

## ODIOUS DEBT

Excerpt from *The Doctrine of Odious Debts*, Chapter 17 of the book *Odious Debts: Loose Lending, Corruption, and the Third World's Environmental Legacy* by Patricia Adams

The legal doctrine of odious debts was given shape by Alexander Nahum Sack a quarter of a century after the settlement of the Spanish-American War. Sack, a former minister of Tsarist Russia and, after the Russian Revolution, a professor of law in Paris, authored two major works on the obligations of successor systems: *The Effects of State Transformations on Their Public Debts and Other Financial Obligations* and *The Succession of the Public Debts of the State*. With colonial territories becoming independent nation states and colonies changing hands, with monarchies being replaced by republics and military rule by civilian, with constantly changing borders throughout Europe, and with the ascendant new ideologies of socialism, communism and fascism overthrowing old orders, Sack's debt theories dealt with the practical problems created by such transformations of state. Like many others, Sack believed that liability for public debts should remain intact, for these debts represent obligations of the state — the state being the territory, rather than a specific governmental structure. This he based not on some strict dictate of natural justice, but on the exigencies of international commerce. Without strong rules, he believed, chaos would reign in relations between nations, and international trade and finance would break down.

But Sack believed that debts not created in the interests of the state should not be bound to this general rule. Some debts, he said, were "*dettes odieuses*."

*If a despotic power incurs a debt not for the needs or in the interest of the State, but to strengthen its despotic regime, to repress the population that fights against it, etc., this debt is odious for the population of all the State.*

*This debt is not an obligation for the nation; it is a regime's debt, a personal debt of the power that has incurred it, consequently it falls with the fall of this power.*

*The reason these "odious" debts cannot be considered to encumber the territory of the State, is that such debts do not fulfill one of the conditions that determine the legality of the debts of the State, that is: the debts of the State must be incurred and the funds from it employed for the needs and in the interests of the State.*

*"Odious" debts, incurred and used for ends which, to the knowledge of the creditors, are contrary to the interests of the nation, do not compromise the latter — in the case that the nation succeeds in getting rid of the government which incurs them — except to the extent that real advantages were obtained from these debts. The creditors have committed a hostile act with regard to the people; they can't therefore expect that a nation freed from a despotic power assume the "odious" debts, which are personal debts of that power.*

*Even when a despotic power is replaced by another, no less despotic or any more responsive to the will of the people, the "odious" debts of the eliminated power are not any less their personal debts and are not obligations for the new power....*

*One could also include in this category of debts the loans incurred by members of the government or by persons or groups associated with the government to serve interests manifestly personal — interests that are unrelated to the interests of the State.*

For creditors to expect any protection in their loans to foreign states, their loans must be utilized for the needs and interests of the state, otherwise the loans belonged to the power which contracted them, and were therefore, "*dettes de régime*."

The doctrine of odious debts is open to abuse by self-serving interpretation. To avoid arbitrarily repudiated debts, Sack proposed that a new government be required to prove that the debt ill-served the public interest and that the creditors were aware of this. Following these proofs, the onus would be upon the creditors to show that the funds were utilized for the benefit of the territory. If the creditors could not do so, before an international tribunal, the debt would be unenforceable.

### **The Doctrine of Odious Debts: Using the Law to Cancel Illegitimate Debts**

Patricia Adams. Probe International. Author, *Odious Debts: Loose Lending, Corruption, and the Third World's Environmental Legacy*. For the Conferences on Illegitimate Debts Organized by the German Jubilee Network (Berlin, Bielefeld, Essen, Frankfurt, Hannover, Leipzig, Stuttgart). June 21-30, 2002

Just over a year ago, I gave a speech on the international legal doctrine of odious debts to a conference in Jakarta, Indonesia. After my speech, and during the question period, a rather distinguished, elderly man went up to the microphone and he said:

"I feel so happy to learn about the Doctrine of Odious Debts. I have always considered myself an honourable person, I take my obligations to repay my debts seriously. And yet I do not feel that I should have to repay my government's debts which did not benefit the Indonesia people, but instead were used by corrupt individuals. So, until now, I have felt this great conflict inside me. My conscience tells me that I would be dishonourable not to repay my country's debts, and yet I don't think it is fair to make me repay them. So I am so happy to learn about the Doctrine of Odious Debts which tells me that I am not a bad person and that I am right. The people of Indonesia, do not have an obligation to repay the debts of our previous government which are odious. And most important, my feeling is based in law."

So friends, sit back and listen. If you, like this Indonesian gentleman, have felt great frustration at the fundamental injustice of holding the citizens of Southern countries responsible for the debts of their countries, be prepared to be relieved and to be happy. I will now take you back in time, through a little legal history, to tell you about the Doctrine of Odious Debts.

In the 1920s, a Russian professor of law named Alexander Sack, who was teaching in Paris, published the most extensive and the most important treatises on the treatment of state debts. Professor Sack was then, and he remains to this day, the world's preeminent legal scholar on the treatment of public debts. He wrote in a politically tumultuous time, when colonial territories were becoming independent, when monarchies were becoming republics, and when military rulers were being replaced by civilians. Borders were constantly changing and new ideologies of socialism, communism and fascism were overthrowing old orders.

Professor Sack was no radical. So that international commerce and trade did not break down, Sack believed that government debts should be repaid when a new government or new sovereign came to power. His argument? Sack believed that these debts represent obligations of the state. He defined the state to be the territory, rather than a specific governmental structure.

With one exception. Sack believed that debts not created in the interests of the state, should not be bound to this general rule. Some debts, he said, were odious.

And he defined an odious debt this way: "If a despotic power incurs a debt not for the needs or in the interest of the State, but to strengthen its despotic regime, to repress the population that fights against it, etc., this debt is odious for the population of all the State."

He went on. "This debt is not an obligation for the nation; it is a regime's debt." Sack called it "a personal debt of the power that has incurred it." When this power falls, that debt "consequently . . . falls with the fall of this power."

According to Alexander Sack, these "odious" debts could not encumber the territory of the State, because such debts do not fulfill the conditions that determine the legality of the debts of the State. And here is the pivotal point of Sack's doctrine: "the debts of the state must be incurred and the funds from it employed for the needs and in the interests of the State," in order to be considered legally enforceable.

So what did Professor Sack consider an "odious debt?"

First, as I just mentioned, he said "If a despotic power incurs a debt . . . to strengthen its despotic regime, to repress the population that fights against it, etc., this debt is odious for the population of all the State."

Professor Sack was also more specific. "When a government incurs debts to subjugate the population of a part of its territory or to colonize it with members of the dominant nationality, etc., these debts are odious to the indigenous population of that part of the territory of the debtor State."

Sack also considered a debt odious when, "the loans incurred by members of the government or by persons or groups associated with the government to serve interests manifestly personal – interests that are unrelated to the interests of the State." A bribe is an example of a manifestly personal interest.

Now, in order for a debt to be deemed "odious," Sack said that the lender must also be aware that the loan is "contrary to the interests of the nation."

In this case, Professor Sack said, "the creditors have committed a hostile act" against the people. They can't therefore expect that a nation freed from a despotic power will assume the 'odious' debts, which he called "personal debts of that power."

For creditors to expect any protection for their loans to foreign states, their loans must be utilized for the needs and interests of the state; otherwise the loans belonged to the power which contracted them, and were therefore [but this "therefore" is an exception!], debts of the regime.

To avoid abuse of the doctrine by self-serving interpretation, Sack proposed that a new government be required to prove that the debts it inherited from a previous regime did not serve the public interest and that the creditors were aware of this. Following these proofs, the onus would be on the creditors to show that the funds were utilized for the benefit of the territory. If the creditors could not do so, before an international tribunal, or "in the opinion of competent and impartial representatives of the family of nations," the debt would be unenforceable.

I am delighted to report that this doctrine is more than just legal theory, it is legal practice.

The cases that Professor Sack based his doctrine on will be of great interest to you.

Let me turn to the case of the Cuban debts. After the Americans won Cuba from Spain in the Spanish-American War of 1898, the Spanish argued in the peace negotiations that the Cuban debts should be assumed by the Americans. The Spanish argued the

prevailing principle of international law: that state obligations belong to a land and its people, not to a regime.

The Americans replied that the so-called "Cuban debt," "imposed upon the people of Cuba without their consent and by force of arms" was indeed one of the main reasons Cubans were struggling for their independence.

Furthermore, the Americans added, much of the borrowing was designed to crush attempts by the Cuban population to revolt against Spanish domination, and was spent in a manner contrary to Cuba's interest. "They are debts created by the Government of Spain, for its own purposes and through its own agents, in whose creation Cuba had no voice."

"The debt was contracted by Spain for national purposes, which in some cases were alien and in others actually averse to the interest of Cuba . . . in reality the greater part of it was contracted for the purpose of supporting a Spanish army in Cuba." [Averse: unwilling or opposed, usually to people. Adverse, meaning unfavourable, usually refers to events.]

The Americans had little sympathy for the lenders. "The creditors," they said, "from the beginning, took the chances of the investment."

The United States never acknowledged liability for the Cuban debt, nor did they assume any Spanish debts. The holders of the so-called "Cuban debt" never collected fully on their claims.

About 20 years later, and still before Alexander Sack defined the Doctrine of Odious Debts, another very important case occurred. This case involved the Royal Bank of Canada, a private commercial bank from my country, which made a loan to the outgoing dictator of Costa Rica, President Tinoco. The new Costa Rican government challenged the debt before Chief Justice Taft of the U.S. Supreme Court who was asked to sit as arbitrator.

In his 1923 ruling, Chief Justice Taft noted that the transactions in question were "full of irregularities." They were also "made at a time when the popularity of the Tinoco Government had disappeared, and when the political and military movement aiming at the overthrow of that Government was gaining strength."

The payments, Justice Taft discovered, were made to cover either Frederico Tinoco's expenses "in his approaching trip abroad," or his brother's salary and expenses in a diplomatic post to which Tinoco appointed him.

The Royal Bank, Justice Taft ruled, cannot simply base its case for repayment on "the mere form of the transaction" but must prove its good faith in lending the money "for the real use of the Costa Rican Government under the Tinoco régime . . . for its legitimate use."

"It has not done so." Justice Taft ruled. "The 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."

In conclusion, Justice Taft ruled, "The Royal Bank of Canada cannot be deemed to have proved that the payments were made for legitimate governmental use. Its claim must fail."

Alexander Sack based his Doctrine of Odious Debts on these and many other cases. But what became of this legal principle over the next 60 years? Though the Doctrine of Odious Debts has been buried in the tomes of law libraries, its principles have not gone completely unnoticed. In fact they have nagged lenders for decades. In 1982, lawyers at The First National Bank of Chicago wrote in a professional journal, "The consequences of

a change of sovereignty for loan agreements may depend in part on the use of the loan proceeds by the predecessor state. If the debt of the predecessor is deemed to be "odious," i.e., the debt proceeds are used against the interests of the local populace, then the debt may not be chargeable to the successor."

Although bank loan agreements usually say what the loan is intended for, the lawyers went on, the use described is often too general to ensure that the loan benefitted the people and so too general to guarantee loan enforcement. Moreover, the loan documents rarely restrict the money's use.

"Commercial banks should be alert to the dangers of such doctrines," the First National Bank lawyers warned. "Because successor governments have invoked doctrines based on an 'odious' or 'hostile' use of proceeds, lenders should describe with specificity the uses of the loan proceeds and, if possible, bind the borrower by representation, warranty, and covenant to those uses."

We now know, that for years, bankers – both public and private – did not exercise this kind of due diligence. As a result, banks cannot ensure that their loans were used for the needs and interests of the state, and they must accept that their claims to repayment could fail.

But how do we, as civil society, turn that evidence into a legal challenge and a legal victory?

I am delighted to report that an extensive study on the odious debts doctrine has just been completed by a legal team at McGill University in Montreal, Canada. This 200-page investigation into the legal avenues for cancelling odious debts states: "Upon hearing of the doctrine, anyone familiar with public international law is likely to be virtually certain that the doctrine could never be applied in practice. However, after examining the state practice, general principles of law and writings and judicial decisions, it seems that there is much more material available to make such an argument than one would initially think. . . ."

"The conclusion from the investigation is that the doctrine may be coherently defined, has a lengthy history in international relations, is relatively well supported under international law, and can be modified with relative ease to accommodate some of the problematic aspects that may be held against it."

The authors conclude that there is a convincing legal argument in favour of the recognition of the "morally compelling" doctrine of odious debts.

To borrow a term from the North American media, the Doctrine of Odious Debts "has legs."

The McGill University legal scholars have picked up where Alexander Sack left off, filling in legal, financial, and political analysis to apply the principles of the Doctrine of Odious Debts in the 21st century.

They rely on international custom (precedents), international conventions (such as the 1983 Vienna Convention on Succession of States in Respect of State Property), the general principles of law (such as unjust enrichment, the abuse of rights, and the obligations of agents), and judicial decisions and the teachings of the most highly qualified publicists and scholars, to expand on Alexander Sack's Doctrine of Odious Debts.

There are three necessary conditions for a debt to be considered odious, they say: 1) the debt must not have received the consent of the nation; 2) the funds borrowed must have been contracted and spent in a manner that is contrary to the interests of the nation, and; 3) the creditor must be aware of these facts.

The McGill legal team also proposes a number of fora for challenging odious debts, including the International Court of Justice, international arbitration, and domestic courts.

They also analyze the history of sovereign lending – going back 500 years – and note that when the stakes are high, both creditor and debtor have an interest in finding manageable solutions, or at least workable stopgap measures. "Debtors struggle to service debts, at least minimally, so that they are not shut off from further lending; creditors offer further loans so that debtors are not driven into complete bankruptcy. The relationship is at once symbiotic and pathological."

In order to end these "symbiotic and pathological" debt workouts, the McGill legal team reviews the various outstanding loans of the different creditors and recommends that World Bank loans might provide the best test cases for an odious debts challenge. I agree wholeheartedly.

First of all, World Bank loans have not been sold on secondary markets or restructured to make making the identification of odious loans clearer, and, secondly, disputes over World Bank loans are subject to arbitration tribunals, and lastly, there is good evidence that the Bank knew their loans were not always in the interests of the borrowing nation.

Take the case of Indonesia.

Thanks to the superb research by NGOs in Indonesia and around the world, academics, and thanks to the concerned whistle-blowers inside the World Bank who leaked crucial documents, – we now know that the World Bank lent \$30 billion to the Suharto government between 1966 and 1998 in the full knowledge that as much as \$10 billion of that served, what Alexander Sack would have called, "manifestly personal" interests. Based on this prior evidence, I would recommend that the Indonesian government launch an odious debt arbitration procedure against the World Bank. Such a challenge could fit easily within the Fair and Transparent Arbitration Process proposed by the German Jubilee Network. Here is how I would do it.

In order to show good faith and to reassure the financial world that Indonesia is not a deadbeat, the Indonesian government should place all debt and principal repayments due on outstanding World Bank loans into a trust fund managed by a respected and independent body, to be released only once the legitimacy of World Bank loans is determined. The government of Indonesia should then, together with the World Bank, select an arbitrator or panel. Forensic audits could be conducted on past loans, and evidence submitted for determination by the arbitrators.

Why do I recommend that the Indonesia government continue to make payments on its World Bank debts while the odious debts arbitration is going on? So that Indonesia can seize the moral high ground.

It is important to recognize that the World Bank – indeed all creditors – has a financial moral authority that it doesn't deserve. In the current debt negotiations, be they through the Paris Club or HIPC, the World Bank defends *pacta sunt servanda* – the principle that contracts must be honoured. Many countries are too poor to honour their debt contracts, the World Bank says, so it organizes charitable contributions to help relieve their burden. But, the World Bank threatens Third World governments, don't even think of repudiating your debts – if you do, the World Bank will see to it that country is banished from the world of international finance and commerce.

It is time to tell the World Bank, and other creditors, that *pacta sunt servanda* works both ways. According to the principles of international law laid out by Alexander Sack, the World Bank had a legal duty to the Indonesian people – that the money it lent to the people's representative would indeed be spent in the interest of the people. If the World Bank failed to honour its side of the contract, then the people of Indonesia could not be held responsible for those debts.

You must understand that the World Bank is determined not to admit culpability on this count. Let there be no mistake. The World Bank and other multilateral agencies, and the export credit agencies – the main creditors of the poorest countries – want no-fault debt relief in order to avoid financial accountability for the odious loans that they extended.

You may think the World Bank and the export credit agencies are the most powerful financial institutions in the world, but they are extremely vulnerable to the bad loans they made. Their survival depends on maintaining a facade of financial solvency. HIPC, Paris Club workouts, and bilateral debt forgiveness help them hide their losses. They must get bad loans off their books, and they must do it in such a way that does not look like write-offs or debt repudiation. If they do, the triple-A credit ratings of the lending institutions will be threatened.

If the World Bank and other public agencies faced arbitration panels that could deem their loans to have been odious, the outcome could bankrupt them. They know they are financially vulnerable. They also know they are legally culpable. More than anything, they want to avoid odious debt investigations so a dangerous financial chain reaction is not set in motion.

But, what might be dangerous for the World Bank, would be good for Indonesia and other Southern debtors.

Proving some of the World Bank's loans to Indonesia were odious would relieve the Indonesian people of an unjust debt burden. It would also leave the World Bank with only one choice to recover its lost billions – that is to sue, pursue and, where possible, seize the assets of government leaders who illegally took those funds. This would be a just and elegant end to this decades' long debt debacle: the lenders and the borrowers deserve each other, and they should settle their financial disputes on their own. Today, the citizens of many countries, including Argentina, Brazil, Nigeria, the Philippines, and South Africa are challenging the legitimacy of their countries' foreign debts. Their efforts are not in vain.

When I wrote my book, *Odious Debts*, I merely reviewed legal thought and history. I believe the citizens of the South, with whatever help we in the North can provide, have already started to make history and to give new life to old laws. Challenging just one foreign loan as odious would send shock waves through the financial industry. It would help eliminate the moral hazard that has dominated public borrowing for the past 50 years that has so damaged the economic, political, and social fabric of the Third World. It would, I believe, shift the balance of power in debt negotiations in favour of citizens. Creditors, fearing scrutiny of their own loans for odiousness, would likely become more sympathetic to debt write-offs. Lenders would take greater care to lend to governments with real authority, and not just apparent authority, and to exercise due diligence to make sure that the money is used for legitimate governmental purposes. It would probably be the fastest way to secure measures for accountable public finance that citizens throughout the South have so thoughtfully articulated. Lenders would soon demand evidence that the borrowing public knows about, and consents to, government borrowing before extending credit. And, I believe it would eliminate the threat from "vulture funds," who surely would not want to find themselves holding an odious loan.

I don't know exactly how much of the South's debt burden today could be cancelled if it were challenged as odious. I suspect the majority. But, whether it is that much, or less, the course of financial history would be altered if the Doctrine of Odious Debts became the standard for determining legitimate uses for governmental borrowing. Odious lenders of the past must pay for their recklessness and negligence; otherwise we will be here again in 20 years time, seeking relief from the next generation of debt. I am sure that recourse to odious debt arbitration, would protect future generations from living through more debt crises. In that, I think we have a duty to advance these principles to the best of our ability.

Thank you.