

EURODAD Annual Conference 2006
From Illegitimacy to Responsibility: Transforming Development Finance

Odious Debt: Definition, Application and Context
30 October 2006, Ashfaq Khalfan¹

Nasir Ali was a businessman who wished to establish a duty-free shopping centre at Nairobi's international airport. His proposal to the Kenyan government was well received. He was invited to meet the then-President Moi, and to bring along a donation for a project of the President's choice, in the amount of US \$2 million in cash in a suitcase. Mr. Ali had a strong belief in respecting local customs and went to the meeting appropriately equipped. He left the meeting with an agreement to set up his shopping centre and a suitcase full of corn leaves. Eventually, however, relations soured, and the Kenyan government took back control of the shopping complex. Mr. Ali brought a claim against the Kenyan government before the International Centre for the Settlement of Investment Disputes (ICSID), an arbitration mechanism established by the World Bank. Most developing countries have signed bilateral investment treaties with developed countries in which they permit investors from that country to have recourse to ICSID, which then provides private investors with a mechanism through which they can seek compensation for the expropriation of their investments. Both parties have a say in selecting the members of the panel of each ICSID tribunal. The Kenyan government that replaced the Moi regime contested Mr. Ali's claim.

In its judgement of 4 October 2006, the ICSID tribunal refused to give Mr. Ali any redress. It stated that the contract was procured contrary to international public policy and Kenyan law, since it was concluded through bribery.² Even though President Moi had been complicit in achieving the agreement through unlawful means, Mr. Ali was not able to use ICSID as a means to enforce rights secured through a breach of international public policy. Most importantly, the Tribunal stated that it was necessary to distinguish between the acts of the Kenyan President and those of the Republic of Kenya. The tribunal further stated that international law aims to protect the public, in this case the tax-payers and citizens making up one of the poorest countries in the world. This ruling indicates that even a relatively conservative institution such as ICSID is willing to distinguish between legitimate and illegitimately agreed contracts by governments.

¹ Director, Centre for International Sustainable Development Law. This presentation draws upon the following study (albeit with several revisions and updates): A. Khalfan, J. King and B. Thomas, *Advancing the Odious Debts Doctrine* (Montreal, CISDL, 2003). Chapter 1 of this working paper by Jeff King, Legal Research Fellow at the CISDL, addresses the legal status of the doctrine. Chapter 2 by Ashfaq Khalfan, addresses the strategic legal and political options for its application. Chapter 3 by Bryan Thomas addresses the policy implications of the invocation of the doctrine. The complete working paper and an Executive Summary are available at: <http://www.cisd.org/debtlegitimacy.html>. An academic publication that refines and extends the arguments in the working paper will be released in 2007.

² World Duty Free Company Limited v. Republic of Kenya, ICSID Case No. ARB/00/07, Award, paras. 165-181.

In this presentation, I will discuss:

1. The definition of the odious debt doctrine.
2. Its status in international law
3. The mechanisms through which the doctrine may be applied in dispute resolution
4. Areas of 'illegitimate debt' that the odious debts doctrine does not cover.

1. Definition of the doctrine of Odious Debts

The odious debt doctrine was first formulated by Alexander Sack, and has been added to by a variety of other credible international law scholars. The definition of odious debts as it now stands is as following:

Odious debts are those contracted against the interests of the population of a state, without its consent and with the full awareness of the creditor. Thus, these debts cannot be enforced against a debtor State.

I will elaborate on the criteria for an odious debt, and in doing so, I am drawing upon the work of my colleague, Jeff King, as to the most correct way of applying the doctrine.

First, *absence of consent*: The population must not have consented to the transaction in question. With dictatorial regimes, lack of consent is presumed, unless there is evidence indicating significant public support for a particular use of funds. With democratic governments, lack of consent needs to be proved.

Second, *absence of benefit*: There must be absence of benefit to the population in two ways. First, the purpose of the transaction must be improper and second, the actual use of the loan did not benefit. The purpose requirement means that lenders are not punished for good faith loans that were misspent, in a way that they did not expect, by corrupt governments. It also means that populations that get some benefit from an odious loan are still required to repay the amount that was of benefit. Where the loaned funds were applied to general government revenue, rather than for a specific purpose, the government budgets for the respective years must be assessed according to spending on (1) oppressive, (2) neutral and (3) beneficial institutions.

Third, *creditor awareness*. The creditor must be aware of the absence of consent and benefit. It must either (i) have actually been aware of these facts (ii) have been intentionally blind to the use of the loans or (iii) have been wilfully and recklessly negligent in making the type of inquiries that any honest and reasonable lender would.

These criteria may seem rather vague. However, it is entirely common for tribunals to deal with open-ended criteria of this nature and apply them to particular facts of case. For example, tribunals have to deal with issues such as compensation for damage caused by negligence, the application of legislation that determines when businesses are colluding in a manner than restricts competition or in determining the amount of alimony payments and child support payments a spouse must after a divorce.

There remain a number of grey areas. For example, if odious debt is repaid, there are questions as to whether the payment can be recovered by the debtor. This is unlikely as a successor government can be held to have acquiesced to the validity of the loan agreement. Another question relates to secondary odious debt where the right to obtain payment for a loan is sold by a creditor to another party. An initial answer to that question is that the debt would remain odious and could be repudiated, but that in such circumstances, the secondary buyer would be able to sue the initial creditor for its loss.

2. Status in International Law

The odious debts doctrine is not an aspect of international law that all international lawyers agree upon. However, a strong legal argument can be made in its favour and a strong legal argument can be made against it. Many States and tribunals have, can and certainly will invoke the doctrine. International law is made up of a number of sources, most of which provide significant support to the odious debts doctrine.

First, in terms of treaty law, international treaty law on corruption, including the recent UN Convention Against Corruption, provide a basis for the principle that governments, and those parties that engage in corruption are engaging in unlawful behaviour, and therefore cannot benefit from such conduct.

Second, international customary law, which is made up of State practise together with the acknowledgement by the relevant State that such practise is required as a matter of law, provides significant support for the doctrine. Several States, including the United States, have credibly and successfully invoked the doctrine and thus repudiated odious debts.

Third, a number of international arbitrations have applied the doctrine, in particular the *Costa Rica v. Great Britain* (Tinoco Arbitration), where the arbitrator, US Supreme Court Justice Taft, held that loans advanced to a dictator by the Royal Bank of Canada as its dictator was about to give up power in the face of an insurgency, did not bind Costa Rica due to the irregular nature of the loan.

Fourth, many international law scholars writing on debt repayments issues agree that the doctrine has a strong basis in international law.

Fifth, the underlying concept behind the doctrine has its basis in several general principles of law that are accepted at the national level, and which therefore serve as sources of international law. In particular, domestic law governs the way in which one person can create legal obligations for another. Where an actor has the power of making binding commitments for another, that actor carries the special responsibility of acting in the interests of that person. Classic relationships include doctors and patients, lawyers and clients, corporations and shareholders. Under domestic law, a third party can be held liable for assisting an actor breach its obligations. If a bank were to knowingly assist a CEO to defraud a corporation, that bank can be held liable for the losses of the corporation to the shareholders. Indeed this happened when Citibank was held liable for its actions in the ENRON scandal. This domestic law analogy is probably the single most convincing argument in favour of odious debt.

Those who challenge the legal existence of the doctrine raise a number of issues, three of which are addressed here. First, it is argued that most cases in which the doctrine has been invoked has occurred in cases in which sovereignty over a country changed (state succession), rather than to mere changes in government. The primary response to this point is that there are several cases in which the odious debts doctrine was invoked in relation to changes of government. In addition, customary law is only one source of international law relevant to the issue. The strongest justification for the odious debts doctrine arises in regard to principles of law found throughout national laws, for which the state succession/change of government distinction is irrelevant.

Second, critics point to the fact that most States actually repay debts even where these are odious. The key response is that such repayment is not relevant for the purposes of forming international customary law. Customary law requires States practise, together with the acknowledgement by a State that such practise is required as a matter of law. Thus, actions carried out for reasons of expediency, such as payment of odious debts in order to preserve good relationships with creditors, do not constitute customary law. To challenge this argument, the critics would need to identify a significant number of situations in which a State has acknowledged that part of the debt it owes is odious, but that it considers that such payment is required under international law.

Third, the difficulty of distinguishing precisely between which loans were used for beneficial purposes and which were not has been raised as an issue. Money is fungible, and loans given for a beneficial purpose may free up resources that a regime can then spend on irregular items. It is no doubt true that the doctrine would be difficult to apply. A tribunal addressing this issue, or a negotiation between States on write-downs, would have to estimate the overall proportion of debts that were odious and share the burden of this percentage among all creditors who had given general funding to the regime in question. A negotiation between States would probably make a rough estimate as to which debts are odious. More likely, an agreement, whether implicit or explicit, between creditors and a debtor State that a significant portion of debts were odious would probably lead to a more significant write-down in the debt than would otherwise have been the case. Some scholars now argue that criterion of 'absence of benefit' should be replaced with a criterion that relates to loan agreements that violate international public policy. The latter approach may be promising, and the recent ICSID judgement would certainly support this approach. However, since there is significant legal support for the odious debt doctrine as defined by Sack, it may be useful to see odious debts and violations of international public policy by lenders as parallel but overlapping reasons for holding that debt repayment is not legally required, rather than as alternative formulations of the same doctrine.

Several of these arguments, among others, and the responses, are dealt with in the CISDL working paper on the odious debts doctrine. The legal debate notwithstanding, what is clear is that any sensible lender – whether a State, International financial institution, or private lender - should by now know that the odious debts doctrine can cause them legal difficulties, particularly in the most blatant cases of odious debts where loans are directly going into the personal coffers of the ruler. It is likely that at least some lenders will soon begin to consider the odious debts doctrine prior to granting loans to governments known for their corrupt behaviour.

3. Likely Application of the Doctrine

The CISDL working paper on odious debts has a detailed assessment of the range of processes and dispute-resolution mechanisms in which odious debts might be addressed. In this presentation, I will discuss only the routes that are most realistic.

3.1 Debt negotiations

Where a debtor State can emphasise the odious nature of the loan, it may be able to use this as leverage to negotiate a substantial write-down in the debt owed. When States negotiate, they ‘bargain in the shadow of the law.’ That is to say, they take into account a number of factors: political leverage, legal rights and moral considerations (particularly where there a great deal of public pressure applied on the State). It should be emphasised that almost all legal disputes relating to debts are resolved in negotiations rather than before a tribunal, whether the lenders are States or private parties. There are only two prerequisites for odious debts to be raised in negotiations:

1. A factual situation that justifies a claim that debts are odious. The cases that would carry the most weight would be those of ‘Mobutu variety’ where the corruption of the government was documented and notorious and where the creditors would have had no doubt that their loans were being used for non-public purposes.
2. Guts! The doctrine has been invoked before, and can be invoked again. The main obstacle is political, involving the threat of financial retaliation or perhaps the understanding of corrupt governments that those who live in glass houses should not throw stones.

Iraq is a good example. Senior Ministers and the President of the interim Iraqi government, as well as some U.S. officials, had referred to the odious debts doctrine in calling for Saddam-era debt to be cancelled. This pressure almost certainly influenced the extent of debt cancellation offered to Iraq by the Paris Club, which involved an 80% write-down. Nigeria was similarly offered a significant write-down of its debts. One factor was the resolution passed by its Parliament calling for repudiation and the emphasis placed by its negotiators on the irregular nature of previous lending.

Although debtor countries can raise the doctrine in negotiations and potentially secure concessions on this basis, the most significant write-downs can be expected when there is a concrete threat of repudiation of these debts. The main obstacle to such action is the ability of creditor states, international organizations and private banks to suspend foreign aid and loans. This danger may be mitigated by affected States in two ways. First, those that invoke the doctrine would be better served if their assessment of odious and other illegitimate debt is seen to be fair and following consistent principles. Second, a high degree of international acceptance of the odious debt doctrine among most Southern states and at least some Northern states would reduce the political cost of invoking the doctrine.

There are four particular routes by which the doctrine could secure greater international acceptance:

1. More debtor States burdened by odious debts could forcefully raise the doctrine forcefully, with a credible threat of repudiation. This would probably require a significant group of debtor States to coordinate their strategies on this issue. National pressures from civil society, including social movements and political parties, will probably determine the strength of debtor State resolve.
2. Action by some creditors (State, inter-governmental or private) to write-off debts explicitly based on the principle of odious debts as a legal impediment to collection of debt, would have a significant role in making the doctrine more acceptable in practise (and strengthen the international law argument in favour of the doctrine). The effectiveness of debt activists in creditor States will have a determinative effect.
3. Recognition of the odious debts doctrine in principle by States, particularly States that are normally creditors, will strengthen the doctrine.
4. The role of tribunals and legal scholars should not be discounted. There is now significant debate about the doctrine in legal circles. Legal scholarship can have an impact on State practise, by virtue of legal advice given to States, and can have a significant impact upon the decisions of international and national tribunals. The trends in the treaty law, general principles of law and decisions of tribunals all point towards greater acceptance of the doctrine.

In practise, creditors who agree to a write-down of odious debt will resist any explicit mention of the odious debts criterion as they would have to admit some culpability in the matter, and more importantly, create a precedent that may tie their hands in the future. Most debtor States will be understandably be more concerned about securing a substantial write-down than in making a legal point. Instances of explicit recognition by creditors will normally be rare. However, implicit and unspoken application of the doctrine will have the practical effect of putting creditors on notice and prod them to become more careful in their future lending.

3.2 Application before international arbitrations and domestic courts

Loan agreements often stipulate the law under which they are governed and the jurisdiction within which the agreement falls. Most agreements involving a private lender stipulate either that the courts of New York, England, or those of the creditor's country have jurisdiction over the loan agreement. In the case of some inter-governmental agreements, agreements between a government and an international financial institution and some agreements between a government and a private party, international arbitration is the stipulated recourse. Should a dispute come before any of these courts or tribunals, it may be feasible for the State in question to raise the odious debts doctrine as a defence to being required to pay.

The decision of a tribunal will depend on the facts of the case and the orientation of the tribunal or court in question. Assuming that the argument for the debtor is well-argued and substantiated, a flagrant case of odious debts, for example a situation in which a government was clearly using loans for personal gain, and where the creditor was actively acting in bad

faith, such as by providing bribes would in most cases result in decision in favour of the debtor. The ICSID case I mentioned at the beginning of this presentation is a good example. However, cases that relate to the grey areas of the doctrine, for example, where loans were provided for projects that benefited only a minority of the population, may not be a safe bet in terms of litigation from the debtor's perspective. For such cases, the type of tribunal or court will be critical, and it is necessary to take account of the previous decisions of that jurisdiction. For example, New York courts have shown a significant level of deference to the views of the American government on questions of international financial law.

A debtor State is not totally bound by the jurisdiction specified in a loan agreement since the two parties can agree that their case may be heard by an independent arbitration tribunal, constituted by the parties. A debtor State may be in a position to insist on this method of dispute resolution by threatening to unilaterally repudiate the debts. Although arbitrations do not have any means of enforcing their decisions, their decisions are generally complied with due to the reputational risk borne by any party that does not comply with a ruling.

Acceptance of the odious debt doctrine by a court or tribunal would provide further evidence for the doctrine under international law, and send a signal to creditors to be mindful of the type of lending in which they engage. Obviously, rejection by a court or tribunal would have the opposite effect.

3.3 Decision by the International Court of Justice

Assuming that the factual situation justified it, the International Court of Justice (ICJ) would potentially have little difficulty in recognising and applying the odious debts doctrine. The ICJ is the equivalent of a Supreme Court for international law. Thus, its decisions cannot be reviewed by another tribunal and it has often, though not always, been willing to take bold steps forward in international law. However, there are procedural hurdles. If both countries have accepted the 'compulsory jurisdiction' of the court, then it can consider a case based on the request of one party. About 67 countries have recognised the compulsory jurisdiction of the court. If this condition does not apply, the ICJ can only address a dispute if a relevant treaty between the two parties to the dispute specifies recourse to the ICJ or if both parties consent to its jurisdiction. The latter is perhaps unrealistic as a creditor would prefer to not have its culpability in an odious transaction broadcast to the world. An alternative route would be for the UN General Assembly to request an ICJ Advisory Opinion on a particular debt. However, obtaining a majority of States in the General Assembly to request an Advisory Opinion would not be easy since odious debt is a double-edged sword for both creditors and prospective borrowers. The ICJ does not have any mechanism to enforce its judgement. Notwithstanding this fact, a judgement in favour of the debtor State would be self-effecting as the debtor could simply withhold payments on the basis of the ICJ judgement.

3.4 A standing tribunal to address odious debts

There have been many proposals for a new international arbitral tribunal that has the mandate to resolve odious debts. In principle, such a tribunal would hold odious debts unenforceable, while at the same time making clear what the rules of appropriate lending are,

thus preventing instability in the financial markets. However, there is the possibility that a tribunal established through agreement of many or all States would have a mandate that reflects compromises between States, and thus the mandate of the tribunal would adopt a limited definition of the odious debts doctrine, or one that applies only to future loans. In addition, creditors would be unlikely to agree to a tribunal in the absence of significant political mobilisation and a significant number of unilateral repudiations. The creation of a stand-alone tribunal is not likely, and would likely take several years.

3.5. Human rights treaty bodies

In the last decade, there has been significant attention, among scholars, and in discussions within the UN human rights system, to the argument that States are obliged under their human rights law treaty obligations, in particular the International Covenant on Economic, Social and Cultural Rights (ICESCR) to ensure that their actions do not undermine the realization of human rights outside their borders. The UN Committee on Economic, Social and Cultural Rights, which has a mandate from the UN General Assembly to interpret the ICESCR, has indicated States are bound by such international obligations beyond their borders. Many developed States reject this argument, and so legal debates and political struggles continue on this point.

A country that is complicit in misappropriation of funds by a dictator could be found to be in violation of the ICESCR since it is helping to impose unnecessary financial burdens on another State, the cost of which will be borne by the debtor State's population to the detriment of their economic and social rights. A human rights monitoring body, such as the UN Committee on Economic, Social and Cultural Rights could well make this determination, and thereby call on that creditor to refrain from seeking repayment of that loan. However, this possibility is speculation at this point. UN human rights bodies may be willing to set out broad principles that have an impact on international financial interactions, but it would be quite another matter for them to state that specific loan agreements should not be repaid.

States that have ratified human rights treaties are expected to periodically report to UN human rights treaty monitoring bodies such as the UN Committee on Economic, Social and Cultural Rights. The latter body expects to receive reports every five years. After reviewing the report and a dialogue with the State, and with NGOs, the Committee will issue its 'Concluding Observations' on the extent of the State's compliance with its obligations. In recent years, the UN Committee on Economic, Social and Cultural Rights has begun to pronounce on the actions of States that affect economic, social and cultural rights in other countries. It should be noted that the observations of treaty bodies are not legally binding and there is no mechanism to enforce them. However, they can have political effect depending on a variety of factors, including whether there are civil society actors who utilise the observations as a source of legitimacy for their demands.

Unlike the dispute resolution mechanisms in points 3.1 to 3.4, it should be pointed out that there is a clear opportunity for civil society to directly participate in the determinations of treaty bodies. Indeed, the fact that the UN Committee on Economic, Social and Cultural Rights has begun looking at obligations beyond borders largely has been made possible due

to the information provided to it by Northern civil society groups. It should be clarified that human rights treaty bodies can only currently only hold States directly accountable. Private corporations and international financial institutions (IFIs) do not report to the human rights treaty bodies. However, in principle, States may be held accountable, respectively, for their voting in IFIs and for the extent to which they do, or do not, adequately regulate the actions of corporations headquartered within their jurisdiction.

4. Odious Debts as a sub-set within a Broader Category of ‘Illegitimate debts’

There are many situations in which debts can be seen to be illegitimate, but to which the odious debts doctrine would not apply. Three of these types of situations are briefly surveyed below:

4.1 Debt repayment that undermines the realisation of economic and social rights

There are many situations where developing countries have to repay debt at the cost of realizing basic social and economic rights for its citizens. In some cases, this occurs even though the initial loan provided some benefit to the population of the borrower. In certain circumstances, it may be possible to identify an obligation upon a creditor to cancel debt, or to refrain from demanding payment, where such debt is of a magnitude that it cannot be paid without making it impossible for a State to fulfil core aspects of economic, social and cultural rights, and where the creditor is a wealthy State that has met core economic, social and cultural rights for its population. However, there are difficult questions here that may prove an irresolvable obstacle. In particular, many creditors could point to expenditures of the State that are not related to economic, social and cultural rights, and argue that cuts should occur there before debt cancellation can be considered, given that the State is the primary actor responsible for its citizens. Such expenditures could include items such as military goods, tax rebates, and incentives to corporations to invest in the country. It therefore can be unclear at what point a specific debt becomes the obstacle to realisation of economic, social and cultural rights in the debtor State.

In spite of the difficulty of applying the human rights law to specific debts, it may have a role in justifying debt cancellation at a per-country level. The human rights approach is more compelling than the World Bank and IMF definition in which debt sustainability is calculated in accordance with economic measures. It is also better than the potential option suggested in the Monterrey Consensus of 2002, which is to link debt sustainability analyses to the ability of a country to meet the Millennium Development Goals (MDGs). The target set by human rights standards is to ensure, as expeditiously as possible, that each person has at least basic access to rights such as food, water and sanitation, in contrast to the MDG goals of reducing by half the proportion of people without such access. A significant amount of analytical work is needed to concretise the application of human rights law to issues of debt repayment. One concrete area in which the law can be clarified and applied to debt issues is in the periodic review of the ICESCR by creditor countries.

The human rights approach to debt is quite promising, as it includes a mechanism to potentially address odious debt, as described above (in section 3.5) as well as a way to address situations in which an odious debts claim cannot be made. However, human rights arguments cannot replace the odious debts doctrine since the latter doctrine more clearly addresses the question of creditor responsibility and has been applied in practice to debt in contrast to the untested nature of human rights analysis on this issue.

4.2 ‘Ill-advised’ loans

This category refers to situation where loans were accompanied by bad policy advice or they supported a project whose failure should have been foreseeable, as has been the case, for example, for many mega-dam projects. In this case, a claim could be made that the creditor should share responsibility for a loan that should never have been granted. This claim is primarily moral rather than legal. However, as seen in the case of Norway’s cancellation of debts incurred as part of an ill-advised ship-building export credit scheme, a moral and ethical claim can sometimes be sufficient, particularly when accompanied by political advocacy and/or where the political environment is conducive to such a claim.

4.3 Counter-claims

Many debt activists from the South have argued that Northern States owe Southern countries reparations for actions such as complicity in oppression by dictators, proxy wars during the Cold War and colonialism and that these reparations are greater in magnitude than the financial debt owed by the South.³ The settlement of these claims depends on a number of issues, including the difficulty of finding a possible settlement mechanism. Unless, the countries involved agree to a compensation tribunal or other settlement mechanism, it will normally be necessary to sue in the courts of the country accused of responsibility for the damage (since, in principle, international laws considers it outside the jurisdiction of an organ of one State to unilaterally resolve a dispute between that State and another State). Survivors of British abuses carried out during and after the Mau Mau struggle in Kenya have brought a claim against UK in an English court. The result of this action will give a sense of the likely future for this route.

If any of these claims are ever resolved, this is likely to occur through out-of-court settlements and potentially inter-State negotiations. It is likely, however, that the only counter-claims that could be litigated or settled to the advantage of the claimants would be those where the conduct was especially egregious, relatively recent, where the damage can be quantified and where a clear line of causation can be proven between the act of the perpetrator and the damage to the victim. Counter-claims are more likely to be relevant as moral claims that support political advocacy. They provide evidence that global economic inequality has its roots in a legacy of imperial power, force, fraud and collusion between rapacious elites in the North and South, and not only luck and good choices on the part of the better-off States. Counter-claims therefore serve as strong political justification for the elimination of debts for the poorest countries.

³ For more information the issues addressed in section 4.2 and 4.3, see Joseph Hanlon, *Defining Illegitimate Debt* (Oslo: Norwegian Church Aid, 2002).