

PRMED DISCUSSION PAPER

THE CONCEPT OF ODIIOUS DEBT: SOME CONSIDERATIONS

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EXECUTIVE SUMMARY

The last several years have seen a rising chorus of demands from non-governmental and civil society organizations for cancellation of the sovereign debt of many developing countries on the grounds that such debt is “odious”. Yet there is little agreement on a workable definition of “odious” debts. This should be hardly surprising, because those promoting the cancellation of “odious” debts are doing so for a variety of reasons, pursuing often different aims.

Ironically, this lack of agreement persists even though the concept of “odious” debts has been a subject of debate for a long time, and there are only a few examples where the concept has been invoked to justify the non-payment of sovereign debts. Most often, these have been cases when a successor state or government has refused to honor certain debts contracted by its predecessor state or government. Depending on the reason for the repudiation, such cases have been classified under the labels of “war debts”, “subjugation debts” or “regime debts”. But all attempts at distilling a definition of “odious debts” from these few categories and actual cases have met with insurmountable difficulties. Even the International Law Commission (a subsidiary organ of the United Nations General Assembly entrusted with the task of codifying and developing international law), while discussing the issue in its work on succession to property, archives and debts, did not find it necessary to refer to the concept in the final text of its draft articles on succession.

Nor have more recent attempts to define the concept found any greater success. On the contrary, the very extension of the debate to cases other than those of state or governmental succession, the tentative identification of a broader concept of “illegitimate debt”, and its application to diverse situations categorized under the uncertain labels of “criminal”, “unfair” and “ineffective” debts, have further complicated an already controversial concept and diminished its practical value in addressing real problems. Repudiating sovereign debts on this ground would increase the risk of reduced lending to sovereign borrowers, thereby affecting financial flows to developing countries as a result of the danger of *ex post* challenges to lenders’ claims.

The difficulties in agreeing on a definition of odious debts should not deter lenders and sovereign borrowers from acting in a variety of ways to ensure that public loans are used for the benefit of the borrowing states and not to subjugate their populations or enrich the corrupt. After all, good lending and borrowing practices in support of developmental efforts are in the interest of all – the lender, the borrower, and the ultimate beneficiaries of the projects and programs that such loans finance. While efforts to ensure that loans are used for the purposes intended may vary across lending institutions and have considerable room for improvement, the progress achieved so far is already promising. Official lenders, under pressure from their shareholders, are seeking to improve their lending practices in a variety of ways. Commercial creditors may seem, at first sight, to have fewer incentives to do so, but the adoption of the Equator Principles by many commercial financial institutions suggests otherwise. Fresh ideas along these lines promise to inject new energy into the efforts to improve lending and borrowing practices in the future. This would serve the international

financial system in better transferring resources for the purposes of development and poverty reduction in poor countries.

While better lending and borrowing practices may help avoid the accumulation of unsustainable debt stocks in the future, how can borrowing countries deal with unsustainable debt stocks as a result of past lending and borrowing decisions? Of course, reckless and unproductive borrowing can quickly accumulate into unsustainable debt. But not all unsustainable debt is the result of misused or misdirected loans. Debts may accumulate for a variety of other reasons, including as a result of economic shocks that are outside the control of lenders or borrowers. That countries must either pay their unsustainable debts or repudiate them is a false dichotomy. In reality, countries have chosen the middle path of restructuring their debt when it has become unsustainable. Iraq and South Africa are recent examples of countries where new governments inherited large sovereign debts but, rather than repudiating them, chose instead to negotiate their restructuring with their creditors. For very poor countries with large debts, the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative provide well-established rules and procedures for official creditors to deliver significant amounts of debt relief. In addition to participating in such international debt reduction initiatives, some international lenders have independently and voluntarily forgiven debts they were owed by developing countries.

I. INTRODUCTION

The debate on odious debts has grown in intensity in recent years, and not only in the international legal literature.¹ The concept has been invoked by some advocacy groups and civil society organizations in their manifestos for unilateral debt repudiation by developing countries. A few years ago, the concept was used as a possible justification for canceling the debts of post-Saddam Iraq. Yet, to different users, the expression “odious debts” may mean different things, largely because they use it to achieve different objectives. It is hardly surprising, then, that the participants in this debate tend to speak past each other. Within this context, the purpose of this discussion paper (which remains work in progress) is modest, namely to:

- examine the main features of the traditional concept and categories of odious debts, and briefly examine whether a rule allowing the repudiation of odious debts may be said to have emerged in international law (Section II);
- consider recent attempts to expand the traditional concept and categories of odious debts, and ask whether they are sufficiently precise to contribute to the solution of the problems they are meant to address (Section III); and
- identify ways in which lenders and borrowers can address, or have indeed addressed, the underlying concerns to the concept of odious debts (Section IV).

¹ For example, *The North Carolina Journal of International Law and Commercial Regulation* held its seventh annual symposium, in February 2007, on the topic of odious debts, with the participation of academics and practitioners. As a result of this symposium, the Summer 2007 issue of this *Journal* was dedicated entirely to odious debts.

In other words, the modest objective of this discussion paper is to provide a summary of the terms of the debate on what remains a controversial subject and examine how the underlying motivating forces driving the debate can be addressed in a constructive way.

II. TRADITIONAL CONCEPT AND CATEGORIES OF ODIIOUS DEBTS

In its initial use, the expression “odious debts” identified those debts that a state or a government had contracted with a view to attaining objectives that were prejudicial to the major interests of the successor state or government or of the local population. The debts thus identified are those contracted with an international legal subject (a state) under legal agreements governed by international law. The issue of the existence of an international legal doctrine on odious debts can arise within the context of litigation both before international courts and arbitral tribunals and before national courts.² With respect to financial agreements governed by a national legal system, the question (which need not be addressed in this discussion paper) is whether a national, as opposed to an international, doctrine on odious debts exists.³

² For this latter case, see, for example, the reference to the fact that “the PRC asserted as a long-established principle of international law that ‘odious’ debts are not to be succeeded to... a view they continue to advance, but do not explicitly rely on, in making this motion to dismiss” in *Marvin L. Morris, Jr., Plaintiff, against The People’s Republic of China, et al., Defendants. Gloria Bolanos Pons, et al., Plaintiffs, against The People’s Republic of China, et al., Defendants*, United States District Court for the Southern District of New York, 478 F. Supp. 2d 561; 2007 U.S. Dist. LEXIS 20784 (March 21, 2007, decided).

³ Ashfaq Khalfan has written that, at present, “it is unclear whether the laws of England and of New York, properly interpreted, provide support for the ‘odious’ debt doctrine. Given the interest of these jurisdictions in maintaining their positions as key financial centers, their courts are likely to reject the ‘odious’ debt doctrine.” (Sites and Strategic Legal Options for Addressing Illegitimate Debt, *Advancing the “odious” Debt Doctrine (CISDL working paper)*, 71.) While an argument based on the doctrine of odious debts may not succeed in municipal courts, other arguments (which are as varied as the existing legal systems) may succeed in reaching the same result.

The operational area of the traditional concept and categories of odious debts, unlike their expanded concept and categories that will be examined in Section III below, is the succession of states and governments. International law requires, as a rule, a successor government to honor the public debt of a predecessor regime.⁴ However, if the question is not one of succession of governments but is one of succession of states, the law becomes uncertain. The extent to which a successor state is bound to honor the public debts of the replaced state is a matter of controversy. The solution reflected in the 1983 Vienna Convention on succession of states in respect of state property, archives and debts,⁵ providing for the passing of the public debt to the successor (unless it is a newly independent state) with a reduction according to an equitable proportion, is not immune from difficulties,⁶ and may be part of the explanation why the Convention has not universally been accepted and has not yet entered into force. In any event, the assumption for the operation of a doctrine of odious debts is that, save for the application of this doctrine, the debt in question would be binding on the successor state or government.

Historically, the theory of odious debts has mainly been developed in the writings of “Anglo-American jurists”.⁷ For example, the well known English lawyer John Westlake discussed odious debts (even though without using this heading) in his treatise on international law at the beginning of the last century.⁸ However, the name most often linked

⁴ See *Oppenheim’s International Law. Peace* (9th edn. Jennings and Watts, 1992), vol. I, 205.

⁵ Doc.A/CONF.117/14. The text of the Convention is electronically available at http://untreaty.un.org/ilc/texts/instruments/english/conventions/3_3_1983.pdf. By the end of August 2007, only seven states had acceded to the Convention.

⁶ See Brownlie, *Principles of Public International Law* (6th edn., 2003), 625-6.

⁷ “Ninth report on succession of States in respect of matters other than treaties by Mr. Mohammed Bedjaoui, Special Rapporteur – draft articles on succession in respect of State debts, with commentaries”, *Yearbook of the International Law Commission* (1977, vol. II, Part 1), para. 115.

⁸ Westlake, *International Law. Part I. Peace* (2nd edn., 1910), 78-83.

to the emergence of a doctrine of odious debts is that of Alexander Nahum Sack, who wrote in the 1920s on the subject, when he lived in Paris as a Russian expatriate. In his principal writing on the topic, Sack identified three categories of odious debts, namely (a) “regime debts” (when a despotic regime “contracts a debt, not for the needs and in the interest of the state, but to strengthen its own despotic regime”),⁹ (b) “subjugation debts” (when the government “contracts debts to subjugate the population of part of its territory or to colonize it by members of the dominant nationality”),¹⁰ and (c) “war debts” (when the government of a state contracts debts “with a view to waging war against another state”).¹¹ This tri-partition has proved helpful in the treatment of the topic by later writers and will therefore be adopted in this discussion paper as well.

War/subjugation/regime debts

There have been cases, in state practice, where a successor state has rejected war debts contracted by a predecessor state to sustain its war effort against the former. A case in point is the treatment of South Africa’s war debts when Great Britain annexed the Transvaal in 1900, after the Boer War. The Crown Counsel, in their opinion to the Colonial office, denied the existence of any international legal principle that would compel the British Government to recognize obligations incurred during the war or in contemplation of the war. However, there have also been cases in the opposite direction where, for considerations of

⁹ “Si un pouvoir despotique contracte une dette non pas pour les besoins et dans l’intérêt de l’État, mais pour fortifier son régime despotique”, in Sack, *Les Effets des transformations des états sur leurs dettes publiques et autres obligations financiers. Traité juridique et financier* (1927), 157.

¹⁰ “Lorsque le gouvernement contracte des dettes afin d’asservir la population d’une partie de son territoire ou de coloniser celle-ci par des ressortissants de la nationalité dominante”, *ibid.*, 158.

¹¹ “Ce sont les dettes conclues par le gouvernement de l’État en vue d’une guerre avec un autre État”, *ibid.*, 165.

political expedience, successor states have assumed the war debts of predecessor states, such as the assumption of a percentage of the Austrian war debts by the former Czechoslovakia after the First World War.¹² This uneven practice has induced such an attentive observer as Feilchenfeld to doubt whether a specific international customary rule has emerged exempting war debts from assumption in the case of annexation or dismemberment.¹³

The classic case of rejection of a subjugation debt is the repudiation, by the United States, of the Cuban debts contracted by Spain allegedly on the ground that they had been imposed on Cuba against its will and that they had not been contracted for Cuba's benefit, but only to keep Cuba under Spanish domination and to suppress Cuba's war of independence. To this claim, Spain opposed the argument that these debts had been contracted on behalf and for the benefit of Cuba and, indeed, had contributed to the island's economic development. The 1898 Treaty of Peace, which ended the dispute, seemed to uphold the United States argument, in that neither the United States nor Cuba assumed the subjugation debts contracted by Spain. However, in this case too (as in the case of war debts), the view that a successor State should be relieved of responsibility for any debt contracted by a predecessor State to subjugate a territory did not go unchallenged. For example, Frantz Despagnet remarked in 1905, commenting on the *affaire* of the Cuban debts, that this view "opens the way to all manner of disputes as to the utility of expenditure incurred by the dismembered country for the portion that is separated from it; it encourages the most arbitrary and most iniquitous solutions."¹⁴ Nor has the practice of states been

¹² For the cases of the South African and Austrian war debts, and other instances from state practice, see Bedjaoui's "Ninth Report", paras. 141 to 156.

¹³ Feilchenfeld, *Public Debts and State Succession* (1931), 718-21.

¹⁴ Despagnet, *Cours de droit international public* (3rd edn., 1905), 111, quoted in English translation in Bedjaoui's "Ninth Report", para. 165. Despagnet's original French text reads as follows: "Cette manière de voir

consistent in its application. For instance, while declaring its readiness to assume certain debts before the Dutch capitulation to Japan on March 8, 1942 (Java), and April 7, 1942 (Sumatra), Indonesia refused to assume various debts after those dates, especially those resulting from Dutch military operations against the Indonesian national liberation movement. At a Round Table Conference in 1949, Indonesia and The Netherlands agreed on a formula of debt apportionment that departed from the principle of repudiation of subjugation debts.¹⁵ While the agreement reflecting this apportionment was later denounced by Indonesia, it remains questionable whether a customary international rule allowing the repudiation of subjugation debts really exists.

As a rule, arguments based on the non-enforceability of war and subjugation debts have been used within the context of state succession. The case of regime debts is different. The argument here is that, despite the continuity of the state, there has been a change in government and the successor government refuses to honor the debts contracted by the predecessor regime on account of their having been contracted in the exclusive interest of the predecessor regime, and not to the benefit of the state or its population. The traditional example is that of the loans extended by the Royal Bank of Canada to Frederico Tinoco, a former Secretary of War of Costa Rica who, at the time of the loans in question, was the head of the Costa Rican government, after having overthrown the previous government in 1917. Tinoco's government lasted two years, and the loans were contracted a couple of months before he left the country. Great Britain started arbitral proceedings against Costa Rica to force the new Costa Rican government to honor Tinoco's debts. The sole arbitrator (William

ouvre la voie à toutes les contestations sur le caractère utile des dépenses faites pour le pays démembré pour la portion qui est détachée de lui; elle favorise les solutions les plus arbitraires et les plus iniques.”

¹⁵ On the Cuban and Indonesian subjugation debts, see Bedjaoui's "Ninth Report", paras. 157 to 170.

Howard Taft, a former US President and, at the time of the arbitration, the US Chief Justice) held that the transactions involving Tinoco were “full of irregularities”, and that the Royal Bank of Canada knew that the money would only benefit Tinoco, not the state or the people of Costa Rica. The new Costa Rican government was therefore right in declining its responsibility for the repayment of the loans.¹⁶ In this arbitral award, there was no recognition of any international customary norm allowing a successor government to repudiate the debts contracted for personal gain by the predecessor government. Rather, there was a factual analysis of the irregular transactions and the consideration that the lender knew of the use of the funds.

Is there an international legal norm on “odious” debts?

Treaties of peace and other international agreements may have indirectly recognized the claims of successor states to repudiate war and subjugation debts, but they have not led to any codification treaty embodying a general rule on odious debts. The International Law Commission (a subsidiary organ of the United Nations General Assembly entrusted with the task of codifying and progressively developing international law) was faced with a proposal to include an article on odious debts in its draft articles on the succession of states in respect of state property, archives and debts, which draft articles were the basis for the international conference that adopted the 1983 Vienna Convention mentioned above. However, having discussed the proposed articles presented by its Special Rapporteur (Mohammed Bedjaoui, who would later become President of the International Court of Justice), the Commission

¹⁶ Arbitration between Great Britain and Costa Rica, 1 *United Nations Reports of International Arbitral Awards* (1923), 369.

concluded that “the rules formulated for each type of succession of States might well settle the issues raised by the question and might dispose of the need to draft general provisions on it.”¹⁷ Without entering into the details of this conclusion, it will be sufficient to note here that the International Law Commission (a) declined a request to adopt a draft article on odious debts, and (b) in doing so, remarked that the practical issues that the concept of odious debts is intended to address may be settled in other ways.

A similar conclusion can be reached regarding the question whether a rule on odious debts has developed in the other main source of international law besides treaty, namely international custom.¹⁸ International law distinguishes mere usages from customs. A usage is a practice that does not reflect a legal obligation, such as the ceremonial tradition of saluting at sea. A custom, on the other hand, is a consistent and general practice (the objective element of custom) accompanied by a sense of legal obligation (the subjective element of custom, called *opinio juris*). By comparison with treaty law, a distinctive feature of custom is its general sphere of validity, whereby a customary norm (other than a local custom) is binding on all states, except for those that have objected to it since its very inception (the so-called principle of the “persistent objector”).¹⁹

¹⁷ “Report of the International Law Commission on the work of its thirty-first session”, *Yearbook of the International Law Commission* (1979, vol. II, Part 2), para. 43.

¹⁸ For the limited purposes of this discussion paper, there is no need to examine the third source of international law listed in Article 38(1) of the Statute of the International Court of Justice, namely the “general principles of law recognized by civilized nations”. In the committee of jurists that prepared the Statute (for what, at the time, was the Permanent Court of International Justice) there was no consensus on the meaning of this phrase. Moreover, despite occasional references to general principles in the legal literature on odious debts, there is hardly any sustained effort to investigate a plurality of national legal systems (assuming such principles have their origin in national law) with a view to showing that the exception to the repayment of odious debts is indeed a “general principle of law recognized by civilized nations”.

¹⁹ On the principle of the “persistent objector”, and the question whether it applies also to norms of *jus cogens*, see Maurizio Ragazzi, *The Concept of International Obligations Erga Omnes* (1997), 59-72.

In the case of odious debts, there have undoubtedly been instances, such as the ones mentioned above, in which war, subjugation or regime debts have been repudiated and found not to be transferable to a successor state or government. However, it is highly doubtful whether these instances have amounted to a general practice and whether the states and governments concerned have acted with the conviction of following a legally binding rule. In other words, it is questionable whether the two constitutive elements of international custom, i.e. general practice and *opinio juris*, have materialized in the case of an alleged international customary rule on “odious” debts or, better, an exception based on customary international law to the operation of the principle *pacta sunt servanda* on treaty compliance.²⁰

This is also the conclusion reached by two practitioners who, while recently investigating the question whether there is a recognized legal doctrine of odious debts in customary international law, have concluded that “neither the threshold for state practice nor *opinio juris* have been met.”²¹

²⁰ Article 26 (*pacta sunt servanda*) of the 1969 Vienna Convention on the law of treaties reads as follows: “Every treaty in force is binding upon the parties to it and must be performed by them in good faith.” The Vienna Convention entered into force in 1980. Its text is electronically available at http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf.

²¹ Yianni and Tinkler, “Is There a Recognized Legal Doctrine of Odious Debts?”, 32 *The North Carolina Journal of International Law and Commercial Regulation* 749 (2007), at 771. In a 2007 monograph headed *Unconstitutional Regimes and the Validity of Sovereign Debt. A Legal Perspective*, Sabine Michalowski observed: “Given the uncertain status of the doctrine of odious debts in international law in the case of state succession, and even more so with regard to regime changes, the main purpose of the preceding analysis of the doctrine of odious debts was to come to a conclusion as to whether or not its recognition as a principle of international law would be desirable. However, the analysis identified many shortcomings of the doctrine, one of its main weaknesses being that it is very difficult to give it a clear enough content to make it workable at least at a basic level” (at 64, footnote omitted).

Weaknesses in declaring *ex ante* that certain regimes are “odious”

A different proposal that has recently been put forward, and which constitutes a convenient bridge between the traditional and the expanded concept of odious debts, is to have some internationally accepted entity or individual(s) to declare *ex ante* that certain regimes are “odious”.²² This would put lenders on notice that loans to such regimes could be repudiated by successor regimes with the support of the international community unless, of course, the lender can demonstrate that due diligence had been used to ensure the loan proceeds were used for legitimate purposes. But even such a seemingly appealing approach has many weaknesses. First, who — individual, group, agency, or institution — would declare *ex ante* that regimes are “odious”? Second, on which decisive factors would this arbiter distinguish “odious” from non-odious regimes — unrepresentative government, ethnic cleansing, racial discrimination, denial of fundamental human rights? Third, how would such declarations be treated in national courts having jurisdiction to resolve debt disputes? Although, as one writer has recently put it, the problems with the *ex ante* model “may outweigh its advantages”,²³ there is of course nothing preventing governments (as it has indeed happened) from imposing sanctions on, and prohibiting lending to, regimes that they

²² See Jayachandran and Kremer, “Odious Debt”, 96 *The American Economic Review* 82 (2006), electronically available at www.stanford.edu/~jayachan/odious_debt.pdf#search=%22Jayachandran%20Kremer%20%22odious%20debt%22%22.

²³ King, “Odious Debt: The Terms of the Debate”, 32 *The North Carolina Journal of International Law and Commercial Regulation* 605 (2007), at 659. This writer identifies three main problems with this approach: “The first problem is that such an institution [entrusted with the task of designating certain regimes ex-ante as “odious”] will likely designate very few regimes as odious... A second problem is that declaring a regime, rather than a set of actions, to be odious is a rather ‘nuclear’ type of option and is unlikely to be deployed until the regime reaches pariah status... Both the first and second problems lead inexorably to the third, and indeed perhaps the most significant problem: if a given regime is not so designated, a creditor can rely on this fact in lending to it. In other words, and quite ironically, the idea of calling this model the ‘due diligence’ model is highly misleading. It would eliminate the need for any diligence at all.” (Ibid., 659-60.)

consider “odious”, either unilaterally or through their participation in international organizations.²⁴

Conclusion

Three conclusions may be drawn from the analysis developed in this section. First, the traditional concept of odious debts is not open-ended but is instead restricted to easily identifiable categories (war, subjugation and regime debts), discussed within the context of the succession of states or governments. Second, even within these strict limits, no customary international rule allowing the repudiation of odious debts seems to have emerged from the scattered instances of state practice and arbitral decisions, nor has any codification treaty embodied an exception based on the odiousness of the debt. It is also noteworthy, in this regard, that Iraq and South Africa, just to take two recent examples of countries with new governments that inherited large sovereign debts, chose not to repudiate those debts unilaterally on grounds that they were “odious”, but instead chose to negotiate a debt restructuring with their creditors. And, third, proposals to declare *ex ante* that certain regimes are “odious” have their own weaknesses, some practical and some conceptual, and have consequently attained little traction.

²⁴ Under the United Nations Charter, the Security Council can take, pursuant to its powers in the area of peace and security, decisions binding on states. On this ground, the Security Council has decided on economic sanctions and prohibited states from undertaking certain financial transactions with targeted states. However, even in such rare instances, all the Security Council can do is create a legal obligation for states not to enter into financial transactions. On the other hand, the authority of the Security Council does not extend to rendering invalid such transactions. In other words, non-compliance by a state with a Security Council’s prohibition to enter into a financial transaction would trigger the international responsibility of such a state, but not the invalidity of the financial transaction in question.

III. EXPANDED CONCEPT AND CATEGORIES OF ODIIOUS DEBTS

While the debate on the traditional concept of odious debts focused on whether debt obligations may be repudiated by successor states or governments under exceptional circumstances, recent decades have seen a rising chorus of demands by non-governmental and civil society organizations to apply the concept of odious debts to new and different sub-categories. But the objectives behind these demands are as different as the groups advancing them. Some may be seeking a legal basis for the cancellation of debt owed by developing countries. Others may want to punish international lenders for what they see as irresponsible and reckless lending. And yet others could be keen to suppress “odious” regimes by starving them of the flow of capital.²⁵

There are several respects in which the revived concept of odious debts and its newly articulated sub-categories differ from the traditional concept and categories that have just been examined. First, the limited setting of succession of state or government has been abandoned, with the consequence that the new concept is advocated in the case also of state or governmental continuity. Second, instead of a case-by-case analysis of individual loans with a view to determining whether they have given rise to odious debts, there is a tendency to proceed to an overall assessment not so much of the financial transactions in question as of the “odious” nature of the borrower (i.e. there would be “odious” debtors rather than

²⁵ These three examples do not exhaust the universe of motivations. Other examples include those who may be looking for a legal defense to protect themselves against creditors seeking repayment, or those attempting to carve a role for themselves as international arbiters of disputes between international creditors and sovereign borrowers.

“odious” debts).²⁶ (Such an extension rests on the concept of fungibility, namely loans ostensibly provided for one purpose can release monies already allocated for that purpose and used for an entirely different purpose with or without the knowledge of the lender.) Third, greater emphasis is placed on the actual or presumed lender’s knowledge (and ensuing accountability) of how the borrowed funds will be used by the borrower. Fourth, unlike the traditional concept and categories of odious debts considered before, there is no appeal to any international customary rule that would justify the new concept and categories, the stress being rather on the moral or political unacceptability of repayment.

This expanded concept of odious debts and its various sub-categories can be found in some of the international literature and in advocacy materials produced by various non-governmental organizations. But they often lack the legal precision necessary to allow for a meaningful debate. For example, sometimes within the same article, the epithet “odious” is ascribed to lenders, regimes, countries, or debts. And within these writings one can identify different categories of odiousness. For reasons of convenience, this paper has chosen to focus on three — “criminal”, “unfair” and “ineffective” debts.²⁷ While it is not easy to find a common thread that connects them, the term “illegitimate” is sometimes used as a term encompassing all these categories. (At other times, however, this term is described in a category of its own.)

²⁶ See the paragraph on declarations *ex ante*, in Section II above.

²⁷ While the present investigation is restricted to these three categories, the literature has spawned several other categories of odious debts, including “unpayable” debts, “onerous” debts, “unsustainable” debts, “dubious” debts, “honorific” debts, etc.

“Illegitimate debt” is, according to the definition provided by Hanlon, a debt “that the borrower cannot be required to repay because the original loan or conditions attached to that loan infringed the law or public policy, or because they were unfair, improper, or otherwise objectionable.”²⁸ The key implication of this strand of argument is that it imposes a greater measure of legal responsibility on creditors, even when creditors do not have the power or the authority to control the borrowers’ actions once the loan is disbursed. It is such considerations that have led to the concept of “know your client” in retail and commercial banking, and requires lenders to guard against reckless behavior.

“Criminal” debts

The category of “criminal” debts encompasses loans that involve corruption and kickbacks. Proponents of this category argue that debt repayments by a country are unjust when the original loans to their governments are stolen by officials or businessmen, or where the debt is incurred to rescue an economy ravaged by corruption. In contrast, domestic financial transactions or loans that are misused as a result of corruption are considered to be completely different and do not fall within this category. They are instead categorized as purely domestic affairs that are consequently the subject of national law and domestic legal procedures.

²⁸ Hanlon, “Defining ‘illegitimate debt’: when creditors should be liable for improper loans”, in Jochnick and Preston (eds.), *Sovereign Debt at the Crossroads: Challenges and Proposals for Resolving the Third World Debt Crisis* (2006), 125. In another paper, Hanlon has defined “illegitimate debt” as “loans which are so bad that by making them a bank has failed in its fiduciary responsibilities, and has no right to collect on those loans.” (Wolfowitz, the World Bank, and Illegitimate Lending, 13 *Brown Journal of World Affairs* 41 (2007).)

An essential ingredient of this line of reasoning is that international lenders should be made wholly or partly responsible for the fiscal burden of the misuse of the loan if either (a) they were aware in advance that a part of the loan would be illegally siphoned off, or (b) they have the leverage to prevent (or at least greatly diminish) the illegal misuse of such loans.

But various considerations weaken the above line of argument.

First, once a loan is committed and disbursed by a lender to a sovereign borrower, any subsequent transaction between the sovereign and any other national unit, entity, or individual is, as a rule, a domestic financial transaction subject to national laws and legal procedures and is therefore usually outside the reach of international law. From this, it follows that the fiscal burden of any loss should be borne by the country, with an incentive on the country's law enforcement institutions to recover such losses from the corrupt perpetrators causing the loss.

Second, proponents of the concept of "criminal" debts are not clear whether the required prior knowledge of lenders (as a necessary condition) should be with respect to any individual loan or more broadly to the financial climate within a country. Thus, while lenders may know that corruption exists in a country, they may not have any concrete knowledge in advance of plans to siphon proceeds from any individual loan (a very likely possibility, given that corrupt officials are not in the habit of advertising their intention to conduct an illegal activity). This raises the question of the burden imposed on creditors on

the information they need to have for being held responsible for any wrongful act. For example, within the context of state-to-state relations, the International Law Commission has written, in its commentary on draft article 16 on state responsibility, that a state “providing material or financial assistance or aid to another State does not normally assume the risk that its assistance or aid may be used to carry out an internationally wrongful act.”²⁹ The relevant point here is that it is not presumed knowledge, but actual knowledge, that may trigger responsibility.

Third, the proponents of the concept of “criminal” debts do not clarify how one can assess the lender’s ability to influence the borrower’s actions, and therefore the extent to which the international lender can be held responsible for the alleged corruption of the nationals of the borrowing country.

“Unfair” debts

The category of “unfair” debts would include a wide variety of debts which have either been incurred for activities considered inappropriate, or which contain unacceptable conditions, such as usurious interest rates or policy demands inconsistent with the borrower’s national law. (The international law equivalent would be lending that would violate the purposes and principles contained in Articles 1 and 2 of the United Nations Charter,

²⁹ Para. (4) of the commentary on draft article 16 (Draft Articles on Responsibility of States for Internationally Wrongful Acts with commentaries, 2001), electronically available at http://untreaty.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf.

including such all-encompassing principles as the prohibition of aggression, the protection of fundamental human rights, and self-determination.)

In the context of national law, courts have determined that repayment demands can be considered illegal on the grounds that the terms of the original loan were usurious, that the lenders perpetrated fraud on the borrowers, or that the lenders broke other national laws in order to extend the loan.

“Ineffective” debts

Finally, the category of “ineffective” debts would be that of loans that do not reach their developmental purpose and loans directly linked to capital flight. This line of argument differs from the previous two in that it recognizes that projects could fail and development purposes of loans may not be reached even when there is no corruption and all applicable national and international laws are scrupulously followed.

Such a line of argument needs careful scrutiny, for its equivalent would be that domestic lenders to private borrowers should not be repaid when commercial projects fail. This, of course, is not the usual practice in most financial systems. On the contrary, when commercial projects fail on account of commercial risk, bankruptcy laws require that lenders be among the first ones to be repaid (after all production costs and arrears to suppliers have been met). In international lending, especially to poor countries for developmental purposes, the risks of failure are just as high, if not higher than those faced in private transactions.

National financial laws do not require lenders to pay the costs for such failure for two reasons: first, the act of lending usually cannot be considered the proximate cause of the failure of the project or activity, under any scenario; and, second and more importantly, it could potentially create incentives for irresponsible behavior by borrowers (the so-called “moral hazard”), because the costs would be born by the lenders.

Another line of argument for declaring “ineffective” debts as “odious” derives from a more sophisticated line of reasoning. The essence of the argument rests on the principle that advisers to governments should be held legally accountable for their advice, and that failed projects are sometimes the result of poor advice provided by the lender. Where loans and advice are bundled together, the liability of the adviser for a failed project should be the non-payment of the loan itself.

But even this more sophisticated line of reasoning needs critical examination. First, finding the advisers to be responsible for the failure would require isolating their advice from the more general context of the country’s circumstances and identify it as the sole cause of the failure. Second, even if it can be proved that the advisers are responsible for giving poor advice, there is little logic to suggest that this should result necessarily in refusing loan repayments. There are no contracts which underwrite advisory services with loan non-payment. Third, a legal system making advisers culpable for failure (i.e. considering them to have undertaken an obligation of result — “obligation de résultat” — rather than an obligation of means — “obligation de moyens”) would prevent any delivery of technical advice, especially if that technical advice is provided for free or as part of a broader aid

package. And, fourth, the incentive structure of such a possibility still enhances the dangers of “moral hazard”, because it would encourage the reckless use of loans if there is a sense that the cost of failure would be borne by others.

Conclusion

It is difficult to detect, from the increasingly wide literature on the topic, a clear and legally viable concept of odious debts in the expanded version in which it is often used today. The categories that are being proposed often overlap, lack clarity, and tend to apply the concept with equal facility and often at the same time to loans, regimes, countries, and debts. This lack of precision, and the array of practical objections that confront them, make it difficult to accept the expanded concept of odious debts, which is often advanced in recent discourse (and which has not been reflected in the practice of states). A different approach is required in addressing the concerns that motivate many of these proposals. This is the subject of the next section.

IV. IMPROVING LENDING AND BORROWING PRACTICES

The proponents of the expanded concept of odious debts, which was discussed in the previous section, argue that lenders must be held accountable for “illegitimate” debts. The underlying objectives for such a proposition are in principle laudable, as they aim at ensuring that international lending to developing countries (a) diminishes corruption (or, at the very least, does not encourage it), (b) is conducted in accordance with national and international laws, and (c) is used effectively for developmental purposes. A further objective is to provide some legal support for the unilateral repudiation of debts by sovereign borrowers.

The previous section has shown, however, that taking lenders to court to force them to meet these objectives runs into various problems, among which is the risk of disrupting international financial flows to developing countries altogether. There are other means by which the same objectives can be met, and it may be more appropriate to focus on them. Should these measures be found to be insufficient, the best approach does not seem to be the conversion of uncertain concepts and categories into law but the rigorous identification of the problem, the assessment whether even partial answers to the problem already exist and, if not, the search for reasonable solutions in the interest of borrowers and lenders alike, and the continued healthy functioning of the international financial system.

Fighting corruption in international lending

Perhaps, the most important factor motivating the call for the cancellation of odious debts is the conviction that loan proceeds are often embezzled by corrupt officials and leaders in the borrowing countries, leaving it to future administrations and generations to pay back the debts. These corrupt practices deserve not only moral outrage but also a thoughtful reaction on how to deal with them most effectively. In addition to what can be done by national governments, elected bodies, and civil society organizations within countries (which are essential components of the equation), external lenders too can commit to follow good lending practices that may help remedy the problem over time. Not least among such practices is to assess the pecuniary and non-pecuniary risks of lending, to disclose these fully to the shareholders as well as the borrower, and to develop ways that would mitigate these risks such that the probability of the loan being misused is minimized. For example, lenders could, among other things, implement the following measures:

- Examine the overall governance standards in the borrowing country, including anti-corruption programs and measures.
- Projects considered at high risk of corruption could be required to include anti-corruption action plans that build on knowledge gained from the experience of implementing previous projects and which draw on tried-and-tested requirements for transparency and oversight that could include enhanced disclosure provisions, civil society oversight, complaints handling mechanisms, policies to mitigate chances of collusion, mitigation of fraud and forgery risks, and sanctions and remedies.
- Well publicized mechanisms need to be put in place that allow the public – and “whistleblowers” – to come forward if they have allegations of corruption, with adequate safeguards to protect them against possible reprisals. Such allegations will

need to be investigated thoroughly by the lender as well as the borrowing authorities, in full conformity with national laws and regulations. Any evidence emerging from investigations of wrongdoing should be made public and handed over to the authorities for appropriate action consistent with the laws and regulations of the country concerned.

- As a form of protection against the possibility that covenants in loan agreements may be breached and loan proceeds may not be used for their intended purposes, lenders should reserve the right to cancel part of the loan and seek reimbursement of any funds that have been misused. In addition, those found guilty should be prosecuted by the borrower governments to the full extent under national law.
- Mechanisms need to be put in place for the debarment of firms and individuals that are found to be participating in fraud and corruption. Every effort should be expended by governments and the international community to recover stolen government assets, including money stolen from sovereign loans. And not only could lenders and borrowers publicize instances of fraud and corruption and the remedial measures taken, but at the same time join forces to develop systems that make such crimes harder to commit.

The above examples of good lending practices can be complemented by new initiatives to strengthen the array of anti-corruption measures that countries can implement, such as the Stolen Assets Recovery (StAR) initiative. In recent years, countries as far flung and diverse as Nigeria, Peru and the Philippines have enjoyed some success in securing the repatriation of assets stolen by their corrupt former leaders. Success, however, has been neither easy nor quick. To help developing countries seeking to recover stolen assets more

easily and effectively, the United Nations Office on Drugs and Crime (UNODC) and the World Bank are jointly working on the StAR initiative. The StAR initiative expands the ambit of traditional support to improve governance and anti-corruption practices within countries and brings in the “other side of the equation”: stolen assets are frequently hidden in developed country financial centers, and often include bribes paid by multinational corporations. This initiative will specifically help countries that are parties to it to implement the United Nations Convention Against Corruption (UNCAC), which entered into force in 2005 as the first global anticorruption agreement.³⁰ It will also develop pilot programs to help specific countries recover the stock of stolen assets by providing needed technical assistance while also supporting improvements in public financial management, investigative capacity and fiscal transparency to prevent future looting. Finally, StAR aims at helping countries ensure that recovered assets are used effectively in support of development through monitoring programs with the voluntary agreement of the countries concerned.

Ensuring the “fairness” of loans

Just as lenders can play an important pro-active role in protecting their loans from fraud and corruption, they could also exercise appropriate due diligence to ensure that the loans themselves are the results of processes and procedures consistent with the laws of the borrowing country and expected good practice according to international standards. These include:

³⁰ The text of the Convention is electronically available at http://www.unodc.org/unodc/crime_convention_corruption.html.

- Providing ample opportunities within the country to comment, criticize, and shape the proposed loan, and stressing a country representative's freedom to decline the loan throughout its preparation, appraisal and approval process.
- Subjecting loans to intensive preparation, evaluation, appraisal, and negotiation, with full participation by the authorities of the country concerned and, as and where appropriate, by civil society and other relevant groups, and disclosing to the public the final appraisal documents. Depending on the applicable laws, regulations, and procedures, this could include scrutiny by elected representative bodies.
- Requiring legal opinions regularly, from acceptable counsel, confirming that the loan agreement in question is legally binding in accordance with its terms and has been approved in conformity with the internal laws and procedures of the borrowing country.

Of course, such steps could raise the cost of loan preparation, and this could prove to be a disincentive for lenders (and borrowers, if it raises the cost of borrowing). On the other hand, these increased costs of loan preparation may be seen as an investment in obtaining potential benefits: for the borrower, better use of the loan proceeds, and, for the lender, a lower risk of default on the loan.

Improving the effectiveness of loans

To meet the concerns that underlie the proposals to declare “ineffective” debts as odious, lending institutions could adopt a variety of measures. Before considering these, it is

worth reiterating one point: as a rule, loan agreements do not create a link between the final success of the loan proceeds and the borrower's repayment obligation. The reason is simple. One of the key aspects of international lending to *sovereigns* is the borrower's "ownership" and complete control of the use of the proceeds and the acknowledgment that the lender's role is limited to assisting the borrower in achieving the aims it has itself decided and for which it has requested financial assistance. Moreover, loan agreements usually do not include a link between the repayment obligation and the final success of the financial assistance because it is recognized that (a) the success of a project entails risks that are usually outside the control of lenders, who usually face larger risks since they have less information than borrowers (the so-called "information asymmetry"); (b) such a link would reduce incentives for borrowers to make the project a success (since part of the cost of failure would be borne by the lender); and (c) such a feature in loan agreements would give these loans an equity, rather than a debt, characteristic.

International lenders could nevertheless engage in efforts to ensure that the risks of inappropriate use are managed to the extent possible. These could include the following:

- Covenants in loans could expressly require that the loan proceeds be used for their intended purposes, and subsequent supervision efforts, in which the borrower and the lender cooperate, should be designed to ensure that proceeds are being used for and achieving their intended purposes.
- Lending institutions could regularly conduct – together with the sovereign borrower's authorities – evaluations of the use of their loan proceeds and whether such loans have achieved their intended purposes. These evaluations may be conducted

independently of the management of these institutions and the results could be made public.

- If international lending institutions are aware that they are lending into a high-risk environment because the borrowing country's economic management institutions are weak and controls over the use of public resources less than adequate, then there may be a case for applying even higher standards of probity and more stringent safeguards than normal. Of course, there are few objective indicators on which such judgments can be based, which makes international lending for development purposes highly risky in the first place.

Differentiating between official and commercial creditors

Good lending practices of the sort described in this section could apply to official as well as commercial creditors. Since the shareholders of official creditors are sovereigns, the policies of such financial agencies – bilateral and multilateral – tend to be driven by public policy considerations. Shareholders in these institutions tend to apply constant pressure to improve lending practices, in part because they are concerned about the development impact of the finance provided by these agencies, but also because they hear the concerns raised by non-governmental and civil society organizations in their own countries as well as in the developing countries. This constant pressure has led to improved lending practices in some official lending institutions, although the room for improvement remains considerable.

One might think that commercial creditors would have less incentive to improve lending practices – especially if implementing such practices imposes additional costs. But the existence of the Equator Principles suggests otherwise. The Equator Principles are a set of ten benchmarks against which 52 of the world’s most prominent commercial financial institutions have agreed to determine, measure, and manage the social and environmental risks associated with project financing.³¹ One of the key motivations for this initiative was the perceived importance of mitigating credit and reputational risk – a good example of how commercial considerations can potentially lead to socially desirable results. Supported by the International Finance Corporation (one of the institutions of the World Bank Group), the Equator Principles also facilitate the collaboration and learning on broader policy application, interpretation and methodologies between member financial institutions, and also helps knowledge transfer, learning and development of good lending practices.

Of course, good lending practices, whether by official or commercial lending institutions, while important cannot by themselves guarantee the appropriate use of loan proceeds for development purposes. The responsibility of achieving this result must ultimately rest with the borrower.

Dealing with unsustainable debt stocks

There is little doubt that, if loans become the subject of fraud, embezzlement, or corruption, such debts can quickly accumulate to the point that they become unsustainable. Proponents of the expanded concept of odious debts would like to see a legal basis for the

³¹ See <http://www.equator-principles.com/index.html>.

unilateral repudiation of debt stocks if such unsustainable debts were found to be odious. As was recalled earlier, there are many difficulties associated with applying the concept of odious debt to this effect. There are other ways to deal with the problem of unsustainable debt stocks.

It is important to observe at the outset that, while misused loans can quickly accumulate into unsustainable debts, not all unsustainable debts are the result of misused loans. Loans can be used well and yet not achieve their desired results simply because circumstances can change, the economic environment affecting investments can suddenly deteriorate for reasons outside governmental control, natural disasters can strike, or the design of the investment itself may have been faulty from start. When such unforeseeable situations (or “shocks”) occur, debts can accumulate in relation to the repayment capacity of the country.³²

That countries must either pay their unsustainable debt or repudiate it is a false dichotomy. In reality, countries have chosen the middle path of restructuring their debt when it has become unsustainable. Such restructurings usually involve losses to creditors and therefore tend to be the result of prolonged and complex negotiations. But they do provide a useful alternative to repudiation, and allow countries to maintain good relations with their creditors. Iraq and South Africa are recent examples of countries where new governments inherited large sovereign debts but, rather than repudiating them, chose instead to negotiate their restructuring with their creditors.

³² See Kraay and Nehru, “When is External Debt Sustainable?”, *The World Bank Economic Review*, Volume 20, Number 3, 341-65.

In the case of commercial creditors, debt restructuring negotiations have been between the sovereign and creditors' committees such as the London Club or, as in more recent cases, representatives of bondholders. With official creditors, debt restructurings have usually taken place in the context of the Paris Club, an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by sovereign debtors. The most prominent recent examples of large Paris Club debt reduction deals are those for Nigeria and Iraq.

Multilateral creditors are governed by agreed international frameworks on the treatment of debt problems in developing countries.³³ Most notable among these are the Heavily Indebted Poor Countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI), which together are expected to provide significant debt reduction to the poorest, most heavily indebted countries of the world. These initiatives implicitly recognize that the debts accumulated by the recipient countries have reached a point where they cannot be repaid without imposing unacceptable hardship on the population.

In addition to participating in international debt reduction initiatives, some international lenders have independently and voluntarily forgiven debts they were owed by developing countries. The most recent example is that of the Norwegian government which, in the 2007 national budget, cancelled, *ex gratia* and not out of any legal obligation, NOK 520 million (\$78 million) of official debts owed by Ecuador, Egypt, Jamaica, Peru and Sierra

³³ There have been a few examples of commercial entities canceling their claims on similar grounds, but these have usually been as a result of pressure generated by negative publicity in the media.

Leone stemming from the Norwegian Ship Export Campaign (1976-80). The Norwegian government considered this campaign a development policy failure and consequently assumed “shared responsibility” for the debts that followed. This debt cancellation is additional to Norway’s ordinary overseas development assistance.

Dispute resolution

Notwithstanding all the above measures that international lenders or borrowing countries can apply, disputes will inevitably arise between lenders and borrowers and must be settled. Usually, loan agreements include clauses on the settlement of disputes. For loans from commercial creditors to sovereign borrowers, the jurisdiction for the settlement of disputes belongs to national courts, such as those of New York or London, which may apply laws that protect debtors against litigants trying to be repaid, despite the evidence of bribery or “unclean hands” on the part of the lender, or of corrupt agents and public officials embezzling state funds behind the cover of government bureaucracy.

In the case of loan agreements to which international institutions are parties, the settlement of disputes is usually devolved to arbitrators, even though in practice such disputes are regularly solved by direct negotiations between the parties, without any need to resort to arbitration.

Conclusion

Many of the concerns that have been raised by proponents of the expanded concept of odious debts have been fueled by moral outrage and the need for a just system of international lending to sovereigns. Such concerns can be addressed by improved practices of international lenders and sovereign borrowers. Despite some promising steps in this direction, much remains to be done. Rather than relying on an expanded and elusive concept of odious debts, it seems more practical to assess what can be done to improve lending and borrowing practices. This approach has the advantage of channeling the valid concerns that underpin the debate on odious debts in constructive and widely shared directions.

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