incurred. Debts imposed on a country without the consent of the citizens are suspect. A creditor that advances money to a ruling regime knowing that the proceeds will not benefit the nation or its people can expect repayment only from the individuals contracting the debt.

Did the odious debt formulation therefore add anything new to this debate, or was it intended merely as a summary and restatement of the discussion as it stood in the late 1920s? We believe that the odious debt doctrine was just a summary and restatement. From the War Debt and Hostile Debt exceptions, Sack drew the idea of loans that were used only to “strengthen” the governing regime, “suppress a popular insurrection” or were otherwise “hostile” to the interest of the people of the

⁵⁵ See Tinoco Arbitration, reprinted *supra* note 42, at 169 (“[The credit transfers in question were] so closely connected with this payment for obviously personal and unlawful uses of the Tinoco brothers that in the absence of any explanation on behalf of the Royal Bank, it cannot be made the basis of a claim that it was for any legitimate governmental use of the Tinoco government.”).

⁵⁶ See *id.* at 150 (discussing state succession principles under international law); see also FEILCHENFELD *supra* note 4, at 329-343 (discussing the principles established in the Cuban case).

country.⁵⁷ From Taft's decision in the *Tinoco* Arbitration, Sack gleaned the requirement that the lender know about the illegitimate purpose of the borrowing before the loan could be branded objectionable, as well as the notion that such a debt was "personal" to the ruler who commissioned it.

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

C. The Rebirth of the Odious Debt Debate

The concept of odious debts languished in something of a doctrinal backwater for many years. The phrase was occasionally enlisted for its emotive force to describe the pillaging of state treasuries by dictators such as Marcos in the Philippines, the Duvaliers (*père* and *fils*) in Haiti, Mobutu in the Congo or the Abachas in Nigeria.⁵⁸ Only rarely was the legal significance of the doctrine tested in municipal courts of law as a defense to the repayment

⁵⁷ Sack, *supra* note 51 at 157.

⁵⁸ See, e.g., Joseph Hanlon, *Dictators and Debt* (Jubilee Reports, Nov. 1998) (<http://www.jubileeresearch.org/analysis/reports/dictatorsreport.htm>). See also PATRICIA ADAMS, *LOOSE LENDING, CORRUPTION AND THE THIRD WORLD'S ENVIRONMENTAL LEGACY* (1991); Juliette Majot, *The Doctrine of Odious Debts*, in *FIFTY YEARS IS ENOUGH: THE CASE AGAINST THE WORLD BANK AND THE INTERNATIONAL MONETARY FUND* 35 (1994); James L. Foorman & Michael E. Jehle, *Effects of State and Government Succession on Commercial Bank Loans to Foreign Sovereign Borrowers*, 1982 U. ILL. L. REV. 1, 9 (1982); Günter Frankenberg & Rolf Knieper, *Legal Problems of the Overindebtedness of Developing Countries: The Current Relevance of the Doctrine of Odious Debts*, 12 INT'L. J. OF SOCIOLOGY OF L. 415 (1984); M. H. Hoeflich, *Through a Glass Darkly: Reflections upon the History of International Law of Public Debt in Connection with State Succession*, 1982 U. ILL. L. REV. 1, 39 (1982); Theodor Meron, *The Repudiation of Ultra Vires State Contracts and the International Responsibility of States*, 6 INT'L. & COMP. L. Q. 273 (1957); Alexander N. Sack, *Diplomatic Claims Against the Soviets*, New York University, Contemporary Law Pamphlets, Series 1, Number 7, NYU L. Q. REV. (1938).

of a sovereign debt,⁵⁹ or in an international arbitration.⁶⁰

This changed abruptly, however, following the American invasion of Iraq in 2003 to oust the regime of Saddam Hussein. During the roughly 25 years that Saddam controlled Iraq, his regime managed to rack up approximately \$125 billion of unpaid debts.⁶¹ Following the American invasion, a number of commentators argued that most of these liabilities, in light of their provenance and their purpose (in large part to finance domestic tyranny and military aggression), should be declared odious and written off.⁶² This in turn kindled a significant resurgence in the literature

⁵⁹ *Jackson v. People's Republic of China*, 550 F. Supp. 869, 872 (N.D. Ala. 1982); *Jackson v. People's Republic of China*, 794 F.2d 1490, 1495 (11th C. 1986). See James E. Feinerman, *Odious Debts: Old and New* (unpublished draft on file with authors) (forthcoming, DUKE JOURNAL OF LAW AND CONTEMPORARY PROBLEMS, 2006) (providing an extended discussion of the Chinese Railroad debt and the treatment of the odious debt issue in the *Jackson* case itself). See also *United States v. National City Bank of New York*, 90 F. Supp. 448, 452 (S.D.N.Y. 1950) and *Lehigh Valley R. Co. v. State of Russia*, 21 F.2d 396, 401 (2d Cir. 1927). The *Lehigh Valley* court quotes the following passage from Moore:

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

Lehigh Valley, 21 F.2d at 401 (internal citation omitted).

⁶⁰ In the context of an arbitration before the Iran Claims Tribunal, Iran argued that a certain contract of the prior regime was odious and could not be transferred to the Islamic Republic of Iran. The Tribunal's decision refused to take a stand on the "doctrinal debate" about the concept of odious debt in international law. The Tribunal did volunteer its view, however, that the concept of odious debt was limited exclusively to cases of state succession, not governmental succession. *United States v. Iran*, 32 IRAN-U.S. CL. TRIB. REP. 162, Award No. 574-B36-2 (Dec. 3, 1996).

⁶¹ See Ali Allawi, *Why Iraq's Debt Deal Makes Sense*, EUROMONEY (Sept. 2005) at 213.

⁶² See, e.g., *Pentagon Adviser Perle: Private Sector Key to Iraqi Recovery*, 53 THE OIL DAILY, No. 12, June 12, 2003 (reporting that Richard Perle, member of the Pentagon's Defense Policy Board, called for Iraq's \$100 billion plus of debt to be forgiven because it had been accumulated under a "vicious dictatorship"); Patricia Adams, *Iraq's Odious Debts*, September 28, 2004 (Cato Institute Publication No. 526) (available at: <http://www.cato.org/pubs/pas/pa526.pdf>); Joe

and debate surrounding the topic of odious debt.⁶³ You are holding in your hands a specimen of that resurgent literature.⁶⁴

Siegle, *After Iraq Let's Forgive Some Other Debts*, INTERNATIONAL HERALD TRIBUNE, Feb. 19, 2004 (reprinted at http://www.cfr.org/publication/6786/after_iraq_lets_forgive_some_other_debts.html). *But see Iraq's debt: The US should beware the principle of odious lending*, FINANCIAL TIMES, Jun 16, 2003, 20 (available at: <http://proquest.umi.com/pqdweb?index=2&did=347782151&SrchMode=1&sid=3&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1138240556&clientId=15020>).

⁶³ See, e.g., NOREENA HERTZ, IOU: THE DEBT THREAT AND WHY WE MUST DEFUSE IT (2004); Joseph Hanlon, "Illegitimate Debt": When Creditors Should be Liable for Improper Loans, in SOVEREIGN DEBT AT THE CROSSROADS 109 (Chris Jochnick & Fraser A. Preston eds. 2006); Chris Jochnick, *The Legal Case for Debt Repudiation*, in *id.* at 132. Anupam Chander, *Odious Securitization*, 53 EMORY L. J. 923 (2004); Adam Feibelman, *Contract, Priority, and Odious Debt* (unpublished draft dated May 1, 2006, on file with authors); Anna Gelpern, *What Iraq and Argentina Might Learn from Each Other*, 6 CHI. J. INT'L L. 391 (2005); Joseph Stiglitz, *Odious Rulers, Odious Debts*, THE ATLANTIC MONTHLY, Nov. 2003 (available at <http://www.theatlantic.com/doc/prem/200311/stiglitz>); Christoph G. Paulus, *Do "Odious Debts" Free Over-indebted States from the Debt Trap?*, UNIFORM L. REV. (2005) (available at: <http://www.iiiglobal.org/country/germany/UniformLawR.pdf>); Ashfaq Khalfan, Jeff King & Bryan Thomas, *Advancing the Odious Debt Doctrine* 13-21, Center for International Sustainable Development Law Working Paper No. COM/RES/ESJ (Mar 11, 2003) (available at <http://www.cisd.org/pdf/debtentire.pdf>); Michael Kremer & Seema Jayachandran, *Odious Debt* (April 2005 draft available at http://post.economics.harvard.edu/faculty/kremer/webpapers/Odious_Debt05.pdf) (forthcoming American Economic Review, 2006).

⁶⁴ In pursuing a cancellation and restructuring of the Saddam-era debt stock, the new Iraqi authorities were not oblivious to the potential relevance of the odious debt label. Iraq's Minister of Finance, Ali A. Allawi, described the concept in a sympathetic way in a September 2005 article. He wrote:

Widely different views have been expressed about the appropriate treatment of Iraq's Saddam-era debts. Some have argued that all of this debt, in view of its provenance, should be classified as odious and cancelled outright. Lend to a despot, they say, and you should expect repayment only from the despot.

Much of this renewed interest in odious debt enlists the terminology, but not the actual content, of the conventional doctrine. An odious debt, *à la* Alexander Sack, called for a loan-by-loan analysis. Some of the recent commentators are prepared to assume that all odious regimes behave odiously all the time and therefore all of their debts must be odious. The emphasis is thus placed on the odious nature of the regime, not on the circumstances surrounding each loan. All loans to a dictatorial regime are thus presumptively odious and liable to repudiation if the regime collapses.⁶⁵

Under this approach, much of the definitional swamp referred to above can be circumvented. Sack's formulation called for difficult judgments about whether a particular loan "benefits" the country, how the "consent" of the population to the incurrence of a debt could ever be established and what standards will be applied in assessing the lender's "knowing" involvement in the transaction.⁶⁶ These questions are largely irrelevant if the only significant criterion for identifying an odious debt is that the loan was extended to an opprobrious regime. From Sack's original list, therefore, only one significant criterion remains -- deciding whether the borrowing regime is "despotic" (or at least *was* despotic at the time the loan was made).⁶⁷

If a country manages to free itself from the incubus of an odious regime, the citizenry should not be forced to carry the burden of that regime's immoral extravagances for generations to come.

See Allawi, *supra* note 61.

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

⁶⁵ Khalfan, et. al, for example, argue that a Sackian debt-by-debt analysis "assumes without justification that absence of consent may not be presumed in instances involving dictatorial governments." They hold that a "dictatorial government is one that *by definition* rules without the consent of the people. It follows that in purported dictatorial polities consent must be presumed absent, unless proven otherwise (by widespread popular approval of the transaction)." Khalfan, et. al, *supra* note 63, at 42; *cf. also* Hanlon, *supra* note 61 (emphasizing the odiousness of the regime, rather than creditor consent or benefits to the populace, as the primary reason to nullify the debt).

⁶⁶ *See supra* notes 50–51 and accompanying text.

⁶⁷ Khalfan, et. al, *supra* note 63, at 42.

To some modern commentators, therefore, the debate no longer involves odious debts, it involves debts of an odious regime.⁶⁸ This is a major shift. It is curious that some of these commentators do not appear to be aware of how far they have left Alexander Sack and Chief Justice Taft behind.

Indeed, it would astonish Alexander Sack to learn that his catchy adjective “odious” had, in the twenty-first century, become the rallying cry of groups advocating the wholesale forgiveness of the sovereign debt of countries victimized by despotic or kleptomaniacal regimes. Sack himself would have recoiled at casually branding debts as odious. Sack envisioned the formation of international tribunal charged with making the determination of odiousness. In a proceeding before that tribunal, the burden of persuasion would rest with the new government seeking to disavow responsibility for the debt. A new government would be required to establish that the proceeds of the borrowing were used for purposes contrary to the interests of the population of the country and that the lender, at the time the loan was extended, knew this to be the case.⁶⁹ Even then, Sack’s tribunal would afford the lender an opportunity to rebut the inference of an odious purpose to the loan.⁷⁰

Throughout the balance of his long career as a law teacher, Alexander Sack advocated a very strict application of the doctrine of government succession to debt obligations. State public debts, he later wrote, are a “charge upon the territory of the State,” by which he meant the entire financial resources of the State within its territorial limits.⁷¹ He openly ridiculed the argument of the Soviet government in the USSR in 1918 that it, as the government of the “workers and peasants”, had the legal right to repudiate the debts incurred by prior Russian governments of the “landlords and bourgeoisie”.⁷²

III. Do We Need a Doctrine of Odious Debts?

It is morally repugnant to saddle the population of a country, down unto generations yet unborn, with the obligation to repay debts that are truly odious in the

⁶⁸ See generally note 63 and accompanying text.

⁶⁹ Sack, *supra* note ___ at 163.

⁷⁰ *Id.*

⁷¹ Alexander Sack, *The Judicial Nature of the Public Debt of States*, 10 N.Y.U. Law Quarterly 341, 357-58 (1932).

⁷² See Alexander Sack, *Diplomatic Claims Against the Soviets (1918-1938)*, N.Y.U. Law Quarterly Rev., 1, 10 (1937).

Sackian sense. Most people instinctively believe that the consequences of reprehensible acts should be visited exclusively on the malefactors (in this case, the corrupt regime and its complaisant creditors). The question is: can this moral imperative be translated into a workable legal theory?

We might start by questioning the fundamental premise of the rule about government succession to debt obligations. Why should international law start with the presumption that all state debts automatically bind successor governments, and force the naysayers to wring out begrudging exceptions to this rule? Why not turn the thing on its head and presume that successor governments are bound only by those obligations that they expressly agree to assume? After all, as noted above, this is the rule that our society has found appropriate for the transmission of the unsatisfied personal debts of a decedent.⁷³

There are two answers to these questions. The inheritance of Virtuous Debts by successor governments and generations of citizens does not strike most people as unreasonable. The benefit/burden theory articulated by the early publicists has a foundation in common sense. Our property and inheritance laws also reflect it.⁷⁴ Uncle Otto's gambling debts will not automatically pass to Otto's next of kin, but the mortgage on Uncle Otto's house must be assumed by his heir if that person wants to live in the house. With the benefit comes the burden.⁷⁵

On the practical side, no one will lend to a sovereign borrower knowing the debt will automatically be extinguished by the next election or even by the next revolution. Nor, by the way, would anyone lend to a corporate borrower if the debt could be legally repudiated by a successor board of directors or majority shareholder. The presumption of state succession to previously-incurred debts thus provides the legal basis for all cross-border lending to sovereign borrowers. Undermining that presumption could significantly affect the ability of sovereign borrowers to raise capital.⁷⁶

The dilemma therefore boils down to this: can the strict rule of government succession to debt obligations be moderated to prevent it from sanctioning the

⁷³ See *supra* note 2 and accompanying text (referencing the general operation of inheritance laws in the United States).

⁷⁴ See RESTATEMENT OF PROPERTY § 537 (1944) (discussing the relationships between benefits and burdens).

⁷⁵ *Id.*

⁷⁶ See, e.g., Raghuram G. Rajan, *Odious or Just Malodorous*, FINANCE & DEVELOPMENT 54 (December 2004).

morally repugnant consequence of an involuntary transmission of objectionable debts, without bringing a significant part of cross-border sovereign finance to a standstill?

A. What Is the Objective?

The muddled nature of the recent debate about odious debts cannot be blamed exclusively on the tendency of some modern commentators to allow the adjective “odious” to migrate away from modifying the word “debt” into a position where it instead modifies the word “regime”.⁷⁷ Beneath the surface of the debate, there is also a fundamental disagreement about the objective of the entire exercise.

A traditionalist -- a Sackian -- would say that the objective is to identify objectionable cross-border financial transactions that should not be enforceable, by legal or diplomatic means, if the governmental regime in the debtor country changes. Others, however, aim at a more ambitious goal. They wish to define both the standard and the mechanism by which odious regimes can be spotted *before* the money is lent.⁷⁸ The theory is very similar to a public notice system for the recording of security interests: once the mortgage or security interest has been filed, subsequent lenders are on notice that the property is encumbered by a prior lien.⁷⁹ In this case, once a regime has been publicly and authoritatively branded as odious, subsequent lenders are on notice that their credits to the regime may be legally repudiated by a successor government.⁸⁰

For these modern odious debt theorists, therefore the most important thing is to be able to spot the despot, the dictator, the tyrant -- in other words, the odious regime.⁸¹ From there the analysis can proceed easily through a series of presumptions. Odious regimes can be presumed to act only in their own self-interest, that’s how they earned the moniker “odious” in the first place. Creditors who deal with such regimes can be presumed to know their self-dealing habits. Those

⁷⁷ See Gelpern *supra* note 43, at 393; Khalfan, et. al., *supra* note 63, at 47; Seema Jayachandran, Michael Kremer, & Jonathan Shafter, *Applying the Odious Debts Doctrine While Preserving Legitimate Lending*, (forthcoming, ETHICS & INT’L AFFAIRS (2006)); KREMER & JAYACHANDRAN, *supra* note 63, at 3-4.

⁷⁸ E.g., KREMER & JAYACHANDRAN, *supra* note 63, at 3-4.

⁷⁹ See generally, 55 AM. JUR. 2d Mortgages § 307 (2005).

⁸⁰ *Id.*

⁸¹ *Id.*

creditors are thus knowingly placing an “all or nothing” bet on the continuance of the regime when they assess the commercial risk of the loan. And finally, lenders being lenders, one may confidently predict that the pricing of the loan will reflect (upward) this all or nothing political gamble on the part of the creditors. If the risk materializes, the theory concludes, the legal judgment and the moral judgment on the lenders should be identical -- too bad.⁸²

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

At least one principled argument can be marshaled in support of a regime-centric approach to odious debt. An odious regime is, by definition, a curse upon the people of the country. Anything done to support such a regime is therefore hostile to the interests of those people. If financing a new hospital for children with terminal diseases allows the regime to present itself as compassionate and civilized, and if that illusion allows the regime to remain in power even one day longer than would otherwise have been the case, then the financing for that project is inimical to the general interests of the population. Naturally, this same argument would support the repudiation of any contractual arrangement with an odious regime, not just debt contracts.

Similarly, international humanitarian organizations send emergency relief teams into some of the most appalling conditions imaginable and they are occasionally pilloried for doing so.⁸³ By alleviating the suffering inflicted by a barbarous regime, critics argue, these humanitarians are just deferring the time when that regime must face the full unbuffered wrath of its own people and the

⁸² Richard Perle’s call for the elimination of Iraq’s debts on the grounds that this would have the effect of teaching banks about the risks of lending to a “vicious regime” was in this vein. See James Harding, *Top Adviser Backs Loan Forgiveness*, FINANCIAL TIMES, 12, June 12, 2003. See also Jayachandran, Kremer, & Shafter, *supra* note 77 (proposing an ex ante designation for regimes that are “Odious Debt prone”).

⁸³ Michael Wines, *When Doing Good Also Aids the Devil*, N.Y. TIMES, Dec. 25, 2005, § 4, at 5.

international community.⁸⁴ Are the humanitarians not, under the guise of helping a few people, only prolonging the agony of many others?

These are deep moral waters. A regime-centric approach to identifying odious debts seeks to shut off the flow of funds to a contemptible regime -- and thus hasten its demise -- by threatening to invalidate the loans under public international law if the regime changes. International economic sanctions, of course, have the same goal. But the effect of such sanctions on the people of the target country (sanctions on Iraq between the first and second Gulf Wars are a good example) can be terrible, and such sanctions are not lacking in critics.⁸⁵

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

Some commentators would like to elevate the category of odious debts into a recognized exception to the rule of state succession⁸⁶; elevate it in such a way that bilateral (governmental) creditors would not be able to exert diplomatic pressure on successor governments to honor odious debts, and commercial creditors would not be able to enforce odious debts in municipal courts. Before it can be so elevated, however, the characteristics of this odious debt category need to be sharply defined.

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

⁸⁴ See, e.g., Doug Bandow, *Help or Hindrance: Can Foreign Aid Prevent International Crisis?*, 273 POL’Y ANALYSIS 1 (1997).

⁸⁵ See, e.g., David A. Baldwin, *Reconciling Political Sanctions with Globalization and Free Trade: Prologamena to Thinking about Economic Sanctions and Free Trade*, 4 CHI. J. INT’L L. 271, 276 (Fall 2003) (outlining the criteria for determining if economic sanctions are successful); Justin D. Stalls, *Economic Sanctions*, 11 U. MIAMI INT’L & COMP. L. REV. 115, 146–52 (Fall 2003) (highlighting the factors policy makers utilize when judging the effectiveness of economic sanctions). See also Carla Fried, *How States Are Aiming to Keep Dollars Out of Sudan*, N.Y. TIMES, Feb. 19, 2006 at B5.

⁸⁶ The categories of War Debts and Hostile Debts have probably reached this status already. See *supra*, notes 27 to 40 and accompanying text. See also J.G. STARKE, AN INTRODUCTION TO INTERNATIONAL LAW 274 (5th ed. 1963).

⁸⁷ SACK, *supra* note 45.

subjects. These were, interestingly, the only specific examples Sack himself offered of odious debts.⁸⁸

There is no need, by contrast, under the contemporary approach to the issue, to fret about whether the citizens of the debtor country had “consented” to a particular loan, or whether the loan “benefited” the country as opposed to the despot. These difficult judgments are swept away in the cascade of presumptions that follow from tagging a borrowing regime as odious. Unfortunately, even that one remaining judgment -- is this regime odious? -- can be elusive. One is tempted, strongly tempted, to adopt an approach along the lines of Justice Holmes’ rule-of-thumb for distinguishing an unconstitutional statute (“does it make you want to puke?”)⁸⁹ or Justice Stewart’s “I know it when I see it” standard for pornography.⁹⁰ But it isn’t that easy.

Odiusness -- whether of regimes, individuals or certain cooked green vegetables -- is a subjective concept. But in this context, it dangerously invites ethnocentrism. Is a democracy a necessary condition for avoiding the label odious? Is it a sufficient condition?⁹¹ Is universal suffrage a necessary predicate? Equal rights for women? Is a regime odious if it misprizes environmental issues or civil rights? And so forth and endlessly so on.

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

⁸⁸ *Id.*, at 157.

⁸⁹ See Letter from Justice Holmes to Harold Laski (Oct. 23, 1926), reprinted in 2 HOLMES LASKI LETTERS 1124, 888 (Mark DeWolfe Howe ed., 1953).

⁹⁰ *Jacobellis v. State of Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

⁹¹ See, e.g., Renwick McLean, *U.S. Bars Spain’s Sale of Planes to ‘Undemocratic’ Venezuela*, N.Y. TIMES, Jan. 14, 2006 at 6 (discussing a statement released in January, 2006 by the U.S. embassy in Caracas that described the administration of Venezuelan President Hugo Chavez, as “[d]espite being democratically elected, the government of President Hugo Chavez has systematically undermined democratic institutions, pressured and harassed independent media and the political opposition, and grown progressively more autocratic and antidemocratic.”).

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

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

This leaves the international community, or some subset or organ of the international community. But is this realistic? It would thrust the matter into the realm of international politics, a place where morality and predictability rarely penetrate. We do not believe that the international community, or any part of it, can be relied upon to reach a principled judgment about the odious character of a regime, divorced from the immediate geopolitical interests of the states (or their proxies) making that judgment. Saddam Hussein was, after all, the darling of the United States and its allies in the early 1980s when he was seen as a bulwark against Iran; he became a villain in their eyes only later in his career. Was Saddam odious (but unacknowledged as such) in the 1980s? Or did he mature into rank odiousness over time? And if the latter, why should the debts he incurred on behalf of Iraq in his more benignant youth be branded odious twenty years later?

Finally, to be useful in a litigation in the United States over an allegedly odious loan, the sovereign defendant would have to establish that the odious debt doctrine was now part of "international customary law" -- that is, part of the "general and consistent practice of states and followed by them from a sense of legal obligations."⁹² Even the advocates of an odious debt doctrine might hesitate before claiming that it is now part of the "general and consistent practice of states."⁹³

⁹² RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 102(2).

⁹³ See Christoph G. Paulus, *Odious Debts vs. Debt Trap: A Realistic Help?*, 31 BROOK. J. INT'L L. 83, 91 (2005) (noting that the doctrine of odious debts has not yet achieved the status of customary international law); Jeff King, *Saddam's Evil Debts*, FIN. POST (Oct. 23, 2003) ("... the [odious debt] doctrine is contestable under international law ..."); Paul B. Stephan, *The Institutional Implications of an Odious Debt Doctrine* (unpublished draft on file with authors) (forthcoming JOURNAL OF LAW & CONTEMPORARY PROBLEMS (2007)) (noting the lack of precedent on the matter of odious debt). Anna Gelpern writes:

IV. The Alternative: Principles of Private Law

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

We propose to focus on three fact patterns, each involving a loan to the Republic of Ruritania. The loan agreement is expressed to be governed by the law of the State of New York and Ruritania submits to the jurisdiction of New York courts for purposes of disputes about the loan.⁹⁴ In each case, the Ruritanian Minister of Finance signs the loan on behalf of the Republic, pledging the full faith and credit of the Republic for repayment of the debt. The three situations are:

- (i) At the time the money is borrowed, Ruritania is ruled by a corrupt dictatorship. The lender knows that all or a part of

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

Gelpern, *supra* note 43, at 406.

⁹⁴ Some advocates of an odious debt doctrine recommend actively trying to *avoid* New York courts as the forum for lawsuits involving sovereign debts that could qualify as odious. See Khalfan, et al., *supra* note 63, at 68-69 (“... New York would not be the ideal preliminary site for odious debts litigation.”) They argue - - correctly, in our view -- that New York courts would not be receptive to a defense based on a purported public international law doctrine of odious debts. The defenses discussed in Part IV.A, *infra*, however, are based upon existing principles of New York law and do not require a resort to a separate concept of an odious debt.

the proceeds of the loan will be stolen by members of the ruling regime (the “Corrupt Loan”). The lender accepts this pilfering in order to win the mandate or perhaps because the government is prepared to pay a higher interest rate on the loan than would have been true in the absence of this special feature of the transaction.

- (ii) Ruritania is ruled by a corrupt dictatorship. The lender suspects, but does not know for sure, that some or all of the proceeds of the loan will be stolen by members of the ruling regime (the “Suspicious Loan”).
- (iii) Ruritania has an elected, representative government. That government uses the proceeds of the loan for the sole purpose of funding a program to count -- individually -- each grain of sand in the vast Ruritanian desert; the counting to be done by a team composed exclusively of Nobel prize-winning economists. No personal corruption by government officials is involved or suspected (the “Utterly Fatuous Loan”).⁹⁵

The ruling regime in Ruritania subsequently changes; the new administration disavows the loan as being contrary to the interests of all honest Ruritanians; the loan goes into default; and the lender brings an action to enforce the loan in a U.S. court. What principles of U.S. domestic law might be relevant to the defense of such an action?

⁹⁵ In the world of sovereign borrowing, conjuring up a use of proceeds that would be recognized by the reader as *utterly fatuous* requires creativity. See, e.g., Richard N. Ostling, *The Basilica in the Bush: The Biggest Church in Christendom Arises in the Ivory Coast*, TIME (July 3, 1989) at 38 (reporting on a basilica, larger than St. Peter’s in Rome, built in the African bush, 135 miles from the nearest urban center with an estimated cost of over \$200 million).

A. Possible Defenses

1. Considerations of Public Policy

Bribery, whether in a commercial,⁹⁶ domestic political⁹⁷ or foreign governmental context,⁹⁸ is contrary to the public policy of the United States and its constituent states. In our hypothetical about the Corrupt Loan, the lender knew that the Ruritanian officials executing the loan agreement on behalf of the Republic were intending to pocket some or all of the proceeds of the loan. The lender acquiesced in this behavior because, in return, the lender received the mandate (and the fees) to arrange the loan, or perhaps the government officials committed the Republic to paying an above-market rate of interest on the loan. Whether the Ruritanian officials were paid an outright bribe to issue a mandate or to accept an overpriced loan, or whether the lender agreed to look the other way as the officials skimmed the proceeds of the loan itself, strikes us as irrelevant. The Ruritanian officials were induced to breach their fiduciary duty to Ruritania. They were bribed.

Had the lender been subject to the jurisdiction of the United States at the time the loan was extended, this conduct may have been criminal -- a possible violation of the U.S. Foreign Corrupt Practices Act.⁹⁹ But regardless of the lender's domicile, a

⁹⁶ Commercial bribery may violate state laws. *See Bankers Trust Company v. Litton Systems*, 599 F.2d 488 (2d Cir. 1979) (holding lease contracts for photocopiers unenforceable because they had arisen through an illegal bribe); *Pharmaceutical Sales and Consulting Corp., v. J.W.S. Delavau Co., Inc.*, 106 F.Supp.2d 761 (D.N.J. 2000) (stating that under New Jersey law, a public policy defense of commercial bribery can be asserted to avoid enforcement of a contract); *see also* N.Y. Penal Law § 180.00

⁹⁷ *See, e.g., U.S. v. Marmolejo*, 89 F.3d 1185 (5th Cir. 1996) (holding that a local sheriff was subject to a federal bribery statute enacted by Congress to further the public policy against bribery of government officials); *Brown Const. Trades, Inc. v. United States*, 23 Cl.Ct. 214 (Cl.Ct. 1991) (holding that the conviction of a public contractor on charges of bribery of a government official was sufficient to render a contract unenforceable).

⁹⁸ The Foreign Corrupt Practices Act of 1977, 15 U.S.C. §78dd-1(a) (2000); *Adler v. Federal Republic of Nigeria*, 219 F.3d 869 (9th Cir. 2000) (finding that an illegal contract entered into by plaintiff to bribe Nigerian officials barred the plaintiff's ability to recover on a breach of contract claim).

⁹⁹ 15 U.S.C. §§ 78m (2000).

subsequent lawsuit by the lender to enforce a contract (the loan) that had been procured by the plaintiff's own misconduct (the bribe) would not prosper in a U.S. court. As the New York Court of Appeals expressed it:

Consistent with public morality and settled public policy, we hold that a party will be denied recovery even on a contract valid on its face, if it appears that he has resorted to gravely immoral and illegal conduct in accomplishing its performance.¹⁰⁰

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

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

The general American rule regarding the assignment of contract rights provides that -- except in the case of negotiable instruments (which the Ruritanian loans are not) -- "[a]n assignee never gets a better right than the assignor had. If for any reason the assignor's claim was void, voidable, unenforceable, or conditional, so is the claim of the assignee."¹⁰² Consequently, the assignee of an unenforceable loan will thus face the same defenses that the borrower could have raised against the original lender/assignor.¹⁰³ An innocent assignee of such a loan, if denied the ability

¹⁰⁰ *McConnell v. Commonwealth*, 7 N.Y.2d 465, 471 (1960). *See also Oscanian v. Arms Co.*, 103 U.S. 261 (1880) (contracts to bribe or influence officials of foreign governments will not be enforced for public policy reasons; and the parties to the contract themselves cannot waive that illegality).

¹⁰¹ *See supra* Part II.B.3.

¹⁰² Arthur Corbin, *Assignment of Contract Rights*, 74 U. PA. L. REV. 205, 229 (1926). *See also* N.Y. Gen. Obligations L. § 13-105 (2005).

¹⁰³ An understandable desire to protect innocent assignees from financial loss can occasionally lead a court astray. An example is *Bankers Trust Co. v. Litton Business Telephone Systems*, 559 F.2d 488 (2d Cir. 1979), in which the court

to recover from Ruritania itself, may not be wholly without a remedy. That assignee would presumably have a claim against the original lender/assignor for rescission, fraud, or breach of representation.¹⁰⁴

In addition, American law provides ample maneuvering room for a judge who wants to balance equities in a case involving illegal behavior by one or more of the parties to a transaction. In the sovereign context, this flexibility could be used to validate a portion of a debt (for which the borrowing country received a benefit), while invalidating the remainder (for which no benefit accrued to the country as a whole).¹⁰⁵ Under the headings of “restitution” and “unjust enrichment”,¹⁰⁶ a court can fashion a remedy that penalizes a wrongdoer, apportions blame (and the consequences of blameworthy behavior) among multiple wrongdoers, shields the innocent, differentiates between venial and mortal sins against public policy, or does any of the foregoing in a manner that supports public policy while doing justice among the parties.¹⁰⁷

(wrongly) classified a lessee’s obligation under an equipment lease as a negotiable instrument in order to give commercial bank assignees of the lease payments “holder in due course” status (thereby shielding them from the lessee’s bribery defense against the lessor). *Id.* at 490–91.

¹⁰⁴ See RESTATEMENT (SECOND) OF CONTRACTS § 333(1)(b) (suggesting that an assignment for value is deemed to convey a warranty by the assignor that the debt is subject to no defenses good against the assignor other than those stated or apparent at the time of the assignment). See also, Lee C. Buchheit, *Legal Aspects of Assignments of Interests in Commercial Bank Loans*, in J. LEDERMAN, ET AL., *THE COMMERCIAL LOAN RESALE MARKET* 443, 449-50 (1991).

¹⁰⁵ An obvious example might involve a situation where the corrupt government officials in Ruritania misappropriated only a portion of the proceeds of the loan, the balance having gone into the Ruritanian state treasury. A claim for restitution or unjust enrichment might lie for the recovery of the funds not stolen by the corrupt officials. See generally, Christoph H. Schreuer, *Unjustified Enrichment in International Law*, 22 AM. J. INT’L L. 281, 295-96 (1974).

¹⁰⁶ See RESTATEMENT OF THE LAW OF RESTITUTION § 1 (“Unjust Enrichment”) (1937).

¹⁰⁷ See RESTATEMENT (SECOND) OF CONTRACTS Topic 5, Introductory Note, §§ 197-199 (1979). See also John Wade, *Restitution of Benefits Acquired Through Illegal Transactions*, 95 U. PA. L. REV. 261, 302 (1947) (“[A]s long as the matter [relief by way of restitution] is within the general discretion of the courts, flexibility . . . is possible. It would seem decidedly unfeasible to attempt to

2. Unclean Hands

The public policy concerns about enforcing contracts that are tainted by bribery or other illegal activity can also be vindicated through the defense of “unclean hands” (the maxim of equity being that “he who comes to equity must come with clean hands.”).¹⁰⁸ This doctrine can also limit the ability of a lender to enforce a debt contracted under irregular circumstances. As explained by the Supreme Court:

This maxim . . . is a self-imposed ordinance that closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief, however improper may have been the behavior of the defendant.¹⁰⁹

The maxim has been applied in a sovereign context to deny a recovery to plaintiffs that were participating in a criminal scheme with foreign governmental officials. In *Adler v. Federal Republic of Nigeria*,¹¹⁰ the plaintiff, James Adler, had been lured by Nigerian government officials and others into a bogus scheme through which he hoped to share in a \$130 million bonanza from over-invoiced contracts with the Nigerian government.¹¹¹ Neither the contracts nor the money ever existed; Adler was simply the dupe of what is, in Nigeria, a quotidian confidence fraud. But what an enthusiastic dupe he turned out to be. Adler paid more than \$5 million as bribes and commissions to Nigerian government officials and others in order to stay in the game.¹¹² When the scales finally fell from his eyes, Adler sued the Republic of Nigeria, its Central Bank, a former Central Bank Governor and others in a federal court in California to recover the bribes and commissions.¹¹³

reduce the law in this field to a series of inflexible rules which would seek to cover every possible situation.”)

¹⁰⁸ See HENRY L. MCCLINTOCK, *HANDBOOK OF THE PRINCIPLES OF EQUITY* 52 (1948).

¹⁰⁹ *Precision Instrument Manufacturing Co. v. Automotive Maintenance Machinery Co.*, 324 U.S. 806, 814 (1945).

¹¹⁰ 219 F.3d 869 (9th Cir. 2000).

¹¹¹ *Id.* at 872-73.

¹¹² *Id.* at 873.

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

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

This argument met with a frosty reception at the Court of Appeals. “[T]he fact that the defendants will receive a windfall,” the Ninth Circuit said, “is not an absolute bar to the unclean hands defense.”¹¹⁶ In addition,

[P]ublic policy favors discouraging frauds such as the one perpetrated on Adler, but it also favors discouraging individuals such as Adler from voluntarily participating in such schemes and paying bribes to bring them to fruition.¹¹⁷

Applying this doctrine to the Republic of Ruritania, a lender attempting to enforce in a U.S. court the Corrupt Loan (which involved, with the lender’s knowledge and acquiescence, corruption on the part of Ruritanian officials) could be met by a defense of unclean hands. The defense might even be available in the case of the Suspicious Loan, depending on how deliberately obtuse the lender may have been in its investigation of the use of proceeds of the loan.¹¹⁸ An unclean hands

¹¹⁴ Under New York law, however, the ability to raise an equitable unclean hands defense in an action at law may not be as clear, despite New York’s abolition of all distinctions between actions at law and suits in equity. See N.Y. Civil Practice Law and Rules § 103(a)(2006); *Digiulio v. Robin*, 2003 WL 21018828 (S.D.N.Y. 2003).

In *Byron v. Clay*, Judge Posner noted: “[W]ith the merger of law and equity, it is difficult to see why equitable defenses should be limited to equitable suits any more; and, of course many are not so limited, and perhaps unclean hands should be one of those. Even before the merger there was a counterpart – *in pari delicto* – which forbade a plaintiff to recover damages if his fault was equal to the defendant’s.” 867 F.2d 1049, 1052 (7th Cir. 1989) (citations omitted).

¹¹⁵ 219 F.3d 877.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ See *infra* notes 129– 131, and accompanying text.

defense put forward by a successor Ruritanian government could relieve Ruritania from the obligation to repay the tainted loan.

Unclean hands is an equitable defense. In some states (but not in all), this equitable defense may be unavailable in an action at law for money damages. If sued in such a state for money damages, the defendant may have to rely on legal defenses that cover much the same ground, such as fraud, illegality¹¹⁹ or *in pari delicto*.¹²⁰

3. Agency Law

Our three hypothetical loans may also be analyzed under principles of agency law. For this purpose, we view Ruritania (meaning the country and its population over time) in the position of the “principal,” and the individual members of the government or ruling regime in Ruritania (representative or despotic) at any particular time as the “agents” of that principal insofar as they enter into contracts on behalf of the Republic of Ruritania with third parties such as lenders.¹²¹

In *Alaska Continental Bank v. Anchorage Commercial Land Assoc.*, 781 P.2d 562 (Sup. Ct. Alaska 1989), for example, a bank lent money to a limited partnership knowing that the consent of the limited partners (and not just the general partner who signed the loan) was required for such a borrowing under the partnership agreement. When the partnership subsequently sought a declaration that it was not obligated to repay the loan, the bank argued that the partnership was equitably estopped from contesting the validity of a loan whose proceeds it had received.

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

¹¹⁹ See Dan B. Dobbs, *Dobbs Law of Remedies*, vol. 1 at 152 (2d ed. 1973).

¹²⁰ *Id.*, at 95, n. 6 and accompanying text.

¹²¹ At least two other commentators in the modern odious debt literature look to principles of agency law to buttress their arguments. In both cases, however, the discussions are brief and tangential to the central point being made, which is to argue for recognition of a doctrine of odious debts under principles of

Viewing the people of a country as the principal, and the government as the agent, is more than just a metaphor; it is how American political philosophy¹²² and American law¹²³ have always viewed the governmental relationship.¹²⁴ It doesn't matter that despotic regimes would contest this characterization. It is the very nature of despotic regimes that they regard themselves -- like Nero (by the grace of the Praetorian Guard) or Louis XIV (by the grace of Divine Right) -- as the rulers of the people, rather than their agent, much less their servant.¹²⁵ But the fundamental premise of the American political experiment is that ultimate sovereignty and political authority rests with the people, and it is this premise that we believe would

international law. See Hertz, *supra* note 63, at 179 (using the doctrine of actual authority from agency law to justify the first of the Sackian criteria; arguing that democratic consent should, as a matter of international law, be a precondition to recognizing the authority of a regime to contract on behalf of its citizens); Khalfan, *et al.*, *supra* note 63, at 37-39 (pointing to common law principles of agency law, drawn from British and Canadian cases, that impose liability on third parties who willfully or knowingly assist in a breach of trust.)

¹²² See THE FEDERALIST NO. 46, 243 (James Madison) (George W. Carey & James McClellan eds., 2001) (“[G]overnments are in fact. . . agents and trustees of the people. . . .”).

¹²³ See Richard I. Pierce, Jr., *The Role of the Judiciary in Implementing an Agency Theory of Government*, 64 N.Y.U. L. REV. 1239 (1989) (“The Constitution is premised on the belief that government should act as the agent of the people.”); see also Steven G. Calabresi, *Political Parties and Mediating Institutions*, 61 U. CHI. L. REV. 1479, 1523–24 (1994) (finding a “noncontractual agency relationship” between voters and government officials); Robert G. Natelson, *The Constitution and the Public Trust*, 52 BUFF. L. REV. 1077, 1095–1102 (2004) (finding assertions of fiduciary duties owed by government officials to citizens in Aristotle and Cicero).

¹²⁴ The conceptualization of “the people” as the principal and the government (whether constituted by a monarch an external colonizer, or democratically elected representatives), as the agent, has a history dating back at least to the 13th century. See Jedediah Purdy, *Trust, Agency, Wardship: Private Law Concepts in the Development of Sovereignty* (draft dated May 1, 2006, on file with authors)

¹²⁵ See THOMAS HOBBS, *LEVIATHAN* 255 (C.B. MacPherson ed., 1968) (comparing the relationship between a despotic ruler and his citizens to that of a master over his servants).

guide an American court in applying the law of agency to the legal relationships created by our hypothetical Ruritanian loans.¹²⁶

The sovereign debt context raises a typical concern of agency law -- that of the faithless agent who purports to bind her principal to an obligation to a third party when the fruits received in return for the obligation accrue only to the agent. Who, as between the principal (the country and its citizens) and the third party (the lender) should bear this risk of the faithless agent? American agency law, using familiar concepts of “authority,” is clear that this risk is usually laid at the feet of the principal. The reasons reflect both business expediency and some element of efficient risk bearing.¹²⁷ Commerce would slow to a crawl if too severe a burden were put on creditors constantly to check back with a principal as to whether an agent

¹²⁶ A lack of consent can be argued to defeat an agency relationship, since the common law bases its agency rules on a consensual relationship manifested by both the principal and agent. *See* Restatement (Second) of Agency, Section 1(1). (“Agency is the fiduciary relation which results from the manifestation of consent by one person [the principal] to another that the other [the agent] shall act on his behalf and subject to his control, and consent by the other so to act.”)

The consent of the governed sometimes slips insensibly into usurpation by the governors. Ferdinand Marcos was twice elected President of the Philippines until, legally banned from seeking reelection, he declared martial law and clung to power for another thirteen years. *See* Stanley Karnow, *In Our Image* 356-57 (1989). If an agent, initially enjoying the consent of the principal, eventually overbears and controls the principal, has the agency relationship been destroyed? If so, this may not be apparent to the third parties who continue to deal with the agent as agent. The better way to analyze this situation is to see the principal as being temporarily deprived of its ability to instruct and control agent.

¹²⁷ The commentary to the *Restatement (Second) of Agency* observes that while a person relying on the appearance of agency knows that the apparent agent is not authorized to act except for the benefit of the Principal, this is something that the third party normally cannot ascertain “and something therefore for which it is rational to require the Principal, rather than the other party to bear the risk. The underlying principle based on business expediency—the desire that third persons should be given reasonable protection in dealing with agents, finds expression in many rules...The line at which the Principal’s liability ceases is a matter of judicial judgment.” RESTATEMENT (SECOND) OF AGENCY §262, Comment a.

had authority. As between the principal and the third party, the principal who puts the agent in a position to cause the harm ought normally to bear the risk.¹²⁸

But there are circumstances -- out-of-the-ordinary and suspicious circumstances -- in which U.S. agency law places the risk of a runaway agent, and the burden of unclocking such a runaway, on a third party such as a creditor. For instance, where a corporate officer signs a guaranty for a debt for which the corporation is not receiving any benefit, “the duty of diligence in ascertaining whether an agent is exceeding his authority devolves on those who deal with him, not on his principal.”¹²⁹ In a well-known case where the vice-president and treasurer of the Anaconda Corporation purported to act for Anaconda in guaranteeing the debt of another company, the court held that the third party, the recipient of the guaranty, could not rely on the asserted agency to bind Anaconda.¹³⁰ What shifts to the third party the burden of verifying the agent’s fidelity to his principal in a particular transaction is the presence of visibly suspicious circumstances or behavior.¹³¹

Such a shift usually shows up in the context of “apparent authority” when elements of the “actual authority” of the agent cannot be shown.¹³² It is relatively easier in a sovereign debt context (as opposed to the normal corporate setting) for the agents to provide the instruments of authority that are typically taken to satisfy indicia of actual authority. The same upturned hand that receives a bribe can, when inverted, sign the decree authorizing the incurrence by the state of the obligation procured by that bribe. This is one of the reasons why the laws of many countries

¹²⁸ *See id.*

¹²⁹ *Strip Clean Floor Refinishing v. New York District Council No. 9*, 333 F. Supp. 385, 396 (E.D.N.Y. 1971).

¹³⁰ *General Overseas Films, Ltd. v. Robin International, Inc.*, 542 F. Supp 684, 690 (S.D. N.Y. 1982) (“Because the circumstances surrounding the transaction were such as to put Haggiag on notice of the need to inquire further into Kraft’s power and good faith, Anaconda cannot be bound.”).

¹³¹ Absent such suspicious circumstances or behavior, however, the law will not penalize innocent third parties if an agent--acting under color of authority--is subsequently exposed as faithless. The decision in the *General Overseas Films* case makes this clear: “Had Kraft [Anaconda’s Vice President and Treasurer, with apparent authority to bid Anaconda] purported to borrow money for *Anaconda* [instead of guaranteeing the debts of an unrelated corporation], or in a credible manner for *Anaconda’s benefit*, he could have bound Anaconda even if he in fact intended and managed to steal the money.” *Id.* at 692 (emphasis added).

¹³² RESTATEMENT (SECOND) OF AGENCY § 49 (1958).

require the government to secure the approval of the legislature before undertaking any external borrowing. In countries where the legislature is a representative assembly, these requirements operate to force the third party (the lender) to seek the ratification of the principal (the people, acting through their elected representatives) for the actions of the agent (the government). Corruption by government officials is still possible, of course, but only where the legislature (acting on behalf of the principal—the people) fails to monitor the actions of the agent (the government) in carrying out the authorized borrowing. In practical terms, such monitoring would involve accounting for the full proceeds of the loan, and ensuring that the terms of the borrowing are arm's length and in line with prevailing market terms.

By way of comparison, American law does not usually regard directors as agents of the shareholders of a corporation,¹³³ but American law is willing to curb the power of a corporate governing body when the body is acting wrongfully, usually defined as in breach of its fiduciary duty. A well-known example is the breadth of a board's ability under corporate law to terminate a shareholder derivative suit that has been instituted to challenge possible self-dealing conduct by directors. American courts are clear that a board has the power not to pursue litigation, but courts will not respect the wrongful exercise of that power. The Delaware Supreme Court put it this way “a board has the power to choose not to pursue litigation when demand is made upon it so long as the decision is not wrongful....the board remains empowered under §141(a) to make decision regarding corporate litigation. The problem is one of member disqualification, not the absence of power in the board.”¹³⁴ Similarly, an American court faced with a governing authority that had purported to act in a self-dealing transaction will not accord respect to such wrongful action.

In addition, the validity of the delegation of actual authority from the governing authority to the agent who acted for the regime is constrained by several principles of agency law. The existence of actual authority of the agent to perform certain functions does not automatically mean that the agent has the apparent authority to bind the principal in all matters, nor does it always remove from the third party the responsibility for ensuring that the agent has not strayed into the realm of self-dealing. For example, the Restatement of Agency specifies that the authority to

¹³³ Restatement (Third) Agency §1.01, comment e (Tentative Draft #1 at 31 (2000) (“Directors’ powers originate as the legal consequence of their election and are not conferred or delegated by shareholders.”))

¹³⁴ *Zapata Corp. v. Maldonado*, 4330 A.2d 779 (Del 1981)(“a board decision to cause a derivative suit to be dismissed as detrimental to the company after demand has been made and refused will be respected unless it is wrongful.”)

act as an agent includes only the authority to act for the benefit of the principal,¹³⁵ and that agents owe a fiduciary duty to their principals.¹³⁶ Where a third party is aware that the agent is acting for his own purpose, the principal is not liable to the third party.¹³⁷ Indeed, agency law goes beyond merely voiding the contract between the principal and the third party in such situations, it declares that a third party who suborns a betrayal of trust by the agent is answerable in tort to the principal.¹³⁸ If the circumstances of the transaction raise reasonable doubts about whether the agent is faithfully representing the interests of his principal, these principles suggest that the third party is under a duty to investigate.¹³⁹

¹³⁵ See *id.* at § 39, cmt. a (1958) (“In business enterprises, an agent normally has no authority to seek personal advantage otherwise than through faithful performance of his duties.”).

¹³⁶ RESTATEMENT (SECOND) OF AGENCY §13 (1958).

¹³⁷ *Id.* § 165. An 1893 decision of the New York Court of Appeals expressed the rule in these terms:

It is an old doctrine, from which there has never been any departure, that an agent cannot bind his principal, even in matters touching his agency, where he is known to be acting for himself, or to have an adverse interest....

The plaintiff in such a case assumes the risk of the agent’s disloyalty to his trust, and has no occasion for surprise when he discovers that the agent has served himself more faithfully than his principal.

The Manhattan Life Ins. Co. v. The Forty-Second St. and Grand St. Ferry Railroad Co., 139 N.Y. 146, 151 (Ct. App. 1893) (citations omitted).

More recently, the Second Circuit reaffirmed the vitality of this “Faithless Servant Defense” but held, in that case, that the party asserting the defense offered no factual allegations in support of its claim that the agent was engaged in self-dealing. *Citibank. N.A. v. Nyland (CF8) Ltd.*, 878 F.2d 620, 624 (2d Cir. 1989).

¹³⁸ RESTATEMENT (SECOND) OF AGENCY § 312, comment d (1958).

¹³⁹ *The Restatement (Second) of Agency* states: “Whether or not the Third Party has reason to know of A’s improper motives is a question of fact. If he knows that the agent is acting for the benefit of himself or a third person, the transaction is suspicious on its face and the Principal is not bound unless the Agent is authorized.” *Id.* at §165 comment c. Comment a to this provision says the agent’s actions come under inherent agency authority. *The Restatement (Third)*

The Restatement (Third) of Agency's admonition should apply here: "A principal should not be held to assume the risk that an agent may act wrongfully in dealing with a third party who colludes with the agent in action that is adverse to the principal."¹⁴⁰ That quote derives from a section specifying a rule against a third party being able to impute a faithless agent's knowledge to a principal, a discussion the Restatement puts squarely within a risk assumption framework.¹⁴¹ That is, the third party should not benefit from imputing the agent's knowledge to the principal when the third party itself acted wrongfully or otherwise in bad faith. The circumstances surrounding a transaction, including the magnitude of benefit it will confer on the agent who arranges it, may place a reasonable third party on notice that the agent will withhold material information from the principal.¹⁴²

The Restatement prescribes similar rules for other contexts. The "adverse domination" doctrine tolls the statute of limitations that otherwise would block, on timeliness grounds, a principal's suit.¹⁴³ The typical Adverse Domination case today involves a corporation that for some period was controlled (adversely dominated) by

of Agency, now in the final drafting stages, makes a similar point within the context of apparent authority (having abandoned inherent agency power as a distinctive label and incorporated it within the concept of manifestation under authority generally.) See RESTATEMENT (THIRD) OF AGENCY § 2.03, Comment d at 160 (Tentative Draft #2 2001) ("In a transactional context, the agent's position as a fiduciary should prompt doubt in the mind of the reasonable third party when the agent appears to be using authority to bind the principal to a transaction that will not benefit the principal.").

¹⁴⁰ See Restatement,(Third) Agency Tentative Draft No. 4 (2003), at 215

¹⁴¹ See Restatement,(Third) Agency Tentative Draft No. 4 (2003), at 294 ("It is helpful to view questions about imputation from the perspective of risk assumption taking into account the posture of the third party whose legal relations with the principal are at issue.")

¹⁴² See Tentative Draft No. 4 (March 17, 2003), at 215. See also *Invest Almaz v. Temple-Inland Forest Prods. Corp.*, 242 F. 3d 57, 74 (1st Cir. 2001) (stating that "[i]n the majority of jurisdictions the law has evolved towards a recognition that information given to even a fraudulent agent should normally be imputed to the principal, unless the third party providing the information has notice that the agent is acting adversely or otherwise colludes with the faithless agent"); cf. *Lysee v. Marine Bank*, 2005 WL 1630854 (Wis. App. 2005) (where the principal, a widow, slips into dementia during course of an agency relationship, was unable to control the actions of her agent, self serving actions of the agent in assigning certificates of deposit are held void).

¹⁴³ Restatement (Third) Agency (Ten. Draft #4 2003 at 215).

a self-dealing set of directors or managers. When the self-dealing crowd exits the scene, a new set of directors may sue their predecessors for their misbehavior while in control of the company. But what if the malefactors argue that their alleged misdeeds took place years ago and that the statute of limitations on those misdeeds has elapsed. The doctrine of Adverse Domination solves that problem by tolling the statute of limitations clock for the period during which the self-dealing managers were in control; a period during which the corporation could not sue because the bad guys prevented it from doing so.

Application of agency law principles to an odious debt context should also include one further traditional agency issue, that of ratification. The general worry encompassed by ratification is that the principal will sit back and behave opportunistically as against the third party by, for example, accepting the benefit that the third party provided and, when time comes to pay back the loan, arguing that the agent lacked the authority to speak for the principal. The Restatement (Third) describes the general rule this way: “A person may ratify an act...by receiving or retaining benefits it generated if the person has knowledge of material facts and no independent claim to the benefit.”¹⁴⁴ A debt becomes odious in the eyes of the citizens of a country, however, in part because the proceeds of a borrowing do not benefit those people; the benefits flow to the governing regime that incurred the debt. Thus, the principal here (the people) are never given a chance to behave opportunistically vis-à-vis the third party lender. To use the terminology of the Restatement, there were never any “benefits” for the principal to retain.

Applying these principles to our three hypothetical Ruritania loans yields these conclusions. The Corrupt Loan is voidable at the option of a successor government in Ruritania. The reason? The lender knew that the prior ruling regime (or officials in that regime) had breached its fiduciary duty to its principal -- the country and the people of Ruritania -- by committing Ruritania to repay money that was misappropriated by the government officials for their own purposes. Indeed, a successor regime in Ruritania may even have a claim against the lender for the damages (the money previously paid to service the loan while the old regime was in power) resulting from the lender’s bribery of the corrupt government officials involved.

Agency law would also say that the Suspicious Loan imposes an affirmative duty on the lender to investigate whether the governmental officials contracting the loan were indeed acting in the interests of Ruritania, as opposed to their own interests. It is here that the reputation of a corrupt governmental regime becomes relevant to the analysis. A loan will not be unenforceable merely because it was

¹⁴⁴ Restatement (Third) Agency §4.01(g) Tentative Draft #4 2003 at page 370.

contracted by a corrupt regime. But that regime's reputation for corruption may place upon the lender, as a matter of agency law, a higher burden to satisfy itself that the proceeds of the borrowing are benefiting the principal (the country) and not just the agent (the government officers signing the loan agreement).

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

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

4. Piercing the Governmental Veil

We have been speaking in this article about the circumstances in which principles of private (domestic) law in the United States might permit a successor government legally to disavow a debt obligation incurred by its predecessor. The common theme running through these possible defenses is that when a third party suborns a government to betray its duty to the country on whose behalf it purports to act, or when a third party consciously turns a Nelsonian blind eye to such a betrayal, the resulting contract between that third party and the traduced sovereign state is voidable at the option of a successor government.

There is, we believe, an additional way to analyze these legal relationships that draws upon the American law approach to the legal fiction known as the corporation. On several levels, the legal analysis of a sovereign state parallels that of a corporation. Both are artificial persons recognized by law as separate persons from their constituent members (a state has citizens,¹⁴⁵ a corporation has shareholders¹⁴⁶).

¹⁴⁵ RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 201, cmt. c (1987).

¹⁴⁶ WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES, 124–27 (9th ed. 2004).

A state is managed by a government, a corporation is managed by officers and directors. Both may have creditors or other contractual counterparties.

This recognition of entity separateness creates benefits in terms of streamlining collective action and permitting the entity an enduring life beyond the death of any one participant. The corporation achieves this status as a creature of positive law in the jurisdiction in which it is incorporated. A sovereign state, however, achieves this status only by being recognized as such by other sovereign states, much like a stray wolf who follows a new pack at a distance for some period of time until -- after being appropriately sniffed, pawed and bitten by the incumbents -- is admitted to full membership in the pack.¹⁴⁷

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

One prominent exception in corporate law is the doctrine known as “piercing the corporate veil” (“PCV”).¹⁴⁸ Indeed, it is the most litigated issue in corporate law.¹⁴⁹ In the garden-variety PCV case, creditors of the corporation will seek a court’s permission to look through (to pierce) the limited liability veil of the corporation, with the goal of recovering their claims from a controlling shareholder that abused the corporate form by treating the corporation as its alter ego. In the typical fact pattern, a separate corporate entity with no assets has been inserted by a richer shareholder between it and a third party creditor, with the consequence that the creditor has no realistic source of recovery for future payment obligations of the company. A court, if it finds that the shareholder and the corporation have abused

¹⁴⁷ RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 201, comment (h) (1987) (observing that “Whether an entity satisfies the requirements for statehood is ordinarily determined by other states when they decide whether to treat that entity as a state.”). *See id.* at § 203(1) (“A state is not required to accord formal recognition to the government of another state, but is required to treat as the government of another state a regime that is in effective control of that state, except as set forth [in this section under the rules governing the use of force under the United Nations charter.]”).

¹⁴⁸ For discussions of the subject, see STEPHEN B. PRESSER, *PIERCING THE CORPORATE VEIL* (1991 ed. & Supp. 2004); Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479 (2001).

¹⁴⁹ Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1036 (1991).

the normal limited liability characteristic of a corporation to harm the third party creditor, will disregard the separate entity and pierce the veil so that the creditor can recover directly from the controlling shareholder.¹⁵⁰ In other examples of disregarding the entity, courts will pierce the veil to block the shareholder from using the separate entity to avoid a government regulation or for other nefarious purposes.¹⁵¹

The PCV doctrine in American law has thus evolved in a flexible manner to address the many different ways in which legal fictions such as corporations can be abused by insiders. The law has an interest in seeing that any entity carrying the suffix “Inc.” or one of its substitutes will be operated in a manner consistent with the legal requirements and expectations that the legislature had in mind when it authorized these legal fictions. “Abuse of the corporation” therefore is a shorthand way of saying that one or more of the stakeholders in the enterprise has acted outside of the range of the rights and duties anticipated by the legislature when it authorized the creation of limited liability entities.¹⁵² In effect, the wrongdoer will have taken advantage of the unspoken expectations of the other stakeholders (that they are all playing by these rules) as the camouflage to conceal the misbehavior. This is probably a workable definition for the concept of cheating in any rules-based game, with the possible exception of solitaire.

Sovereign debt involves a similar risk of possible misuse of separate entity status. The same trio of actors is involved -- the principal (the country or the entity), the agent (the managers of the corporation or the government of the country) and the third party who extends credit to the entity or country. Abuse results when two of the three try to use the separate character of the legal fiction (the corporation or the state) to victimize the third. In a typical pattern of corporate misuse, the manager/agent and shareholders are aligned in creating a “no asset” corporation that will shift the risk of non-payment to the third-party creditor. In the sovereign debt setting, however, the danger is that the third party creditor and the faithless agent (the corrupt government)

¹⁵⁰ See, e.g., *Van Dorn Co. v. Future Chemical and Oil Corp.*, 753 F.2d 565, 569–70 (7th Cir. 1985) (observing that the veil may be pierced where maintenance of the legal fiction would “sanction a fraud or promote injustice”).

¹⁵¹ STEPHEN B. PRESSER, *supra* note 148, at § 1:5 (1991 ed. & Supp. 2004). See also § 1:13 (discussing the need to disregard the corporate form when it is used “to defraud creditors, to evade existing obligation, to circumvent a statute, to achieve or perpetuate a monopoly, or to protect knavery and crime.”).

¹⁵² See, e.g., *Sea-Land Services, Inc. v. Pepper Source*, 941 F.2d 519, 521 (7th Cir. 1991) (applying the Van Dorn analysis in observing that the defendant was using the corporate form as his “plaything”).

will collude to take advantage of an innocent principal (the citizens or future citizens). By lifting the veil of separate entity status, a court may fashion a remedy that allows the creditor to recover from the abusing shareholder (in the corporate context), or the state to avoid the debts contracted by the collusive lender and corrupt government officials (in the sovereign context).

B. Possible Problems

1. The Problem of Proof

Challenging the enforceability of the Suspicious Loan extended to a predecessor regime in a court of law places upon the sovereign defendant a burden of proving the “irregular” (to use Chief Justice Taft’s adjective in the Tinoco Arbitration) circumstances surrounding the incurrence of the loan.¹⁵³ This may not be an easy task. By their very nature, fraud and corruption can be notoriously difficult to prove. Cross-border corruption is even more difficult to substantiate, and cross-border corruption that occurred years or decades earlier exceptionally difficult. In the 27 years (through 2004) that followed the passage of the U.S. Foreign Corrupt Practices Act (“FCPA”), for example, the U.S. Department of Justice brought only 39 criminal prosecutions and seven civil enforcement actions under the anti-bribery provisions of the FCPA.¹⁵⁴ One imagines that in nearly three decades, there were many other transgressions that went undetected, unproven and unpunished.

We believe that governmental corruption in some countries at certain times is so suffocatingly ubiquitous that a U.S. court could legitimately shift onto the plaintiff the burden of showing that a particular a transaction was *not* tainted by corruption. A reputation for corrupt behavior is no longer, as it once was, just a matter the accumulated sediment of hundreds or thousands of personal anecdotes recounted by those on the receiving end of what Mexicans charmingly call “the bite”. Several independent groups have devised methods by which the extent of governmental corruption in a particular country can be assessed and even ranked in a comparative matrix with other countries.¹⁵⁵ Against a showing of pervasive corruption, is it

¹⁵³ Tinoco Arbitration, reprinted at *supra* note 41, at 168.

¹⁵⁴ U.S. Dept. of Commerce, International Trade Administration, *Addressing the Challenges of International Bribery and Fair Competition 2004* (July 2004) (available at <http://www.tcc.mac.doc.gov/pdf/2004bribery.pdf>).

¹⁵⁵ See *e.g.*, Press Release, Transparency International, Transparency International Corruptions Perceptions 2004 (Oct. 20, 2004) (available at http://ww1.transparency.org/pressreleases_archive/2004/2004.10.20.cpi.en.html);

unreasonable to ask the plaintiff/lender to explain how it alone had managed to preserve its virtue in dealing with the corrupt regime?

In a variety of contexts, U.S. courts are called upon to acknowledge the existence of widespread corruption in foreign countries and to draw reasonable inferences about the conduct of persons who do business with governmental agencies in those countries. The original version of the FCPA passed in 1977, for example, criminalized payments to foreign government officials, or to an intermediary for such an official, where the payor knew or “had reason to know” that the purpose of the payment was to influence a foreign governmental action or to obtain business.¹⁵⁶ The phrase “had reason to know” was widely criticized by American businesspeople.¹⁵⁷ In many cross-border transactions, exporters find it useful to retain the services of a local agent or intermediary. How can the exporter be sure that some of the compensation paid to a local agent will not find its way into the hands of government officials?

In response to complaints that the phrase “reason to know” was so imprecise that it inhibited legitimate competition by American exporters, Congress amended the FCPA in 1988 to delete this phrase.¹⁵⁸ The 1988 amendments limited the bribery prohibition of the FCPA to payments made with “knowledge” that all or part of the money would be used for bribery.¹⁵⁹ Drawing from the Model Penal Code, however, the 1988 amendments defined a person’s knowledge with respect to conduct or circumstance or a result (in this context, a bribe) as that person’s being aware of a “high probability” of the occurrence of the conduct or circumstance, or being “substantially certain” of the result.¹⁶⁰ The Conference Report for the 1988 amendments said that the conferees intended that the requisite state of mind for this offense include a “conscious purpose to avoid learning the truth,”¹⁶¹ and used phrases such as “willful blindness”,

Press Release, Transparency International, Transparency International Releases New Bribe Payers Index (BPI) 2002 (May 14, 2002) (available at http://ww1.transparency.org/pressreleases_archive/2002/2002.05.14.bpi.en.html).

¹⁵⁶ 15 U.S.C. §§ 78dd-1, 78dd-2 (1977).

¹⁵⁷ See, e.g., Peter D. Trooboff, *Current Development: Proposed Amendment of the Foreign Corrupt Practices Act of 1977*, 77 A.J.I.L. 340, 341 (April 1983).

¹⁵⁸ Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107, 1419 (1988).

¹⁵⁹ H.R. Conf. Rep. No. 100-576, at 920 (1988).

¹⁶⁰ 15 U.S.C. § 78 dd-2(h)(3) (1988).

¹⁶¹ H.R. Conf. Rep., supra note 159, at 919.

“deliberate ignorance,” “conscious disregard” and “a head in the sand”,¹⁶² to explain when a party can be held to “know” that illicit conduct is afoot.¹⁶³

American judges will take judicial notice of foreign governmental corruption in other contexts as well. One of the grounds for nonrecognition in the United States of a foreign court judgment, for example, is the absence of impartial tribunals or fair procedures in the country in which the judgment was handed down. This determination must be made by the U.S. court that is asked to recognize the foreign judgment. “The recognizing court may make this determination without formal proof or argument, on the basis of general knowledge and judicial notice”.¹⁶⁴

In *Bridgeway Corp. v. Citibank*,¹⁶⁵ a Liberian corporation (Bridgeway) sought to enforce in a U.S. federal court a money judgment it had obtained against Citibank in Liberia.¹⁶⁶ The U.S. federal district court granted summary judgment in favor of Citibank on the ground that Liberia’s courts did not constitute “a system of jurisprudence likely to secure an impartial administration of justice”.¹⁶⁷ On appeal, the parties quarreled over who bore the ultimate burden of proof with respect to the fairness of the Liberian judicial system.¹⁶⁸ The appeals court declined to express an opinion on this issue, but held that even if the burden of proof rested with Citibank, that burden had been carried by the production of affidavit evidence and an unflattering U.S. State Department report about the Liberian judiciary.¹⁶⁹ Although the Second Circuit’s opinion does not say so explicitly, Citibank’s evidence about the generally bleak state of the Liberian judicial system shifted the burden onto Bridgeway to contradict Citibank’s characterization. Bridgeway failed to do so. The

¹⁶² *Id.* See also John E. Impert, *A Program for Compliance with the Foreign Corrupt Practices Act and Foreign Law Restrictions on the Use of Sales Agents*, 24 INT’L LAWYER 1009, 1014 (1990).

¹⁶³ *Id.*

¹⁶⁴ RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 482 cmt b (1987).

¹⁶⁵ 201 F.3d 134 (2d Cir. 1999).

¹⁶⁶ *Id.* at 137.

¹⁶⁷ *Id.* at 139.

¹⁶⁸ *Id.* at 141–42.

¹⁶⁹ *Id.*

dismissal of Bridgeway's action for recognition of the Liberian judgment was therefore affirmed.¹⁷⁰

In motions for dismissal on *forum non conveniens* grounds, U.S. judges are occasionally asked to take judicial notice of the fact that the courts of a proposed alternative forum are so corrupt, or so inefficient, that they do not meet even a minimally-acceptable standard for an adequate alternative forum for the action. In *Eastman Kodak Co. v. Kavlin*,¹⁷¹ a federal district court denied a motion by Bolivian defendants to dismiss the case on *forum non* grounds.¹⁷² The plaintiffs developed an extensive record showing that the Bolivian judicial system was corrupt at all levels. The court reached this conclusion despite its recognition that "the 'alternative forum is too corrupt to be adequate' argument does not enjoy a particularly impressive track record."¹⁷³

More directly on point in the area of foreign governmental corruption is *Republic of Haiti v. Duvalier*.¹⁷⁴ In that case, the Republic of Haiti brought an action in a New York state court against the wife of the deposed Haitian dictator ("Baby Doc" Duvalier) for embezzlement and conversion of public assets.¹⁷⁵ The trial court granted Mrs. Duvalier's motion for summary judgment and an appeal followed.¹⁷⁶

The Appellate Division noted the evidence produced by the Haitian Government at trial concerning the widespread corruption of the Duvalier regime, including circumstantial evidence suggesting that the Duvaliers had pilfered substantial amounts of public funds. "This combination of direct and circumstantial evidence," the appeals court ruled, "is sufficient to establish [Haiti's] conversion claim, *prima facie*."¹⁷⁷ The Court held that the burden had thus shifted to Mrs. Duvalier to produce evidence that would establish a triable issue of fact on the corruption allegation".¹⁷⁸ She failed to do so and the trial court's summary judgment in her favor was reversed.

¹⁷⁰ *Id.* at 144.

¹⁷¹ 978 F. Supp. 1078 (S.D. Fla. 1997).

¹⁷² *Id.* at 1082.

¹⁷³ *Id.* at 1080–82 (reviewing the track record).

¹⁷⁴ 626 N.Y.S.2d 472 (App. Div., First Dept. 1995).

¹⁷⁵ *Id.* at 473.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.* at 476.

¹⁷⁸ *Id.*

There is, in short, no reason to believe that Ruritania would have to produce “smoking gun” evidence of a lender’s collusion with corrupt officials of the prior regime in order for Ruritania to prevail in one or more of the defenses discussed in this Part. Nor could a lender escape a compelling, if circumstantial, inference of corruption merely by turning a Nelsonian blind eye to those circumstances.¹⁷⁹ There is indeed a price to be paid for dealing with a notoriously corrupt regime and that price, at the very least, is a higher standard of vigilance and investigation.

2. *In Pari Delicto*

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

In the Ruritanian Corrupt Loan example, the corrupt government that stole the proceeds of the loan would have been awkwardly placed to construct a legal defense based on its own misconduct or the misconduct of the lender that bribed it. Like the *Adler* case discussed in Part IV.A.2 above,¹⁸⁰ all the parties appearing before the trial court under these circumstances would share a degree of culpability. But following a regime change in Ruritania, the new (blameless) government may well try to mount defenses to enforcement of the loan along the lines of those suggested in Part IV.A above. This may in turn prompt the lender to argue that the defendant Republic of Ruritania -- ignoring the interim change of government -- was at the very least *in pari delicto* (of equal fault) with the lender in the whole affair. The equitable doctrine of *in pari delicto* precludes one wrongdoer from asserting claims against a

¹⁷⁹ In an appeal of a criminal conviction brought under the mail fraud statute, for example, the First Circuit approved jury instructions that the required element of knowledge of the fraud could be proved by circumstances showing the defendant’s “deliberately closing his eyes to what otherwise would have been obvious to him” and “[r]efusing to investigate something that cries out for investigation....” *United States v. Kaplan*, 832 F.2d 676, 682 (1st Cir. 1987).

¹⁸⁰ *See supra* note 110 and accompanying text.

confederate who is equally at fault. This is precisely the argument on which Adler relied in his (unsuccessful) attempt to disarm Nigeria's unclean hands defense.¹⁸¹

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

There are parallels in the corporate field. A trustee or a receiver in the bankruptcy of a corporation similarly "steps into the shoes" of the bankrupt enterprise.¹⁸² In a derivative suit, shareholders assert the rights of the corporation to redress injuries to the corporation.¹⁸³ In each of these situations, a similar question can arise: will the successor (the trustee, the receiver or the shareholder in a derivative action) be entitled to assert the claims of the enterprise against third parties and, if so, will that successor be subject to any equitable defenses (such as unclean hands or *in pari delicto*) that those third parties may have had against the enterprise itself?

In the case of a trustee in bankruptcy, U.S. courts have generally interpreted Section 541 of the Bankruptcy Code to limit a trustee's rights to those of the corporation as they that existed at the time of the commencement of the bankruptcy proceeding.¹⁸⁴ Accordingly, if the bankrupt corporation had participated in the wrongdoing, it would on the date of commencement of the bankruptcy have been disabled from pursuing claims against confederate wrongdoers on *in pari delicto* grounds. The trustee, stepping into those shoes, suffers that same disability.¹⁸⁵

Court-appointed receivers, however, are a different matter. Receivers are not limited by Section 541 of the Bankruptcy Code and, in pursuing claims of the

¹⁸¹ See *Adler v. Federal Republic of Nigeria*, 219 F.3d 869, 877 (9th Cir. 2000).

¹⁸² *KLEIN & COFFEE*, *supra* note 146, at 258–59.

¹⁸³ *Id.* at 205.

¹⁸⁴ 11 U.S.C. § 541 (2000).

¹⁸⁵ See, e.g., *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 357 (3d Cir. 2001). See also Reynolds B. Brissenden, *In Pari Delicto Doctrine May Bar Receiver's Third-Party Claims*, 3 DEPAUL BUS. & COM. L.J. 169, 171-73 (2005). This rule may soon be changed by legislation. See the discussion of the draft bill captioned "Bankruptcy Reform Technical Amendment Act of 2005" in Steven P. Caley, *In Pari Delicto in the Bankruptcy Courts – Big Changes in the Offering?*, *The Metropolitan Corporate Counsel*, June 2006 at 20, 21.

corporation against other wrongdoers, receivers are generally not hampered by the *in pari delicto* defenses raised by those third parties.¹⁸⁶ In *Scholes v. Lehmann*,¹⁸⁷ for example, a 1995 Seventh Circuit decision, the court confronted those facts: Michael Douglas had set up several corporations and caused those corporations in turn to create limited partnerships for the ostensible purpose of investing in commodity trades.¹⁸⁸ Prospective investors in the limited partnerships were lured by promises of a return of 10 to 20 percent *a month* on their original investments.¹⁸⁹

The entire arrangement was a Ponzi scheme. Douglas himself stole most of the money. The balance was strategically paid out to early investors to establish the track record that Ponzi operators need to prime the pump for future victims. Within two years, the scheme collapsed. Douglas went (more precisely, went back) to jail.¹⁹⁰

The U.S. Securities and Exchange Commission brought a civil suit against Douglas's corporations and asked a federal court for the appointment of a receiver for both Douglas and those corporations.¹⁹¹ That receiver, Steven Scholes, set about recovering as fraudulent conveyances money that Douglas had siphoned from the corporations and transferred to his wife (ex-wife by the time of the lawsuit), one of the investors and several charitable organizations. These transferees argued that Douglas and his three corporations were integral components of the Ponzi scheme.¹⁹² How then, the transferees asked, could a receiver stepping into the shoes of Douglas and his three corporations pursue fraudulent conveyance claims against third parties in the face of the *in pari delicto* doctrine?

In a masterful opinion by Judge Posner, the Seventh Circuit articulated a displacement theory. The rationale behind the *in pari delicto* doctrine is that wrongdoers should not be allowed to benefit from their own wrongdoing. That rationale, the court concluded, is inapplicable to a receiver. Once Douglas had been displaced by the court-appointed receiver, Douglas no longer stood to benefit from the recovery of the fraudulently-conveyed funds. Thus, the *in pari delicto* doctrine did not bar a recovery by a successor administrator (the receiver) once the wrongdoer

¹⁸⁶ 11 U.S.C. § 541 (2000).

¹⁸⁷ See *Scholes v. Lehmann*, 56 F.3d 750, 758 (7th Cir. 1995).

¹⁸⁸ *Id.* at 752–53.

¹⁸⁹ *Id.* at 752.

¹⁹⁰ *Id.* at 752–53.

¹⁹¹ *Id.*

¹⁹² *Id.* at 753.

(Douglas) had been ousted from control of, and beneficial interest in, the corporations.¹⁹³ In language that a successor government of Ruritania might easily adapt to its own situation in the corrupt Ruritanian loan cases, the Seventh Circuit held that after the appointment of the receiver:

The corporations were no more Douglas's evil zombies. Freed from his spell they became entitled to the return of the moneys -- for the benefit not of Douglas but of innocent investors -- that Douglas had made the corporations divert to unauthorized purposes.... Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated.¹⁹⁴

This leaves the interesting question of whether the analogy between a receiver and a successor Ruritanian government is sound.¹⁹⁵ In a situation where the prior regime was ousted from dictatorial control over the country, the successor government truly is, to use the words of one U.S. court in describing court-appointed receivers, "thrust into the shoes" of its predecessor.¹⁹⁶ By definition, that new government was not complicit in the misdeeds of the prior regime. Disabling the successor government from pursuing third parties that assisted the previous regime in perpetrating those misdeeds or, in the Ruritanian corrupt loan cases, depriving the successor regime of a legal defense to the enforcement of a corrupt loan, would only convey a benefit to the wrongdoers at the expense of the citizens and innocent creditors of Ruritania. The rationale of the *Scholes* case should logically apply by analogy to this situation: once the corporation (acting through its receiver) or the sovereign state (acting through its new government) liberates itself from the control of the wrongdoer, the *in pari delicto* doctrine should not disable the innocent

¹⁹³ *Id.* at 754–55.

¹⁹⁴ *See also* FDIC v. American Diversified Savings Bank, 61 F.3d 17 (9th Cir. 1995) (FDIC, as receiver for a failed bank, not subject to defenses based on unclean hands or inequitable conduct that may have been raised against the bank itself). *But see* Knauer v. Heartland Financial Services, Inc., 348 F.3d 230 (7th Cir. 2003) (employing an "equitable balancing" test to reach the conclusion that a receiver *was* subject to an *in pari delicto* defense by third parties).

¹⁹⁵ It is, of course, no more than an analogy. Receivers, like trustees in bankruptcy, are appointed pursuant to specific statutory authority. Regime changes in sovereign states, whether constitutional or extra-constitutional, are not the subject of any U.S. law or regulation.

¹⁹⁶ FDIC v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995).

successor from pursuing claims or asserting defenses against those who knowingly participated in the misbehavior of the recently-departed regime.¹⁹⁷

V. Conclusion

It would never have occurred to Alexander Sack to suggest that successor governmental regimes should rely exclusively on municipal courts of law to invalidate the infamous debts incurred by their predecessors. There was a good reason for this. At the time Sack was writing (the 1920s), most countries recognized an “absolute” theory of sovereign immunity; sovereigns could not be sued in foreign courts without their consent.¹⁹⁸ Commercial creditors were therefore compelled to seek the diplomatic assistance of their own governments in protesting debt defaults by foreign sovereign borrowers.¹⁹⁹ If commercial loans could not become the subject of lawsuits in municipal courts, there was obviously no reason to spend much time speculating about what defenses the sovereign defendants might have run in such cases.

All of that changed dramatically about the middle of the last century. The prevailing notion of absolute sovereign immunity gave way to a “restrictive” theory under which sovereigns could be held accountable in municipal courts for their commercial activities abroad.²⁰⁰ This restrictive theory was eventually codified into law in the late-1970s in both the United States and the United Kingdom.²⁰¹

For Alexander Sack and for all other interested commentators in the 50 years following him, therefore, the only possible countermeasure to the mandatory

¹⁹⁷ In *Republic of Haiti v. Duvalier*, 626 N.Y.S.2d 472 (App. Div., First Dept. 1995), a New York appeals court allowed a successor government in Haiti to pursue monies that had been embezzled by the prior Duvalier regime. *Id.* at 473. The defendant in the case, the wife of Jean-Claude “Baby Doc” Duvalier, did not raise an *in pari delicto* defense to the successor government’s claims, nor did the court mention the issue. The court’s decision assumed a sufficient separation between the new Haitian government and the Duvalier regime. *Id.* at 474–75.

¹⁹⁸ JOSEPH W. DELLAPENNA, *SUING FOREIGN GOVERNMENTS AND THEIR CORPORATIONS* § 1.2 (2d ed. 2003).

¹⁹⁹ See Lee C. Buchheit, *The Role of the Official Sector in Sovereign Debt Workouts*, 6 CHI. J. INT’L L. 333 (2005).

²⁰⁰ *Id.*

²⁰¹ *Id.* 339-41.

inheritance of debts incurred by a despotic regime lay in achieving an international consensus that such obligations should not, as a matter of international law, continue to burden the citizens of the country once the despot had been removed. But lenders now have legal remedies in municipal courts to pursue their debt recovery efforts. For the last 30 years in the United States, the legal enforcement of foreign sovereign debt obligations has been the province of U.S. federal judges applying conventional doctrines of state contract law. In those lawsuits, the sovereign defendants are perfectly at liberty to assert defenses based on principles of that same contract law or on U.S. public policy generally.

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

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

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

A country weighed down by a history of imprudent borrowings is not, however, wholly without recourse. It is not necessary to repudiate (in a legal sense) every loan whose payments the country can no longer afford. Even in the absence of a transnational bankruptcy code applicable to sovereign debtors, overindebted

countries have been able to approach their creditors (bilateral and commercial) for consensual debt relief when the accumulated debt burden becomes unsustainable, or is sustainable only at the cost of diverting all public financial resources away from other necessary expenditures. The sovereign debt restructuring process as it has evolved over the last 25 years is often not pleasant -- indeed, it is frequently exasperating, contentious and attenuated -- but it is a recognized feature of the international financial system.