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The Rise of the Notion of Illegitimate Debt: a Comment on “Rethinking Sovereign Debt: Politics, Reputation, and Legitimacy in Modern Finance” by Odette Lienau

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Abstract: “Rethinking Sovereign Debt: Politics, Reputation, and Legitimacy in Modern Finance” by Odette Lienau convincingly challenges the notion that the norm of debt continuity is a “stable and inevitable market principle” by providing a thorough analysis of the historical and political contexts surrounding this norm. The author’s approach which goes beyond the “market narrative” on the norm of debt continuity provides significant insights into the difficult issues of debt repudiation. This approach reveals the politically and historically variable nature of the norm of debt continuity. As such, the author demonstrates the openness and the possible development of sovereign debt practices towards accepting a more flexible and non-statist approach to sovereign debt management.

Keywords: Sovereign debt crisis, debt continuity, statist theory of sovereignty, odious debt

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1 Introduction: Questions addressed

Odette Lienau’s timely book was published amidst the serious sovereign debt crisis in Europe and Argentina, the ramifications of which are significant and ongoing. Although sovereign debt crises have a long history,¹ they still lack a comprehensive management regime.² This effectively means that sovereigns lack protection from bankruptcy law and are, in principle, subject to 100 per cent debt recovery claims from creditors. The norm of strict debt repayment appears to be generally accepted in sovereign debt markets, but does it, or should it, always apply? If not, how should we address the questions of whether to pay or repudiate, who to pay, when to pay, and how much to pay? Lienau’s book provides significant insight into answering these questions. The focus of the book is clear and consistent: it challenges the notion that the norm of sovereign debt continuity is a “stable and inevitable market principle”. Having defined the norm of sovereign debt continuity as “the rule that sovereign states should repay debt even after a major regime change and the related expectation that they will otherwise suffer reputational consequences”,³ Lienau argues that this norm effectively derives from “a strictly *statist* conception of sovereignty”.⁴ By thoroughly analysing the divergent theories on sovereign legitimacy and providing a historical context of the sovereign debt crises in the twentieth and twenty-first centuries, this book convincingly challenges such “market narrative” as being

1 See generally Federico Sturzenegger and Jeromin Zettelmeyer, *Debt Defaults And Lessons From A Decade Of Crises* (Cambridge, Massachusetts: MIT Press, 2007) Chapter 1.

2 The proposal to create the sovereign bankruptcy mechanisms by the IMF management and staff in 2002, i. e. “Sovereign Debt Restructuring Mechanism” failed to obtain political support and has not yet been launched. See e. g. Sturzenegger and Zettelmeyer, *ibid.*, p. 274–5; Kevin P. Gallagher, “The New Vulture Culture: Sovereign Debt Restructuring and Trade and Investment Treaties” The IDEA’s Working Paper (2011), available at: <http://www.ase.tufts.edu/gdae/publications/GallagherSovereignDebt.pdf>.

3 Odette Lienau, *Rethinking Sovereign Debt: Politics, Reputation, and Legitimacy in Modern Finance* (Cambridge, Massachusetts: Harvard University Press, 2014) p.2.

4 Lienau defines this conception as “the idea that the content of and changes in a state’s internal structure, interests, and popular support are irrelevant to its status as a legitimate sovereign and thus to its external relations and obligations”. She observes that this statist vision has been challenged by competing theories and has been subject to debate and alteration. Lienau, *ibid.*, p. 5.

overly simplistic and misplaced. As such, Lienau demonstrates that the debt continuity norm is “intrinsically political and historically variable”. She also successfully challenges the assumption of the uniformity of creditors approach in supporting continuous repayment, by demonstrating that creditors have actually responded in different ways to cases of debt repudiation. The idea of odious debt, which “operationalizes ... the idea of sovereign legitimacy underpinning the debt regime at a given moment”,⁵ is used as a guide on when the issue of political legitimacy is likely to rise to the surface in international finance.

2 Theory, history and policy

After establishing the questions underlying the book, Chapter 2 presents the theoretical background for the critical examination of the statist approach that underlies the norm of debt continuity. By demonstrating the link between a theory of agency, which is “central to the modern practice of domestic contract law”,⁶ and a theory of sovereignty, Lienau argues that “different theories of sovereignty effectively constitute different theories of agency in the international realm, with divergent ramifications for whether or not a sovereign contract is legitimately enforceable”.⁷ This link also supports the conclusion that “the current system of sovereign lending already, and necessarily, rests on a concept of sovereign legitimacy that takes the role played by agency theory in domestic contract law”.⁸ In addition, this chapter provides a theoretical explanation for the *non*-uniformity of creditors approach in repudiation, in particular, the existence of approaches that allow for debt cancellation. First, Lienau argues that creditors have potentially conflicting interests among themselves, and that they view fellow creditors (i. e. competitors) as “risks”. This then leads to the situation in which a new creditor may be willing to extend credit, even after repudiation, or to accept alternative approaches presented by the “clients” (i. e. borrowers) in order to win the competition in lending.⁹ This competition theory does not apply to sovereign creditors, yet their unique role to generate and enforce norms for the protection of certain political values also could

⁵ Lienau, *supra* note 3, p. 8.

⁶ *Ibid.*, p. 22.

⁷ *Ibid.*, p. 23.

⁸ *Ibid.*, p. 24.

⁹ *Ibid.*, p. 30.

support the non-statist approach to debt continuity.¹⁰ Thus, this chapter examines the development of sovereignty theories, as well as relevant case studies. Lienau identifies theories of sovereignty that have different normative ramifications for the norm of debt continuity,¹¹ and argues that they suggest the existence of alternative approaches to the norm. Chapter 2 concludes that “[t]he dominant norm of debt continuity is not an ahistorical market principle but rather has been actively constructed and supported by changing market structures and broader political ideologies”.¹²

In order to further demonstrate that the political neutrality, reputational stability and creditor uniformity in debt continuation is validly contested, Chapters 3 and 4 address two repudiation events in the early twentieth century: the Soviet repudiation of tsarist debts in 1918 and the Costa Rican repudiation in 1920 after the removal of the Tinoco government. Through a detailed examination of the historical context of these cases, Lienau concludes that both cases evince greater flexibility on actual payment, or more openness to alternatives to the norm of sovereign debt continuity than is usually acknowledged. She also argues that they demonstrate similar patterns, in which the ideas of the (il) legitimacy of the debts of previous regimes, valid sovereignty, and sovereign action played an important role. Notably, it was in this era when the doctrine of odious debt was formalized by a Russian jurist Alexander Sack. Lienau observes that although Sack’s odious debt doctrine is not widely accepted in current international law or financial practice, it could have gained broader recognition.¹³ A case that is widely considered to show such preliminary recognition is examined in detail in this chapter, namely the *Tinoco* arbitration. The Costa Rican repudiation resulted in an arbitration between Great Britain and Costa Rica,¹⁴ as the former state exercised its right to diplomatic protection with respect to two British corporations (the Royal Bank of Canada and Central

¹⁰ *Ibid.*, pp. 32–4.

¹¹ This chapter identifies both process-oriented theories (statist sovereignty, rule-of-law sovereignty and popular sovereignty) and outcome-oriented theories. See especially Lienau, *supra* note 3, pp. 51–2.

¹² Lienau, *supra* note 3, p. 55.

¹³ *Ibid.*, p. 65. See also Lee C. Buchheit, G. Mitu Gulati and Robert B. Thompson, “The Dilemma of Odious Debts”, *Duke Law Journal*, Vol. 56, No. 5 (2007), pp. 1201–62, at 1218; Joseph Hanlon, “‘Illegitimate’ Loans: Lenders, Not Borrowers, Are Responsible”, *Third World Quarterly*, Vol. 27, No. 2 (2006), pp. 211–26 (“Hanlon, ‘Illegitimate’ Loans”) at 214.

¹⁴ *Arbitration Between Great Britain and Costa Rica* (18 October 1923), Record of International Arbitral Awards, Vol. 1 (1923), reproduced in *The American Journal of International Law*, Vol. 18, No. 1 (1924), pp. 147–174 (“*Tinoco* Arbitration”). This case was based on an arbitration treaty between Great Britain and Costa Rica in March 1923.

Costa Rica Petroleum Company¹⁵). The issue in this case was the continuity of the debt the ousted Tinoco regime owed to these corporations. William Howard Taft, as the sole arbitrator, concluded that the Tinoco regime was in *de facto* control of the state, and that a change of government had no effect upon the international obligations of the state.¹⁶ However, Taft ultimately refused to order Costa Rica to repay the debts of the Tinoco regime. He did so on the grounds that these loans were full of irregularities. For example, the Royal Bank “knew that this money was to be used by the retiring president, F. Tinoco, for his personal support after he had taken refuge in a foreign country. It could not hold his own government for the money paid to him for this purpose”.¹⁷ Taft’s approach to linking the enforceability of a sovereign debt contract to a legitimate governmental purpose has been recognized as supporting the idea of the odious debt doctrine. Lienau observes that Taft’s framework initially seems statist, as it did not consider the legitimacy of the state drawn from a strong understanding of individual rights or democratic consent. However, it does adopt a rule-of-law approach to sovereign continuity. Thereby, it “mitigates a narrowly statist idea of sovereign contract obligation”¹⁸ rather than support the continuity of sovereign obligations in *all* cases.

Having demonstrated the emergence of creditor competition and broader political ideas that allowed for some flexibility in interpretations of debt continuity in the early twentieth century, Chapter 5 describes how this trend actually faded away in the mid-twentieth century. Then it examines why the openness towards non-statist ideas of legitimate sovereignty weakened and a statist framework of sovereign continuity became normalized in this era. Lienau’s analysis of this phenomenon offered in the chapter is summarized as follows. As a result of the Great Depression, the source of sovereign funding shifted from private finance to sovereign creditors, at the centre of which was the International Bank for Reconstruction and Development (“IBRD”). As “a longer-term development agency charged with its own financial maintenance”, the IBRD’s understanding of debt continuity became the dominant vision in sovereign debt markets, despite the relatively small size of its funds.¹⁹ Then,

15 The Central Costa Rica Petroleum Company had been assigned the rights under the Amory concession, and therefore was then the owner of the concession.

16 *Tinoco Arbitration*, *supra* note 14, p. 150.

17 *Tinoco Arbitration*, *supra* note 14, p. 168. The validity of the Amory concession was rejected for a different reason, that is, its inconsistency with Tinoco’s Constitution of 1917 (*ibid.*, pp. 169–74).

18 Lienau, *supra* note 3, pp. 112–4.

19 Lienau identifies, in particular, the following reasons for this: the IBRD established a finance- and development-driven system of sovereign finance after the disappearance of private finance from international lending during the Great Depression; and it remained a key

after World War II, the IBRD “eventually depended on issuing its own bonds in private financial markets to sustain and expand its operating capital”,²⁰ as a result of which the IBRD was monitored by external funders. Thus, this “power of the purse” of Wall Street directed the IBRD’s understanding towards a statist framework of debt continuity and sovereign creditworthiness, without considering questions of internal regime legitimacy. As a result, in the post-World War II lending system, the statist framework of sovereign debt continuity became normalized. This also means that sources of private capital were consolidated into a single public channel of sovereign lending. Accordingly, competition among private creditors in the inter-war period (as examined in Chapters 3 and 4) was taken over by a more uniform approach to requiring repayment. Notably, while the IBRD explicitly adopted the political “neutrality” policy,²¹ its close working relationship with New York banks effectively meant that its lending decisions were based on the statist interpretation of sovereignty by “financially buttressing governments claiming power and legitimacy on the basis of physical force alone”.²² Therefore, “the Bank’s refusal to consider *any* question that touched upon explicitly political issues paradoxically took on a political cast”.²³ This chapter also explains how the historic context of the mid-twentieth-century, including the Cold War and decolonization, also supported a strongly statist principle of sovereignty.

The “template” for statist sovereign debt practices established in the aforementioned historical and political context was incorporated and further deepened in the debt restructuring processes in the 1970s and 1980s. Chapter 6 examines why more flexible debt continuity norms did not revive, even after the return of private finance to sovereign debt in the 1970s. Here, the author, finds answers in the material and social structures of the sovereign credit market. That is, in the 1970s and 1980s, major financial institutions moved towards cross-border integration by forming consortiums and coalitions, which weakened the competition between creditors. In addition, in the 1970s, these transnational financial institutions began participating in sovereign lending through syndicated loans, because of which they became “increasingly interlocked”.²⁴

transnational economic link for many post-war countries to which the US government funding had not reached.

²⁰ Lienau, *supra* note 3, p. 132. This is because “the minimal capital available through equity encouraged the Bank to turn to borrowing, and the only institutions with sufficient capital to lend to the Bank resided on Wall Street” (*ibid.*, p. 133).

²¹ *Ibid.*, p. 140.

²² *Ibid.*

²³ *Ibid.*, pp. 140–1.

²⁴ *Ibid.*, p. 160.

The author observes how the international financial institutions’ joint engagement with sovereign lending furthered the normalization of the conventional statist practices. The syndicated loans also detached private banks from questions of governmental legitimacy as a risk assessment. These factors marginalized the odious debt doctrine throughout the 1980s sovereign debt crisis. On the other hand, the joint mechanism for handling debt made distressed debt rescheduling possible by the pressure of ostracism. Other notable features of this era that contributed to statist sovereign debt practices are as follows: (a) the International Monetary Fund (“IMF”) gained a prominent role in the debt crisis (when private financing dried up) as a facilitator of funds and an arbiter of acceptable sovereign borrower action; and (b) the IMF actually followed the statist practices in lending and requiring repayment. This chapter also demonstrates that the debtor countries themselves did not claim the odious debt doctrine in the late 1970s and 1980s debt crises by examining the Nicaraguan debt rescheduling, the Iranian debt default (following the regime change), the controversies around the potential repudiation of the Marcos regime debt in the Philippines, and the South American debt crisis.²⁵ Accordingly, despite the recognition of the odious debt doctrine by some members of the international community (e. g. reference to the doctrine in the International Law Commission draft articles on state succession²⁶), this recognition had no impact, in practice, on the norm of sovereign debt continuity, which deepened further in this era.

Having analysed the background of the normalization of statist sovereign debt practices, Chapter 7 examines the last decade of the millennium. It first notes that two significant events that would affect the sovereign debt market took place in this era. The first was the introduction of the “Brady bonds” and the second was the end of the Cold War. The Brady bonds are tradable instruments issued in exchange for outstanding bank loans. As they can be sold to retail investors, they may be held by a dispersed group of creditors.²⁷ Thus, the introduction of these bonds brought changes to the creditor structure. The second, the end of the Cold War, ended the competition between the United States and the Soviet Union. This created flexibility by opening “space for a

²⁵ It is argued that “this decision likely resulted from reputational concerns in the unified creditor framework at the time” (Lienau, *supra* note 3, p. 171).

²⁶ Mohammed Bedjaoui, Special Rapporteur, “Ninth Report on Succession of States in Matters Other Than Treaties,” *Yearbook of the International Law Commission*, Vol. 2, no. 1 (New York: United Nations, 1977) (“Ninth report on draft articles on succession of states”), pp. 67–74.

²⁷ For example, Argentina’s 2005 sovereign debt restructuring involved 600,000 estimated retail investors (Udaibir S. Das, Michael G. Papaioannou and Christoph Trebesch, “Sovereign Debt Restructurings 1950–2010: Concepts, Literature Survey, and Stylized Facts”, *IMF Working Paper, Monetary and Capital Markets Department*, WP/12/203 (2012), p. 21).

range of global arguments and movements associated with ideas of popular sovereignty”.²⁸ In this chapter, it is “tentatively” argued that these twin developments “have started to mainstream long-dormant ideas about illegitimate or odious debt, which may yet prove indicative of a longer-term shift”.²⁹ With regard to the former development, it is argued that the shift to disintermediated borrowing resulting from borrowing through securities could increase the possibility of divergent and potentially non-statist reputational assessments. This is because a large number of disconnected creditors are open to divergent risk interpretations and reputational assessments.³⁰ Then, the end of the Cold War brought a shift to broader arguments about good governance, anticorruption, human rights and democratic rule in the international financial arena. This, in turn, resulted in a departure from the statist idea of sovereignty in the approaches adopted by major actors in the sovereign debt markets such as regional and international development banks,³¹ international organisations,³² individual creditor governments,³³ and private creditor groups.³⁴ Chapter 7 also examines the approach adopted by adjudicatory bodies – both domestic courts and international tribunals – in terms of debt continuity. Notably, this chapter examines the award of the tribunal established under the International Centre

28 Lienau, *supra* note 3, p. 194.

29 *Ibid.*

30 Lienau, *supra* note 3, pp. 206–7.

31 E. g. Article 1 of the Agreement Establishing the European Bank for Reconstruction and Development (1990) provides that: “In contributing to economic progress and reconstruction, the purpose of the Bank shall be to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics...”.

32 E. g. The United Nations Conference for Trade and Development (“UNCTAD”) finalized the Principles on Promoting Responsible Sovereign Lending and Borrowing, available at: http://www.unctad.info/upload/Debt%20Portal/Principles%20drafts/SLB_Principles_English_Doha_22-04-2012.pdf (“the 2012 UNCTAD Principles”), and these principles provide a non-statist approach. For example, Principle 8 (Agency) provides that “Governments are agents of the State and, as such, when they contract debt obligations, they have a responsibility to protect the interests of their citizens...”.

33 E. g. Norwegian government’s debt relief with respect to the debts of Ecuador, Egypt, Jamaica, Peru and Sierra Leone to the Norwegian Export Credits; the enactment of the UK Debt Relief (Developing Countries) Act, available at: <http://www.legislation.gov.uk/ukpga/2010/22/contents> (see Section 4 below).

34 E. g. The Equator Principles III (effective 4 June 2013, available at: <http://www.equator-principles.com/index.php/equator-principles-3>) set out the guidelines on socially responsible project finance lending. As of January 2014, there are 80 Equator Principles Financial Institutions.

for Settlement of Investment Disputes (“ICSID”) in *World Duty Free v. Kenya*. This case was brought by a company incorporated in the Isle of Man,³⁵ as an indicator of “an increased willingness to adopt non-statist ideas about appropriate sovereign behaviour”.³⁶ In this case, the claimant asserted, *inter alia*, that Kenya breached a concessions contract it had concluded with the Kenyan government of the previous president, Daniel arap Moi, for the construction, maintenance and operation of duty-free complexes at Nairobi and Mombasa International Airports,³⁷ and claimed restitution and compensation.³⁸ On the other hand, the post-Moi government requested that the ICSID tribunal dismiss the claims,³⁹ arguing *inter alia* that: the contract was concluded as a result of a bribe to then President Moi and was, therefore, unenforceable; the claims cannot be heard as a matter of public policy; and as a matter of applicable law, the contract had been validly avoided by Kenya. The tribunal sided with Kenya in concluding that it formally avoided the Agreement, by its counter-memorial of 18 April 2003, for bribery by the claimant.⁴⁰ Lienau considers the tribunal’s approach of requiring the rule of law element in addition to the effective control of territory for the president to validly authorize the contract as a rejection of a statist approach.⁴¹ Finally, this chapter examines the cases of Iraq, Ecuador, and the European debt crises as indicators of a shift to more flexibility in sovereign debt and the wider acceptance of the idea of odious debt by the international community.

The last chapter of the book begins by addressing certain concerns over the non-statist political principles. As to the concern that “[w]eakening the statist framework of sovereignty could justify greater monitoring (or meddling) by other states and by international political and economic institutions with regard to debtor countries’ internal affairs”,⁴² Lienau convincingly argues that it is impossible to clearly separate the concept of sovereignty in international finance and that in global politics. In addition, the complexity of international relations does not allow a binary choice between strictly statist and purely popular accounts of sovereign legitimacy. Thus, the intermediate approaches such as the one adopted

³⁵ It should be noted that this case is based on a contract containing the ICSID arbitration clause, rather than an international investment agreement.

³⁶ Lienau, *supra* note 3, p. 203.

³⁷ *World Duty Free Company Limited v. The Republic of Kenya*, ICSID Case No. ARB/00/7, Award (4 October 2006) (*World Duty Free v. Kenya*), paras. 68–73.

³⁸ *Ibid.*, paras. 76–7.

³⁹ *Ibid.*, paras. 109 and 128.

⁴⁰ *Ibid.*, paras. 182–4.

⁴¹ Lienau, *supra* note 3, p. 204.

⁴² *Ibid.*, p. 230.

in Tinoco arbitration “could ground frameworks that adopt non-continuity in debt while remaining sensitive to concerns about an absolutist (and arguably neo-imperial) non-statist global politics”.⁴³ With regard to the concern that the non-statist approach to repayment might cause a moral hazard (i. e. aggravation of irresponsible behaviour by the debtor), Lienau first points out that the moral hazard problem could in fact arise from the application of debt continuity norm. She argues that the norm of universal repayment has created a moral hazard on the creditors’ side, because it absolves them of a due diligence requirement. Lienau notes that the norm of debt continuity has also caused a moral hazard for borrowing countries, since it encourages them to borrow in the knowledge that future generations will repay the debt.⁴⁴ This being so, Lienau argues, that a moral hazard analysis requires a balance in the light of political and economic risks of corruption and repression. The book concludes by providing certain proposals for the development of legal custom towards the principles of sovereign lending that allow for selective debt cancellation. It is proposed that, transnational and domestic financial regulations should be shaped by considering broader issues than sovereign debt, including the ways that private investors and official creditors interact and interpret risk. According to Lienau, such broader regulations “could, in the long run, have second-order effects on both the acceptance of particular reform proposals and the emergence of new customary international law”.⁴⁵ Lienau aptly argues that such development does not necessarily require the adoption of a new international organization. A better understanding of the new framework based on the rule-of-law and outcome-oriented approaches will stabilize and normalize new practices in the sovereign debt market.

3 Signs of a change?

One of the significant aspects of this book is its approach to examining the historical and political contexts of sovereign debt practices, which go beyond those offered by the “market narrative” on the norm of debt continuity. This examination identifies the unexplored factors behind the long-term prevalence of the statist norm of debt continuity over non-statist ideas in the sovereign debt

⁴³ *Ibid.*, p. 231.

⁴⁴ *Ibid.*, pp. 233–4. For an explanation of why “short-horizon” or myopic governments do not care about a growing accumulation of debt that has to be serviced, see Viral V. Acharya, Raghuram G. Rajan, “Sovereign Debt, Government Myopia, and the Financial Sector” (2013), available at: <https://ideas.repec.org/a/oup/rfinst/v26y2013i6p1526-1560.html>.

⁴⁵ Lienau, *supra* note 3, p. 236.

market. This reveals the politically and historically variable nature of the former case and provides significant insight, from a broader perspective, into the *status quo* of the sovereign debt market. In addition, Lienau suggests the possibility of developing the system towards accepting the non-statist approach, as demonstrated in Chapters 7 and 8. She observes that the change in the structure of the creditors in the sovereign debt market from oligopolistic coordination of major financial institutions to dispersed institutional and individual holders of bonds and other financial instruments set in the 1990s has significant potential to produce divergent views on risk interpretation and reputational assessments. Therefore, this change enables a broader functioning of alternative approaches incorporating ideas of illegitimate debt, a view that I share. Taking full benefit of her strong and persuasive analysis, I would like to add a few points on the prospects of the development of law in this field. The cases arising from the claims of the so-called “vulture funds” and their ramifications suggest an even greater role the dispute settlement bodies may fulfil in developing law and practice in sovereign debt markets. If this is so, then in addition to, and in tandem with, the regulation-oriented approach proposed by Lienau, developing international norms may guide the interpretation and application of applicable laws by these courts. This will also contribute significantly to the future normalization of the non-statist approach to sovereign debt practices. The reminder of this book review briefly discusses these points.

4 The role of the court and pro-creditor laws

The role of the court: On 30 July 2014, Argentina fell into the second default on its external debts, 13 years after the first default in 2001. Behind the second default, there are a series of cases in US courts between Argentina and its leading holdout creditors, in each of which the creditors prevailed. In particular, in November 2012, the United States District Court for the Southern District of New York (“SDNY”) (Judge Griesa) issued injunctive remedial orders⁴⁶ which requested Argentina to “whenever Argentina pays a percentage of what is due on the Exchange Bonds,

⁴⁶ *NML Capital, Ltd. v. Republic of Argentina*, No. 08 Civ. 6978(TPG), 2012 WL 5895784 (SDNY, 21 November 2012); *Aurelius Capital Master, Ltd. & ACP Master, Ltd. v. Republic of Argentina*, No. 09 Civ. 8757(TPG), Dkt. No. 312 (SDNY, 26 November 2012); *Olifant Fund, Ltd. v. Republic of Argentina*, No. 10 Civ. 9587, Dkt. No. 40 (SDNY, 26 November 2012); *Varela v. Republic of Argentina*, No. 10 Civ. 5338, Dkt. No. 64 (SDNY, 26 November 2012). These were amended orders following the request by the Second Circuit in its decision of 26 October 2012 to clarify the scope of injunction. *NML Capital Ltd v. The Republic of Argentina*, 699 F.3d 246 (2nd Cir., 2012).

it must pay plaintiffs the same percentage of what is then due on the FAA Bonds”, and also prevented third parties (the indenture trustee(s), the registered owners, and the clearing systems) from assisting Argentina to evade the injunctions.⁴⁷ These orders were affirmed by the United States Court of Appeals for the Second Circuit in August 2013, and the petition for a writ of certiorari to review the decision by the Second Circuit was rejected on 16 June 2014.⁴⁸ It is believed that these decisions of the US courts triggered Argentina’s second default.⁴⁹ Subsequently, the so called “me too” plaintiffs brought 36 (and, later, an additional 15) separate actions, asking the court to rule that the Republic violated, and continues to violate, the *pari passu* clause of the agreement by issuing and paying on new debts, while refusing to pay on the plaintiffs’ bonds. Judge Griesa granted these “me too” plaintiffs partial summary judgment, in which the court also declared, adjudged and decreed that Argentina violated the *pari passu* clause.⁵⁰ The US courts’ approach on the *pari passu* clause, which continuously favours creditors and, arguably, triggered Argentina’s second default, sparked discussions on the need for a universal system addressing sovereign debt restructurings. These controversies produced Resolution 68/304, “Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes”, adopted by the United Nations General Assembly on 9 September 2014, with 124 in favour and 11 against (41 abstained).⁵¹ A year later, on

⁴⁷ *NML Capital Ltd v. The Republic of Argentina*, 727 F.3d 230 (2nd Cir., 2013). The issue was whether Argentina was in breach of the “*pari passu*” clause by ranking its payment obligations to NML below its obligations to those who accepted the restructuring, to which the court answered in the affirmative. Elliott also prevailed in a case against Peru by employing the *pari passu* clause before a Brussels court, and received the payment from Peru approximately \$58 million for settlement (Elliott Assocs. L.P., General Docket No.2000/QR/92 (Court of Appeals of Brussels, 8th Chambers, 26 September 2000) (“*Elliott v. Peru*”)). Jill E. Fisch and Caroline M. Gentile, “Vultures or Vanguard: The Role of Litigation in Sovereign Debt Restructuring Conference on Sovereign Debt Restructuring: The View from the Legal Academy”, *Emory Law Journal*, Vol.53 (2004), p.1043, available at: http://ir.lawnet.fordham.edu/faculty_scholarship/339, pp.1043–113 at 1086.

⁴⁸ For a chronological list of proceedings and orders on this case, see SCOTUSBLOG, “Republic of Argentina v. NML Capital: Petition for certiorari denied on June 16, 2014”, available at: <http://www.scotusblog.com/case-files/cases/republic-of-argentina-v-nml-capital-ltd/>.

⁴⁹ E. g. Council on Hemispheric Affairs, “Argentina for Sale: Implications of the US Supreme Court Decision on Argentina” (20 June 2014, available at: <http://www.coha.org/argentina-for-sale-implications-of-the-u-s-supreme-court-decision-on-argentina/>).

⁵⁰ E. g. Opinion and Order, *NML Capital, Ltd. v. Republic of Argentina*, 14-cv-8601 (TPG) (SDNY, 5 June 2015); Opinion and Order, *Trinity Investments Ltd. v. Republic of Argentina*, 15 Civ. 2611 (TPG) (SDNY, 22 October 2015).

⁵¹ UNGA Res 68/304 (9 September 2014) UN Doc A/RES/68/304. The resolution includes the recognition of “the sovereign right of any State to restructure its sovereign debt, which should not be frustrated or impeded by any measure emanating from another State” and the

10 September 2015, the General Assembly adopted a draft resolution of the “Basic Principles on Sovereign Debt Restructuring Processes”, with 136 in favour and six against (41 abstained).⁵² These events illustrate the impact of court rulings on the possible development of a system of sovereign debt management and sovereign debt restructuring. However, the disputes between the holdout creditors and Argentina could soon end. Argentina offered to settle with its remaining holdout creditors and then asked the court to vacate the *pari passu* injunctions. Judge Griesa granted the motion by Argentina on the condition that: (a) The Republic repeals all legislative obstacles to settlement with the FAA bondholders, including the Lock Law and the Sovereign Payment Law; and (b) For all plaintiffs that enter into agreements in principle with the Republic on or before 29 February 2016, the Republic must make full payment in accordance with the specific terms of each such agreement. The Republic must also notify the court once those plaintiffs have all received full payment.⁵³

Another instance that demonstrates the impact of the court rulings on the development of law is *Donegal v. Zambia*,⁵⁴ another case examined in Lienau’s book. In this case, the creditor that acquired the debt against Zambia arising from a 15 million USD credit facility provided by Romania for 3.28 million USD⁵⁵ sought payment of 55 million USD.⁵⁶ The English High Court ordered Zambia to

recognition that “the efforts of a State to restructure its sovereign debt should not be frustrated or impeded by commercial creditors, including specialized investor funds such as hedge funds, which seek to undertake speculative purchases of its distressed debt at deeply discounted rates on secondary markets in order to pursue full payment via litigation”. The General Assembly decided “to elaborate and adopt through a process of intergovernmental negotiations, as a matter of priority during its sixty-ninth session, a multilateral legal framework for sovereign debt restructuring processes”. The “no” votes include the United States, the United Kingdom, Japan and Germany. UN General Assembly, Official Records of the Sixty-eighth session of the 107th plenary meeting, 9 September 2014, A/68/PV.107, p. 4.

⁵² UNGA Res 69/319 (10 September 2015) UN Doc A/RES/69/L.84. The “no” votes are Canada, Germany, Israel, Japan, UK and US. UN General Assembly, Official Records of the Sixty-ninth session of the 102nd plenary meeting, 10 September 2015, A/69/PV.102, p. 9.

⁵³ E. g. Opinion and Order, *NML Capital, Ltd. v. Republic of Argentina*, 08-cv-6978 (TPG) (SDNY, 19 February 2016).

⁵⁴ *Donegal International Limited v. Republic of Zambia and Anr.*, Case N: 2005–190, [2007] EWHC 197 (Comm.) (15 July 2007) (“*Donegal v. Zambia*”).

⁵⁵ The credit facility was provided in 1979 for the purchase of agricultural machinery from Romania.

⁵⁶ It should, however, be noted that this litigation was based on the terms of a settlement agreement between Donegal and Zambia to end the court proceedings of a case brought by Donegal before the British Virgin Islands, in which Zambia agreed to pay 15 million USD as well as waive sovereign immunity with respect to liability and enforcement of foreign country judgments arising from the settlement agreement. It is observed that without the settlement

pay its debt – the amount was reserved to further determination – to Donegal. The case was ultimately settled by a payment of 15 million USD from Zambia to Donegal. This ruling, which is substantially in favour of Donegal, is controversial, especially in light of the following facts. First, Zambia was covered by the Heavily Indebted Poor Country (“HIPC”) Initiative, which eliminated some of Zambia’s other external debts.⁵⁷ Secondly, Romania had offers from both Donegal and Zambia to acquire the debt, and Donegal was “very much aware of” Zambia’s likely participation in the HIPC Initiative;⁵⁸ and if the relevant debt was covered by the HIPC Initiative terms, “Zambia could instead have expected 88 per cent cancellation of the debts it owed”.⁵⁹ This case was then considered to be a typical example of the aggressive litigation strategy of the so-called “vulture funds” to purchase highly discounted sovereign bonds and sue for full recovery as holdouts of restructuring plans that are acceptable to the vast majority of the other creditors.⁶⁰ The controversies over this decision eventually resulted in the enactment of the UK Debt Relief (Developing Countries) Act,⁶¹ under which private creditors enforcing their claims against HIPC countries are

agreement, “Donegal would have experienced more significant difficulty in obtaining a judgment”. Jonathan Goren, “State-to-State Debts: Sovereign Immunity and the ‘Vulture’ Hunt”, *The George Washington International Law Review*, Vol. 41 (2010), pp. 681–708 at 684.

⁵⁷ Goren, *ibid.*, p. 682.

⁵⁸ Thomas Laryea, “Donegal v. Zambia and the Persistent Debt Problems of Low-income Countries,” *Law and Contemporary Problems*, Vol. 73 (2010), pp. 192–200, at 194.

⁵⁹ HM Treasury, “Ensuring Effective Debt Relief for Poor Countries: A Consultation on Legislation” (2009), para. 2.11.

⁶⁰ In the context of Argentina’s debt crisis, Lord Phillips, the president of the Supreme Court of the United Kingdom, described a vulture fund as “feed(ing) on the debts of sovereign states that are in acute financial difficulty by purchasing sovereign debt at a discount to face value and then seeking to enforce it” (*NML Capital Limited v. Republic of Argentina*, [2011] UKSC 31). It is observed that such “‘holdout’ strategy can be highly profitable for investors with patience” (J. F. Hornbeck, “Argentina’s Defaulted Sovereign Debt: Dealing with the ‘Holdouts’”, *Congressional Research Service*, 6 February 2013, available at: <http://fas.org/sgp/crs/row/R41029.pdf>, p. 8). See also, David Bosco, “The Debt Frenzy” *Foreign Policy*, No. 161 (2007), pp. 36–42, at 42. It should, however, be noted that the positive aspects of vulture funds in the restructuring process have also been pointed out, including: they may serve as a check on opportunistic defaults and onerous restructuring terms; they may reduce the likelihood of opportunistic defaults. Fisch and Gentile, *supra* note 47, p. 1047. See also, Goren, *supra* note 56, p. at 690; Bosco, *ibid.*, p. 38.

⁶¹ In a report for the consultation on legislation by HM Treasury, it is stated (having summarised *Donegal v. Zambia* (*supra* note 54)) that “[t]he purpose of such legislation would be to maximise the benefits of international debt relief by minimising the extent to which the HIPC Initiative can be undermined at the expense of poor countries and their other creditors, including UK citizens”. HM Treasury, *supra* note 59, para. 3.7.

automatically subject to the same reduction rate as that available under the HIPC. That is, they may not collect more than the limited amount set by the HIPC formula.⁶²

The consequences and responses to the Argentina case and the *Donegal v. Zambia* case demonstrate the potentially significant role of the court in the development of sovereign debt practices. In addition, the combination of the proliferation of private lending to sovereign states and the rise of the doctrine of restrictive sovereign immunity,⁶³ which enabled holdout litigations,⁶⁴ has led to the active use of adjudicatory bodies⁶⁵ by distressed debt investors seeking to

62 However, the Act does not apply to any debt incurred by any HIPC country after the date of the enactment of the Act. This is to prevent the avoidance of English law as the governing law of future debts (as examined in Section 5).

63 In English law, the State Immunity Act 1978 expressly provides that a commercial transaction as a non-immune act includes “any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation” (Articles 3(1)(a) and 3(3)(b)). The US Foreign Sovereign Immunities Act of 1976 (“FSIA”) does not define the categories of acts that fall within the definition of a commercial activity (§ 1605(a)(2)), yet in *Weltover v. Argentina* (*Republic of Argentina v. Weltover*, 504 U.S. (1992) 604), the Supreme Court confirmed that the issuance of the Bonods (international bonds issued by Argentina) was a “commercial activity” under the FSIA. Following this case, “international bond issues by a sovereign, and a subsequent default, are almost always considered commercial activities, regardless of the purpose of the issue, or the reason behind the payments interruption” under the US law. Sturzenegger and Zettlemeyer, *supra* note 1 at 57.

64 In the US, for example, it is observed that the *Libra Bank and Allied Bank* cases opened the door to holdout litigation (*Libra Bank Limited*, *Libra International Bank S.A.*, *Banco De La Provincia De Buenos Aires*, *Banco Espirito Santo e Comercial De Lisboa*, *Banco De Vizcaya S.A.*, *Banque International a Luxembourg, S.A.*, *Banque Rothschild*, and the *National Bank of Washington*, *v. Banco Nacional de Costa Rica, S.A.*, 676 F.2d (2nd Cir., 1982); *Allied Bank International v. Banco Credito Agricola de Cartago*, 566 F. Supp.1440 (SDNY, 8 July 1983)). Fisch and Gentile, *supra* note 47, p. 1081; Kenneth Rogoff and Jeromin Zettlemeyer, “Bankruptcy Procedures for Sovereigns: A History of Ideas 1976–2000” *IMF Staff Papers*, Vol.49, No.3 (2002), pp.470–507, p. 475.

65 The term “adjudicatory bodies” in this context includes international arbitration. Although in loan contracts between commercial creditors and governmental borrowers, dispute resolution in national courts is preferred to arbitration (Michael Waibel, *Sovereign Defaults before International Courts and Tribunals* (Cambridge: CUP, 2011), p. 163), the possibility of choosing ICSID arbitration as a dispute settlement forum in the loan contracts was proposed as early as 1981 (Rogoff and Zettlemeyer, *ibid.*, p. 473). It should be, however, noted that the availability of ICSID arbitration for disputes arising from sovereign bonds as financial instruments and based on investment treaties has been controversial. See *Abaclat & Others v. Argentina*, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility (4 August 2011); *Ambiente Ufficio S.p.A. & Others v. Argentina*, ICSID Case No. ARB/08/9, Decision on Jurisdiction and Admissibility (8 February 2013); *Giovanni Alemanni & Others v. Argentina*, ICSID Case No. ARB/07/8, Decision on Jurisdiction and Admissibility (17 November 2014)); *Poštová banka, a.s. and ISTROKAPITAL SE v.*

enforce their claims.⁶⁶ In the context of adjudication, the legal doctrine that could be employed to justify debt repudiation in certain circumstances is the doctrine of odious debt, which is also examined in Lienau's book. The following analysis focuses on this legal doctrine. While this doctrine and the ideas of selective default have been widely recognized by international organizations and scholars,⁶⁷ the doctrine has not yet become mainstream practice. It is even argued that the doctrine is "more aspirational than operational".⁶⁸ Economists have identified several reasons for the rejection of the doctrine in the practice of international finance: (a) definitional difficulties, including the unexplored boundaries of the odious debt doctrine, will create considerable uncertainty in the international financial system;⁶⁹ and (b) the possibility of "ex post invalidation of sovereign debt on odious grounds" will increase borrowing costs in debt markets⁷⁰ because "creditors would price in an expected probability of the regime being declared odious (and, thus, a higher probability of defaulting)".⁷¹ Yet, this does not affect the possibility that the court could potentially be a major forum in which to discuss (and possibly apply) the odious debt doctrine on a

Hellenic Republic, ICSID Case No. ARB/13/8, Award (9 April 2015). The proceedings of *Ambiente v. Argentina* and *Alemanni v. Argentina* were discontinued on 28 May 2015 and 14 December 2015, respectively, for lack of payment of the costs of the arbitration by the claimant investors according to the Regulation 14(3)(d) of the ICSID Administrative and Financial Regulations.

66 This has raised concerns over the potential "race to the courthouse" as a significant threat impeding orderly negotiations. Rogoff and Zettlemeyer, *supra* note 64, p. 494.

67 Ninth report on draft articles on succession of states, *supra* note 26; International Law Association, Rio de Janeiro Conference (2008) Aspects of the Law of State Succession, Draft Final Report, available at: <http://www.ila-hq.org/en/committees/index.cfm/cid/11>, p. 53 ("there is a general agreement in practice, confirmed unanimously by international doctrine, that so-called odious debts (i.e. debts of the State which do not relate to any interest of the population of the territory or aiming at illegal conduct, like war) are not subject to succession"); Buchheit, Gulati and Thompson, *supra* note 13, pp. 1201–1262; Larry Catá Backer, "Odious Debt Wears Two Faces: Systemic Illegitimacy, Problems, and Opportunities in Traditional Odious Debt Conceptions in Globalized Economic Regimes", *Duke Law and Contemporary Problems*, Vol. 70, No. 1 (2007) pp. 1–46 ("Backer, Odious Debt Wears Two Faces"); R.K. Rasmussen, "Sovereign Debt Restructuring, Odious Debt, and the Politics of Debt Relief", *Law and Contemporary Problems*, Vol. 70, No. 4 (2007), pp. 249–261 ("Rasmussen, Sovereign Debt Restructuring"); Seema Jayachandran and Michael Kremer, "Odious Debt", *The American Economic Review*, Vol.96, No. 1 (2006), pp. 82–92.

68 Rasmussen, Sovereign Debt Restructuring, *supra* note 67, pp. 249–261, at 250.

69 Sean Hagan, "The IMF's Role in a Post-Conflict Situation", *Case W. Res. J. Int'l*, Vol. 38 (2006) pp. 59–60.

70 Hagan, *ibid.*; Laryea, *supra* note 58, p. 198.

71 Carlos A. Primo Braga and Dörte Dömeland, "The Economics of Odious Debt", in Carlos A. Primo Braga and Dörte Dömeland (eds.) *Debt Relief and Beyond: Lessons Learned and Challenges Ahead* (World Bank, Washington 2009), pp. 278–279.

case-by-case basis. Ben-Shahar and Gulati aptly observe that: “[a]s a practical matter, to the extent odious debt conceptions are adopted, these adoptions will likely come via municipal courts”.⁷²

Pro-creditor laws: The current sovereign debt market is dominated by the overtly pro-creditor laws of major financial centres. In cases arising from sovereign debt restructuring, including the recent Argentina cases brought by distressed debt investors, both the English and US courts evidently tend to favour the creditor’s rights.⁷³ It is argued that this approach considers the enforceability of contract as fundamental for the successful operation of global debt markets.⁷⁴ The following statement in *Allied Bank International v. Banco Credito Agricola de Cartago* (the Second Circuit) confirms this argument: “[t]he United States has an interest in ensuring that creditors entitled to payment... under contracts subject to the jurisdiction of United States courts may assume that, except under the most extraordinary circumstances, their rights will be determined in accordance with recognized principles of contract law”.⁷⁵ Indeed, stability and predictability is especially valued in global debt markets. As Lienau points out, uncertainty is also linked directly to higher borrowing costs⁷⁶ and, therefore, may militate against the borrower. On the other hand, the issue of odious, or more broadly illegitimate, debt (as discussed below) ultimately comes down to the question of who – the citizens of the borrower state or the creditors – bears the consequences of irresponsible and inappropriate borrowing and lending, which inevitably requires equitable considerations. Therefore, what is needed is a balance between stability in sovereign debt markets, as reflected in borrowing costs, and respect for equity and legitimacy.

⁷² Omri Ben-Shahar and Mitu Gulati, “Partially Odious Debts? A Framework for an Optimal Liability Regime” 70(4) *Law and Contemporary Problems* (2007), pp. 47–81 at 55.

⁷³ See Goren, *supra* note 56, p. 700: “[t]he verdict shows that under current law, the Donegals of the world typically prevail”. The enforcement difficulty has been pointed out (e.g. Lee C. Buchheit and G. Mitu Gulati, “Responsible Sovereign Lending and Borrowing” UNCTAD/OSG/DP/2010/2 (2010), p. 2), but Elliott’s success in *Elliott v. Peru* (*supra* note 47) and the recent decisions granting extraterritorial discovery against Argentina suggest that enforcement has also become more feasible in recent years.

⁷⁴ Goren, *supra* note 56, p. 700.

⁷⁵ *Allied Bank International v. Banco Credito Agricola de Cartago*, 757 F.2d 516 (2nd Cir., 1985), pp. 521–22.

⁷⁶ Lienau, p.238. For an analysis between the cost of borrowing and high future restructuring costs, see Patrick Bolton, Olivier Jeanne, “Structuring and Restructuring Sovereign Debt: The Role of a Bankruptcy Regime”, 115(6) *Journal of Political Economy* (2007), pp. 901–24.

5 Need for guidance and a step forward – from odious to illegitimate debt

Need for guidance: I fully agree with Lienau that the development towards more flexibility does not necessarily require the adoption of a new international organization. To supplement the regulation-oriented approach proposed in Chapter 8, it is proposed here that providing *international principles* as guidance for adjudicators who deal with creditor-state disputes would contribute to developing sovereign debt management practices. Another possible approach would be to require that creditor countries amend the relevant domestic laws to limit creditors' rights to recovery in certain circumstances. A staff paper of the IMF on the HIPC initiative explicitly recognizes this possibility as a means to enhance the initiative:

[I]n the absence of an international legal regime that protects sovereign debtors from creditor litigation, legislative changes could be introduced in member countries which provide HIPC's protection from lawsuits or from asset attachments in cases where creditors attempt to recover claims in excess of the amount which such creditors would be entitled to receive consistent with the HIPC Initiative.⁷⁷

While this approach would undoubtedly be effective for the normalization of the non-statist approach, it is doubtful if the creditor countries will implement the law reforms applicable to all relevant cases. Creditor countries might well shy away from introducing such a catch-all reform for fear that it may result in avoiding their jurisdiction. Such a possibility is described by Ben-Shahar and Gulati, as follows:

If one jurisdiction (say, either New York or the United Kingdom, the two that dominate cross-border lending) adopts a version of the partial-liability framework, creditors will simply move to a jurisdiction that is more lenient.⁷⁸

The UK Debt Relief (Developing Countries) Act limits its application to debts incurred by any HIPC country before the date of its enactment, because it was considered that applying the Act to new lending would undermine the competitiveness of the UK's financial services. According to the HM Treasury:

⁷⁷ International Development Association and International Monetary Fund, "Enhanced HIPC Initiative – Creditor Participation Issues" Prepared by the Staffs of the World Bank and IMF, Approved by Gobind Nankani and Timothy Geithner (8 April 2003), available at: <http://www.imf.org/external/np/hipc/2003/creditor/040803.pdf>, para. 11.

⁷⁸ Ben-Shahar and Gulati, *supra* note 72, p. 77.

[T]he government favours restricting the domestic legislation discussed in this consultation (the UK Debt Relief Act) to debts contracted before the proposed legislation comes into force. A measure that applied to new lending would need to be taken with international agreement, as otherwise it could readily be through choice of a different jurisdiction to cover new lending. This would be to the detriment of the UK’s financial services sector without achieving its intention.

Moreover, the questions on the doctrine of odious debt, such as determining the necessary conditions of a despotic regime, and how to treat partly odious and partly benign debts,⁷⁹ would be best addressed on a case-by-case basis in light of the circumstances of the particular case.⁸⁰ The accumulation of tailored refinements to the remedies provided by the courts for each case, guided by widely accepted principles, would contribute to standardized and normalized practices. These considerations warrant the importance of international principles that may inform judges or arbitrators, when interpreting and applying the relevant law to a particular creditor-state dispute.

The 2012 UNCTAD Principles are believed to have this potential. Not only do they offer the “promising signs that new approaches to debt resolution may be on the international agenda”,⁸¹ they also set out international standards for sovereign debt markets. Waibel observes that:

Whereas they (the Principles) do not simply codify existing international custom, and are progressive in character, they could, over time, foster consensus on harmonized standards that could be incorporated into the domestic legal infrastructures for sovereign borrowing in all jurisdictions and, in turn, give rise to more consistent state practice and jurisprudence. This demonstrates the innovative character of the Principles.⁸²

⁷⁹ See Buchheit and Gulati, *supra* note 73, p. 3.

⁸⁰ The attempt of adopting universal approach on the doctrine of odious debt faces not only such “definitional” issues, but also the issue of the “power imbalance between lenders and debtors that is often obscured in dominant interpretations of sovereign debt” (Jesse Hembruff, “Critical Review: the politics of sovereign debt”, *Third World Quarterly*, Vol. 34, No. 4 (2013), pp. 710–25 at 712). Hembruff points out that “debtor states need to follow the prevailing development orthodoxy ... because to deviate is to risk losing access to new loans, leading to default” (*ibid.*). Likewise, Rasmussen explains why it is difficult to adopt such a universal approach: “Under the current regime, the United States can balance its financial interests (including those of its citizens) against its political interests when faced with financial distress of any given country. It is difficult to see how it would be in the United States’ interest to give up this ability to balance *ex post*”. (Rasmussen, *Sovereign Debt Restructuring*, *supra* note 67, p. 258).

⁸¹ Gavin Fridell, “Politicising Debt and Development: activist voices on social justice in the new millennium”, *Third World Quarterly*, Vol. 34, No. 4 (2013), pp. 726–45 at 734.

⁸² Michael Waibel, “Out of Thin Air? Tracing the Origins of the UNCTAD Principles in Customary International Law” in Carlos Esposito, Yefen Li and Juan Pablo Bohoslavsky (eds.)

Bohoslavsky and Esposito also argue that:

[W]e are convinced that the Principles have the force to become persuasive enough to influence the interpretation, application, and development of other rules of law or even to become recognized as legal rules in themselves.⁸³

Arbitrator Santiago Torres Bernárdez, in his dissenting opinion in *Ambiente v. Argentina* (this is one of the three ICSID cases arising from Argentina's 2001 default and based on the Argentina-Italy Bilateral Investment Treaty (BIT)), did refer to the 2012 UNCTAD Principles, in particular Principle 15 (Restructuring).⁸⁴

In July 2012, the Guiding Principles on Foreign Debt and Human Rights, prepared by the United Nations Independent Expert Cephias Lumina, were endorsed by the United Nations Human Rights Council at its twentieth session.⁸⁵ The Principles acknowledge the odious debt doctrine in the following terms:

86. The establishment and operation of such a mechanism should be guided by the foundational principles set out in Section II, as well as the following specific considerations:

...

- (d) The mechanism should have the mandate to rule on the alleged “odiousness” or “illegitimacy” of particular external debts. The criteria to be used to ascertain the odiousness or illegitimacy of a particular external debt should be defined by national legislation taking into account the following elements:
 - (i) The absence of consent by the debtor State's population;
 - (ii) The absence of benefit to the debtor State's population; and
 - (iii) The creditor's awareness of the above facts.⁸⁶

Sovereign Financing and International Law: The UNCTAD Principles on Responsible Sovereign Lending and Borrowing (Oxford: OUP, 2013) pp. 87–112 at 89.

⁸³ Juan Pablo Bohoslavsky and Carlos Esposito, “Principles Matter: The Legal Status of the Principles on Responsible Sovereign Financing”, in Carlos Esposito, Yefen Li and Juan Pablo Bohoslavsky (eds.) *Sovereign Financing and International Law: The UNCTAD Principles on Responsible Sovereign Lending and Borrowing* (Oxford: OUP, 2013) pp. 73–86 at 83.

⁸⁴ *Ambiente v. Argentina*, *supra* note 65, Dissenting opinion of Torres Bernárdez, para. 330.

⁸⁵ Human Rights Council, Resolution 20/10 “The effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights” A/HRC/RES/20/10 (18 July 2012) (“Human Rights Council Resolution 20/10”), available at: <http://daccess-dds-ny.un.org/doc/RESOLUTION/GEN/G12/162/01/PDF/G1216201.pdf?OpenElement>, p. 2. The Draft Commentary to the Guiding Principles on foreign debt and human rights was submitted to the Human Rights Council in March 2014. Advance unedited version is available at: <http://www.ohchr.org/EN/Issues/Development/IEDebt/Pages/GuidingPrinciples.aspx>.

⁸⁶ On this paragraph, the Draft Commentary states that: “At the very least, there has to be some form of auditing of a debtor country's external debts at the commencement of any

The Human Rights Council, in its resolution 20/10, “[e]ncourages all Governments, relevant United Nations agencies, funds and programmes, as well as the private sector, to take into consideration the guiding principles when designing policies and programmes”.⁸⁷

Illegitimate debt: These considerations all underlie the importance of further developing legal guidelines at the international level to achieve a balanced shift from rigorous repayment principles to a more flexible approach guided by non-statist considerations. A direction for the development may be the possible evolution of the (narrow) odious debt doctrine that “a government can disavow debts of its predecessors when *creditors know* that these debts were incurred without the consent, or for the benefit, of the government’s citizens”⁸⁸ to the broader notion of “illegitimate debt”. The two cases examined in Lienau’s book – the *Tinoco* arbitration and *World Duty Free v. Kenya* – arguably fall within the notion of odious debt, in that the creditor (a) knew that the loan was to be used by the retiring president for his personal support after he had taken refuge in a foreign country (*Tinoco*), or (b) voluntarily paid out the bribery to the then president, and did not contest the fact (*World Duty Free*).⁸⁹

Recall that the tribunal in *World Duty Free v. Kenya* emphasised the culpability of the claimant’s conduct when dismissing its claims by stating that: “as regards public policy both under English law and Kenyan law ... and on the specific facts of this case ... the Claimant was not legally entitled to maintain any of its pleaded claims in these proceedings on the ground of *ex turpi causa non oritur actio*”.⁹⁰ Indeed, at the centre of the concept of “illegitimate debt” is the concept of responsible lending. In line with the “emotive” cases⁹¹ of odious debt, the concept of illegitimate debt has recently garnered attention. Hanlon explains the rise of this notion as follows:

Towards the end of the 1990s, with the growth of the Jubilee 2000 movement to cancel the ‘unpayable debt of the poorest countries’ by 2000, there were demands from activists and civil society in the South to cancel or repudiate what they called ‘illegitimate

restructuring process to ensure that only valid and legitimate external debts will be included in the restructuring plan, and the people of a debtor country as taxpayers would only repay validly and legitimately incurred international loan obligations”.

⁸⁷ Human Rights Council Resolution 20/10, *supra* note 85, p. 2.

⁸⁸ Laryea, *supra* note 58, p. 198 (emphasis added).

⁸⁹ As Lienau aptly observes, this case is unique in that it is “an unusually clear and uncontested instance of bribery”. Lienau, *supra* note 3, p. 205.

⁹⁰ *World Duty Free v. Kenya*, *supra* note 37, para. 179.

⁹¹ Buchheit, Gulati and Thompson, *supra* note 13, p. 1220.

debt'. This was intended to be more than an odious or dictators' debt, and was seen as a broader category of debts which were the liability of the lender and not the borrower.⁹²

Hanlon provides a "functional" definition of the notion of illegitimate debt: it "consists of loans which were improperly granted and are thus the liability of the lender and are not to be repaid".⁹³ He identifies the situations that make loans illegitimate, including: where a credit bargain is extortionate; usury; lending to oppressive regimes; gross negligence in lending.⁹⁴

Therefore, the notion of "illegitimate debt" requires considering the lenders' responsibility of due diligence, which goes well beyond requiring their actual knowledge of the odiousness of the debt, in assessing the possibility of debt relief.⁹⁵ In other words, illegitimate debts are "those that should not be paid", rather than "cannot be paid".⁹⁶ Backer also supports the broad or "modern" understanding of the doctrine of odious debt, which endorses, *inter alia*, the following factors: "an adherence to the basic contractual context of transactions and consequential emphasis on lender and borrower due diligence"; and "[a] shift of responsibility to the lender, with a move away from state (and borrower) obligation to lender responsibility, and a greater willingness to tolerate imposition of significant penalties for failures of lenders to monitor the use of their funds".⁹⁷

Furthermore, the following considerations support the notion of illegitimate debt. First, every loan is a "two-sided operation"⁹⁸ conducted by both lender and borrower. Therefore, there is no illegitimate debt without improper lending. Secondly, the lender is better positioned than the citizens of the debtor state to conduct surveillance and monitoring as to the use/abuse of their funds. Thirdly,

⁹² Hanlon, 'Illegitimate' Loans, *supra* note 13, p. 218.

⁹³ *Ibid.*, p. 220.

⁹⁴ Joseph Hanlon, "Defining 'Illegitimate Debt': When Creditors Should be Liable for Improper Loans" in Chris Jochnick and Fraser A. Preston (eds.) *Sovereign Debt at the Crossroads: Challenges and Proposals for Resolving the Third World Debt Crisis* (OUP: Oxford 2006) pp. 109–31 ("Hanlon, Defining 'Illegitimate Debt'") at 113–25.

⁹⁵ *Ibid.*, p. 224: "The concept of illegitimate debt places consideration entirely on the lender, and debt cancellation is seen as a stick with which to force the lender to adopt better policies". Likewise, Backer also notes the development of lender due diligence as "a general global consensus moves from a schema requiring actual creditor knowledge of borrower wrongdoing to one predicated on a set of positive obligations centering on creditor surveillance and intelligence-gathering..." (Backer, *Odious Debt Wears Two Faces*, *supra* note 67, p. 4). She concludes that "arguments based on corruption or on knowledge of wrongfulness chargeable to lenders, would now be fair game for avoidance" (*ibid.*, p. 26).

⁹⁶ Hanlon, Defining 'Illegitimate Debt', *supra* note 94, p. 125.

⁹⁷ Backer, *Odious Debt Wears Two Faces*, *supra* note 67 at 13.

⁹⁸ Hembruff, *supra* note 80, p. 713.

while the lender is – in principle - better positioned to take harm-prevention measures,⁹⁹ private lenders actually have less economic incentive to carefully assess the nature of debt or the use of their funds. This is because, owing to the absence of the bankruptcy regime in sovereign debt restructuring and the existing pro-creditor approach adopted by the courts of major financial centres (as examined above), creditors, in the jurisdictions of these financial centres, “can negotiate from the position that they are legally entitled to 100 percent recovery in accordance with the contract terms”.¹⁰⁰

Indeed, the lenders’ duty of due diligence has been widely recognized in the international sphere. The 2012 UNCTAD Principles provide a set of responsibilities for lenders, which include those concerning responsible sovereign lending:

1. Agency

Lenders should recognize that government officials involved in sovereign lending and borrowing transactions are responsible for protecting public interest (to the State and its citizens for which they are acting as agents).

4. Responsible credit decisions

A lender is responsible to make a realistic assessment of the sovereign borrower’s capacity to service a loan based on the best available information and following objective and agreed technical rules on due diligence and national accounts.

Likewise, the Guiding Principles on Foreign Debt and Human Rights incorporate the notion of shared responsibility of creditors and debtors,¹⁰¹ with an explicit reference to the responsibility of due diligence of the former:

23. Creditors and debtors share responsibility for preventing and resolving unsustainable debt situations. For creditors, this includes the obligation to perform due diligence on the creditworthiness and ability to repay of the borrower as well as the duty to refrain from providing a loan in circumstances where the lender is aware that the funds will be used for non-public purposes or for a non-viable project...

The Draft Commentary to the Guiding Principles on foreign debt and human rights (prepared by Cephass Lumina) illustrates the principle of “shared responsibility” as follows:

99 Larry Catá Backer, “Odious Debt and ‘Vulture Funds’: Making a Case for Repudiation of Sovereign Debt” (February 2007), available at: <http://lcbackerblog.blogspot.jp/2007/02/odious-debt-and-vulture-funds-making.html>; Ben-Shahar and Gulati, *supra* note 72, p. 50.

100 Rogoff and Zettlemeyer, *supra* note 64, p. 476.

101 Citing the Report of the International Conference on Financing for Development, Monterrey, Mexico, 18–22 March 2002 (United Nations Publication, Sales No. E.02.II.A.7, Chap. I, resolution 1, annex, para. 47).

Thus, for example, lenders must not provide loans without conducting due diligence or, in the case of development loans, must not lend for projects that have no developmental benefit for the population of the borrower State. For their part, borrower States must not contract loans that they are not in a position to repay, nor must they conclude loan agreements in circumvention of the applicable national legal and institutional frameworks.¹⁰²

Backer makes the following observations with regard to the lenders' responsibility in sovereign debt markets:

The U.N.'s recent attempt to construct a global law for the regulation of multinational corporations and similar enterprises embraced these notions as a general matter. The international community appears to be more energetically embracing the notion that private actors have continuing surveillance and monitoring duties respecting the actions of all parties to agreements to which they are parties.¹⁰³

Buchheit and Gulati also argue that lenders to sovereign borrowers have the duties of responsible sovereign lending, including the following: (a) the duty not to suborn or consciously ignore conduct inconsistent with the fiduciary duties of the government officials contracting the debt; (b) the duty to conduct realistic assessments of the borrower's capacity and willingness to repay the debt; (c) the duty to exercise legal diligence, which includes investigating whether the loan has been appropriately authorized; and (d) in the case of project financing, the duty to consider the reasonably foreseeable consequences of the project being financed, such as its environmental impact.¹⁰⁴ These duties all offer strong support for the recognition of lenders' due diligence liability at the payment stage.

Despite this wide recognition of lenders' duty of due diligence, in the current system the debtor state is, in principle, subject to 100 per cent recovery from creditors. Debt relief mechanisms, such as the HIPC Initiatives, focus solely on the borrower's situation.¹⁰⁵ Therefore, Hanlon observes that "[a]lthough there is

102 Draft Commentary to the Guiding Principles on foreign debt and human rights, *supra* note 85, Section II(3) (Commentary to principles 23 and 24).

103 Backer, *Odious Debt Wears Two Faces*, *supra* note 67, p. 4 (footnote 16).

104 Buchheit and Gulati, *supra* note, 73, pp. 10–11.

105 The criteria for the consideration of HIPC Initiative assistance are: [the country must] be eligible to borrow from the World Bank's International Development Agency, which provides interest-free loans and grants to the world's poorest countries, and from the IMF's Poverty Reduction and Growth Trust, which provides loans to low-income countries at subsidized rates; face an unsustainable debt burden that cannot be addressed through traditional debt relief mechanisms; have established a track record of reform and sound policies through IMF- and World Bank-supported programs; and have developed a Poverty Reduction Strategy Paper (PRSP) through a broad-based participatory process in the country. IMF "Factsheet: Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative" (30 September 2014), available at: <https://www.imf.org/external/np/exr/facts/hipc.htm>. Laryea argues that the

now an implicit acceptance that some debt is illegitimate and should not be repaid, the decision on cancelling the debt still remains in the gift of the very agencies which made the improper loans in the first place”.¹⁰⁶ Therefore, the question that arises is how the lender’s duty of due diligence may have a practical impact in sovereign debt markets and restructuring. It has been argued that the all-or-nothing recovery rule has resulted in the following dilemma. A categorical discharge of every “illegitimate debt” (apart from its definitional problem) will dry up sovereign lending, or make it prohibitively expensive. However, an approach that unduly favours “careless” creditors at the expense of the citizens of the debtor state would not only raise equity issues, but also incentivize a rush to the court.¹⁰⁷

A possible solution to this dilemma is as follows. In cases of improper lending where there was not outright violation of law (e.g. corruption) or knowledge of the odiousness, but a failure to exercise due diligence on the part of the lender, creditors’ claims may be readjusted at the payment stage, reflecting the responsibility of the lender. For example, this may be done by ordering payment with a percentage reduction, which reflects the degree of fault of the lender for its own improper lending. Indeed, if the lenders have failed to fulfil their responsibility to *prevent* illegitimate sovereign debt, fairness requires that they share the consequences of the illegitimate debt. Moreover, as noted, if lenders are entitled to, in principle, 100 per cent recovery, despite their failure to pay due diligence at the time of lending, they will have little economic incentive to prevent illegitimate lending. Conversely, this means it is possible to change creditors’ behaviour as “rational actors” towards greater diligence by imposing legal liability at the payment stage.¹⁰⁸ Rasmussen argues that:

A blanket rule that all debts incurred by certain types of regimes are discharged when the regime is ousted would close the lending window...However, to the extent that the monies received were spent on the follies and fancies of the erstwhile leaders, it is far from obvious that the citizens should remain burdened by the debt. In this situation, lenders may be better positioned to reduce the agency costs that arise between citizens and their rulers

IMF’s focus on the unsustainable debt situations of low-income countries is explained by its duty of neutrality, to avoid any disputes on legal merits. Laryea, *supra* note 58, p. 199.

106 Hanlon, ‘Illegitimate’ Loans, *supra* note 13, p. 223. He observes that this is partly “because of a genuine fear in the early 1980s that banks had made so many bad and corrupt loans that the banking system would collapse if they were held liable”. Hanlon, Defining ‘Illegitimate Debt’, *supra* note 94, p. 117.

107 See Goren, *supra* note 56, p. 693–4.

108 Ben-Shahar and Gulati, *supra* note 72, p. 49: “Creditors are also rational actors whose behavior can potentially change by an imposition of legal liability”.

than are the citizens themselves. These are precisely the issues on which the “odious debt” debate centers.¹⁰⁹

Although he proposes the establishment of “a debt restructuring system that includes an automatic discharge” as a way to “provide a right of discharge that would ensure that any restructuring offers sufficient relief to the nation’s citizens”,¹¹⁰ the rationale squarely applies to the liability-sharing scheme proposed here. Buchheit and Gulati also argue that creditors are obliged to *renegotiate* sovereign loans, which “should engender equal caution in loans to sovereign borrowers”.¹¹¹

The concept of sharing the responsibility of illegitimate sovereign debt between the creditors and the debtor state at the payment stage has been recognized in the international sphere. Paragraph 23 of the Guiding Principles on Foreign Debt and Human Rights, cited above, explicitly provides that creditors and debtors “share responsibility for preventing and *resolving* unsustainable debt situations” (emphasis added). Article 7 of the 2012 UNCTAD Principles provides that “all lenders have a duty to behave in good faith and with cooperative spirit to reach a consensual rearrangement of those obligations” in order to find a mutually satisfactory solution.

Ben-Shahar and Gulati are strong advocates of a partial liability scheme as a replacement for the all-or-nothing structure of the odious debt doctrine. They identify two factors that help determine partial liability: the comparative-fault calculus and the extent to which the populace benefited from the loan. Based on these factors, they suggest a liability scheme that “would generally divide the loss between the creditors and the populace”, that is, “[t]he populace continues to be strictly liable for the national debt, but it now has a defense of contributory negligence against the creditors”.¹¹²

The law or legal principles that could potentially be employed by the court or tribunal to achieve equitable burden sharing in actual disputes would differ depending on each jurisdiction. Although a detailed examination of this issue is outside the scope of this review, the following is worth mentioning. In the context of investor-state arbitration, the principle of contributory negligence has been employed to approximate the responsibility between the claimant investors and defendant states at the remedy phase. The Annulment Committee in *MTD v. Chile* stated that although Article 39 of the

¹⁰⁹ Robert K. Rasmussen, “Integrating a Theory of the State into Sovereign Debt Restructuring” *Emory Law Journal*, Vol. 53 (2004), pp. 1159–1187 at 1177 (citation omitted).

¹¹⁰ *Ibid.*, p. 1187–8.

¹¹¹ Buchheit and Gulati, *supra* note 73 p. 12.

¹¹² Ben-Shahar and Gulati, *supra* note 72, p. 49–50.

International Law Commission Articles on State Responsibility, which endorses the principle,¹¹³ is concerned with claims between States, "[t]here is no reason not to apply the same principle of contribution to claims for breach of treaty brought by individuals".¹¹⁴ There are several investment treaty arbitration cases in which the tribunals awarded partial compensation relying on the principle of contributory negligence.¹¹⁵ A recent example is the series of *Yukos v. Russia* cases,¹¹⁶ which resulted in the highest compensation in investment treaty arbitration. At the merit (liability) phase, the tribunal concluded that the measures adopted by Russia with respect to Yukos had an effect "equivalent to nationalization or expropriation" that did not meet the conditions for lawful expropriation, and therefore Russia was in breach of its treaty obligations under Article 13 of the ECT.¹¹⁷ In assessing the amount of compensation, however, the tribunal reduced the damages awarded to the claimants by 25 per cent, which resulted in the reduction of the award from USD 66.7 billion to USD 50 billion, by employing the notion of contributory negligence. The legal principle that may play a similar function in the US tort law is the principle of comparative negligence, which has replaced the complete defense of contributory negligence.¹¹⁸

113 "In the determination of reparation, account shall be taken of the contribution to the injury by willful or negligent action or omission of the injured State or any person or entity in relation to whom reparation is sought". See also, Borzu Sabahi, *Compensation and Restitution in Investor-State Arbitration: Principles and Practice* (Oxford: OUP 2011) pp. 175–6; Wojciech Sadowski, "Yukos and Contributory Fault" TDM Advance Publication (October 2014), available at: <http://www.transnational-dispute-management.com/journal-advance-publication-article.asp?key=545>, pp. 1–4.

114 *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Chile*, ICSID Case No. ARB/01/7, Decision on Annulment (21 March 2007), para. 99 (citing ILC Articles, Art. 33(2) and commentary, para. (4)). For the view that certain qualifications may be necessary to such an approach, see Sadowski, *ibid.*, pp. 28–36.

115 *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Chile*, ICSID Case No. ARB/01/7, award (24 May 2004); *Occidental v. Ecuador II*, ICSID Case No. ARB/06/11, award (5 October 2012).

116 *Veteran Petroleum Limited (Cyprus) v. Russia*, UNCITRAL, PCA Case No. AA 228, final award (18 July 2014); *Hulley Enterprises Limited (Cyprus) v. Russia*, UNCITRAL, PCA Case No. AA 226, final award (18 July 2014) and *Yukos Universal Limited (Isle of Man) v. Russia*, UNCITRAL, PCA Case No. AA 227 final award (18 July 2014) (collectively, "Yukos awards").

117 Yukos awards, *ibid.*, paras. 1580–1585.

118 As to the theoretical basis of this principle, Grehan points out that "[it] restores the primacy of compensation as the goal of a negligence system" and "recognizes that in the course of seeking to compensate victims basic notions of equity cannot be abandoned". He also observes that "The resolution of the issue usually depends on how the court defines the elements of assumption of risk." (Kevin J. Grehan, "Comparative Negligence" *Columbia Law Review*, Vol. 81, No. 8 (1981), pp. 1668–701, at 1670 and 1675).

It is true that the context in which partial compensation is awarded in investment treaty arbitration is based on the alleged breach of investment treaties, and that this context is different to that of the ordinary lender-debtor state litigations based on contractual claims. The same caveat applies to the principle of comparative negligence as a tort law principle. However, the basic notion of equity underlying these principles¹¹⁹ does apply to liability sharing in sovereign debt restructuring. Note that both England and US law have discussed expanding the scope of the application of the comparative negligence principle to contract law.¹²⁰ This may indicate one possible direction for the development of law to achieve a balance in liability sharing between creditors and the citizens of the debtor state.

6 Conclusion

Admittedly, the approach proposed in the previous section does have application issues. As with the narrow application of odious debt, determining the relative culpability of the disputing parties would be very difficult. In addition, as Lienau points out, “the absence of a clear dividing line between accepted and unacceptable lending behaviour could raise borrowing costs”.¹²¹ It is also true that the case-by-case determination of partial liability by adjudicatory bodies is not free from errors. However, as Ben-Shahar and Gulati point out, this fact alone should not deny the partial-liability framework, because “[a]ny schema imposes errors, even if it does not require courts to affirmatively assess liability”.¹²² In this respect, I appreciate the following direction presented by Lienau:

Any shift in dominant practices will inevitably be accompanied by a period of uncertainty and possible higher debt pricing (borrowing cost). Once the new framework is better understood, however, there is little reason not to expect markets to stabilize and settle into a new normal.¹²³

119 Grehan, *ibid.*, p. 1576: “The goal of a comparative negligence system is to apportion damages equitably among the negligent parties after the injury has taken place”.

120 See e.g. The Law Commission (LAW COM. NO. 219) “Contributory Negligence as a Defence in Contract” (1993), available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/228965/0009.pdf; Ariel Porat, “A Comparative Fault Defense in Contract Law” *Michigan Law Review*, Vol. 107, No. 8 (2009), pp. 1397–412.

121 Lienau, *supra* note 3, p. 237.

122 Ben-Shahar and Gulati, *supra* note 72, p. 73.

123 Lienau, *supra* note 3, p. 238.

In addition, this approach does not deny the importance of discussing the possibility of establishing a universal and structured mechanism to resolve debt crises.¹²⁴ However, in the absence of the prospect of such a universal system in the near future, realistic options are necessary to achieve a proper balance that does not unduly burden the citizens of the debtor state. In tandem with the greater attentiveness to broader regulatory and ideational structures recommended by Lienau, the development of case law in this field could potentially drive more a more flexible and equitable regime of sovereign debt management. For this purpose, further development of international principles to guide the interpretation and application of the applicable law by the courts is necessary. The openness towards flexible non-statist sovereign debt management demonstrated in Lienau’s book through its analysis of the debt continuity norm, as well as the novel insight it provides from theoretical, historical and political perspectives, greatly contribute to the development of such guiding principles.

124 Yuefen Li and Ugo Panizza, “The Economic Rationale for the Principles on Promoting Responsible Sovereign Lending and Borrowing”, in Carlos Esposito, Yefen Li and Juan Pablo Bohoslavsky (eds.) *Sovereign Financing and International Law: The UNCTAD Principles on Responsible Sovereign Lending and Borrowing* (Oxford: OUP, 2013) pp.15–37 at 37.