Odious Debts in International and Private Law

What should instruments look like for the evaluation and cancellation of odious debts, and how should they become established in international and private law? Legal experts from around the world will address this question at a conference in October in Bern, Switzerland. Here we summarize the current debate and present several competing legal approaches.

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The most important principle of civil and private contract law is that contracts must be honored *(pacta sunt servanda*). Non-governmental organizations (NGOs) and legal experts are searching for ways to deviate from this principle for the case of odious debts. It is essential to find a practical instrument that sets clear guidelines and does not discourage creditors from granting future loans, particularly to developing and emerging countries.

The intellectual father of the odious debt doctrine is the Russian lawyer and law professor Alexander N. Sack. In 1927 Sack defined a debt as odious when:

- the loan was taken out by a despotic regime, without the consent of the people
- the loan was used for a purpose that was not in the interests of the state
- the creditors knew how the loan would be used

Sack's theory postulates that a debt that has been identified as odious is only linked to the despotic regime that incurred the debt, and only that regime can be called upon to repay it. Consequently, future democratic governments act legally when they do not take over this debt. An international court of arbitration would rule on the illegitimacy of a loan.[1]

Sack's Theory Seen As Impractical

Today, Sack's theory is considered outdated and impractical by most experts. Charles Abrahams states that it is irrelevant to international law whether loans were entered into by a dictatorial regime or a democratically-elected government; international law does not address governments and the internal legal system of a nation. Therefore, states and not governments would be held responsible for the unlawful activities (as defined by international law) committed by governments. Furthermore, according to Abrahams the distinction between dictatorial and democratic systems is not as clear as it first appears. The apartheid regime in South Africa had a highly-evolved internal legal system, including legislative and executive

branches, legal institutions and other public bodies. Abrahams also points out that as a rule, international law does not concern itself with the internal utilization of a loan.[2]

Sabine Michalowski believes it is difficult to judge if the population has approved the acceptance of a loan or not. In a representative democracy, the elected government is normally authorized to act in the name of the people. Therefore one would say that when a government comes to power without having been elected, it is not authorized to borrow. But what happens when a government, enjoying strong backing from the population, comes to power through revolution? Or what if a country does not have a representative democracy but nonetheless enjoys popular support?

More difficult still is the assessment of the benefit of a loan, according to Michalowski. What criteria should be used? Should spending for a country's infrastructure and for social programs in general be viewed as beneficial? Or what if loans are allocated for specific projects judged as beneficial, which then frees up other resources to be used for ends that harm the welfare of the people? To make matters worse (according to Michalowski), the assessment of benefit appears not only to depend upon how the loan is used, but also upon the undemocratic nature of the regime.[3]

Odious Debt or Odious Regime

While the legitimacy of every loan could be individually assessed according to Sack's concept, some of today's theorists shift the focus of debt to the illegitimate or odious regime. Ashfaq Khalfan, Jeff King and Bryan Thomas share the view that dictatorial regimes act, by definition, without the consent of the people. Moreover, one could assume that the loans granted to such regimes do not benefit the people if they do not serve a specific identifiable purpose.[4] Proponents of an approach that primarily aims to name regimes as odious count on the deterrent effect on potential future creditors.

Lee C. Buchheit, G. Mitu Gulati and Robert B. Thompson consider that when a regime is seen as odious, every form of social and humanitary help is prohibited, because it likewise serves the continued existence of the regime. Such a morally questionable application of the odious debts doctrine would have the same effect as international economic sanctions.[5] Michalowski also believes that it may be nearly impossible for highly-politicized international bodies to judge the undemocratic nature of regimes objectively and free from political self-interests.[6]

Foundations of International Law

This academic discussion shows that Sack's seemingly clear criteria raise complex legal questions, ranging from the acknowledgement in international law to the exact meaning and purpose of the doctrine and the mechanisms for its practical implementation. In addition, it is important to know that international law comes from three sources, presented in Article 38 of the Statute of the International Court of Justice (ICJ):

- International conventions, concerning the conclusion of contracts and the subsequent ratification by the involved subjects of international law (primarily states).
- Customary international law, made up of the elements of long-term practice and the belief that this practice is legal (*opinio juris*).
- The general principles of law, consisting of all principles of state internal legal systems that are inherent to every legal system. An example is the legal principle of *pacta sunt servanda*.

Important agreements have been signed since Sack's odious debt theory appeared, including the United Nations Charter, the Vienna Convention on the Law of Treaties (1969), and the covenants for the protection of human rights. But the odious debts doctrine receives only negligible support from international law accords. The intention to insert a passage concerning odious debts into the (unimplemented) Vienna Convention on Succession of States in respect of State Property, Archives and Debts (1983) failed.

Khalfan, King and Thomas[7], Abrahams[8] and Fischer-Lescano[9] mention several precedents which support the claim of a customary international law norm for the "release of obligation of the successor" in the case of odious debts. An oft-cited example is a court decision from the year 1889. After the Spanish-American War, the U.S. refused to assume Cuba's debts to Spain. At the time, the U.S. government argued that this debt was odious and non-enforceable, because the loans were organized against the will of the Cuban people, and served to finance the suppression of popular uprisings. The creditors had acted with the knowledge of the risk of such an investment when they granted the loans. The U.S. Supreme Court agreed.[10]

For Fischer-Lescano, this customary international law norm can only be used for the case concerning the commitment to law of new states. It apparently does not apply in the case of a simple regime change. The use of the principle of odious debts would be more appropriate in the case of regime change, since regime change would usually have no impact on the relationships between creditor and debtor, says Michalowski. For Fischer and Michalowski it is

unclear why the odious debt doctrine cannot also be applied in the case of regime change.[11] This position is supported by an oft-cited case from 1923, where the U.S. Supreme Court, in an international arbitration, nullified loans from the Royal Bank of Canada to former Costa Rican dictator Federico Tinoco.[12]

The *Jus Cogens* Approach

Various authors, including Abrahams[13] and Michalowski, follow the approach that debts are odious when they contravene international law. If the focus would be shifted from the benefit of a loan for the population, to violation of principles of international law, this would mean that an international court of arbitration would no longer rule over whether a loan benefited the population, but rather whether the nation or the government contravened international law due to its conduct, according to Michalowski.[14] This view is supported by Article 33 of the Vienna Conference on the Succession of States from 1983. Since then, state debts are only recognized when they are in accord with international law.

How does one judge whether a debt is in accord with international law? For Michalowski and Fischer-Lescano, the contestability of odious debts is based on Article 53 of the Vienna Convention on the Law of Treaties from 1969: “A treaty is void if, at the time of its conclusion, it conflicts with a peremptory norm of general international law. For the purposes of the present Convention, a peremptory norm of general international law is a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character.”[15] When a violation of *jus cogens* (peremptory norm) invalidates a contract, it is assumed according to Michalowski that the principle of *pacta sunt servanda* is irrelevant, since a binding contract never existed.[16]

The Vienna Convention on the Law of Treaties offers no precise information regarding which are the norms of compelling law. But there appears to be agreement that the ban on wars of aggression, crimes against humanity, torture and slavery, and the right to self-determination qualify. It is unclear if the universal protection of human rights also qualifies, although the European Court of Justice has expressed its opinion that it does.[17] Furthermore, the fight against corruption with the coming into force of the U.N. Convention against Corruption might equally constitute compelling international law.

For Michalowski, a crucial point is how proof of the violation of a norm of compelling international law can be produced. For her it is clear that a loan can directly or indirectly contribute considerably to a violation of *jus cogens* if it serves to finance corresponding projects, or it

generally strengthens or consolidates the financial resources of a regime. In practice, criteria would have to be worked out to help evaluate when a loan leads to a violation of compelling law and the corresponding contract would become invalid as a result.[18]

The Vienna Convention on the Law of Treaties only concerns itself with contracts between states. Therefore it cannot be directly applied to contracts between states and private creditors. But Michalowski believes that national courts could refer to norms of peremptory norms of international law for the evaluation of claims by private creditors.[19]

The Private Law Approach

According to Buchheit, Gulati and Thompson, no general and standardized state practice exists for addressing odious debts. Together with Michalowski, they doubt that bodies of the international community of nations would be in the position to judge a regime, free from geopolitical interests. They do not believe that an international law principle for odious debts would achieve the necessary consensus and clarity to be an effective instrument for the assessment of debts. As a result, such a principle would have a deterrent effect on the future granting of credit.[20]

Buchheit, Gulati and Thompson propose instead to examine if and how odious debts in the area of existing (national) private law can be dealt with. The authors see the following possible ways to proceed:

1. <u>Considerations of Public Policy</u>

   When a (private or public) creditor has influenced a foreign ruler with a loan, the creditor would fail before a U.S. court with a demand for repayment by the foreign ruler. Buchheit, Gulati and Thompson cite the New York Court of Appeals: "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." This norm would make many of Sack's odious debts non-actionable – at least before a U.S. court. Buchheit, Gulati and Thompson believe that the norm would also be applicable not only for despotic, but also for democratic regimes.[21]

2. <u>Unclean Hands</u>

   The "unclean hands" maxim postulates that only someone with clean hands shall be allowed access to capital. According to the U.S. Supreme Court: "This maxim . . . is a self-imposed ordinance that closes the doors of a court of equity to one tainted with inequita-

bleness or bad faith relative to the matter in which he seeks relief, however improper may have been the behavior of the defendant." This maxim was applied in a California court in the case of James Adler versus the state of Nigeria, where Adler attempted (in vain) to recover several million dollars he had paid with criminal intent to a Nigerian government representative.[22]

3. Agency law

   The authors see another option for the legal treatment of odious debts in agency law (part of the Swiss Code of Obligations). Agents take on long-term obligation for one or more clients to negotiate or conclude contracts with third parties. Viewed in the context of the state, the client is the nation and its people. The agents are then members of the government, and they are obligated to safeguard the interests of the client (Article 418c/1 in the Swiss Code of Obligations). When disloyal agents impose obligations on the client with respect to a third party, but keep the fruits of this obligation for themselves instead of passing them on to the client, it raises the question as to who is bearing the risks and consequences of these dishonest actions.

   Normally, the client is liable for the actions of his agents. American law allows for exceptions, where the risk is transferred to a third party that has concluded a deal with the agent. This is the case when the actions of an agent or the circumstances of the business transaction clearly give reason to doubt the honesty and the allegiance of the agent with regard to his client. In this case the third party would have had to request information (from the client) before signing a contract, to make sure that it is legal. In many countries, the government must seek consent from parliament in order to raise foreign credit. If third parties fail to obtain such clarifications, they cannot hold the client (the state) responsible at some later point in time.[23]

4. Piercing the Governmental Veil

   In American corporate law, "piercing the corporate veil" describes a legal decision where a shareholder is personally called to account for debts and obligations of a corporation for which normally only the corporation is liable. In the context of states and governments, a state (i.e. the corporation) would not be held responsible for odious debts resulting from contracts entered into by a government (i.e. the shareholder).[24]

It is unclear whether the *jus cogens* or the private law approach will prevail as the debate continues. In favor of the *jus cogens* approach is the fact that international law has universal significance, while private law relies on the development of a nation's legal system. On the

other hand, it seems more appropriate for private creditors to assert their claims with national courts instead of with international courts of arbitration. It may well be that neither approach is suitable for all situations, and cases should be considered individually in order to achieve the cancellation of odious debts.

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3 Michalowski, Sabine, Unconstitutional Regimes and the Validity of Sovereign Debt, Ashgate, 2007, pp. 49-58.

4 Khalfan, Ashfaq; King, Jeff; Thomas, Bryan, Advancing the Odious Debt Doctrine, Working Paper, Centre for International Sustainable Development Law (CISDL), Quebec, Canada, 2003, pp. 42-44.

5 Buchheit, Lee C.; Gulati, G. Mitu; Thompson, Robert B., The Dilemma of Odious Debts (draft), 2006, pp. 24-26.

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9 Fischer-Lescano, Andreas in: Kritische Justiz 36 (2/2003), pp. 223-237.

10 Adams, Patricia, Odious debts. Loose Lending, Corruption, and the Third World's Environmental Legacy, Toronto, 1991, pp. 162-164.

11 Michalowski, Sabine, Unconstitutional Regimes and the Validity of Sovereign Debt, 2007, pp. 47-49, and Fischer-Lescano, Andreas in: Kritische Justiz 36 (2/2003), pp. 223-237.

12 Abrahams, Charles, The Doctrine of Odious Debts, 2000, pp. 46-48.

13 Abrahams, Charles in: Füglister, Lis; Howald, Stefan, Illegitime Schulden, Verschuldung und Menschenrechte, 2005, pp. 33-35.

14 Michalowski, Sabine, Unconstitutional Regimes and the Validity of Sovereign Debt, 2007, p. 69.

15 Fischer-Lescano, Andreas in: Kritische Justiz 36 (2/2003), pp. 223-237.

16 Michalowski, Sabine, Unconstitutional Regimes and the Validity of Sovereign Debt, 2007, p. 71.

17 Id. at pp. 73-74.

18 Id. at pp. 74-76.

19 Id. at p. 87.

20 Buchheit, Lee C.; Gulati, G. Mitu; Thompson, Robert B., The Dilemma of Odious Debts (draft), 2006, pp. 26-28.

21 Id. at pp. 31-32.

22 Id. at pp. 34-36.

23 Id. at pp. 36-44.

24 Id. at pp. 44-46.