The Due Diligence Model: A New Approach to the Problem of Odious Debts

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Odious debt is sovereign debt incurred by a government lacking popular consent, utilized for no legitimate public purpose. This specific subset of sovereign debt is separate from such issues as unsustainable debts incurred by democratic or quasi-democratic developing countries, or debts incurred by nondemocratic regimes for legitimate public ends. This paper is concerned with the narrow problem of money borrowed by dictators from foreign creditors that is then either spent on illegitimate ends, such as repressing the country's population, or simply looted and deposited into the private offshore bank accounts of the ruling class. Many legal scholars advocate that international law grants successor regimes permission to repudiate inherited debts meeting the odious debt standard. Whether international law theoretically does or does not provide for such a remedy, however, the fact remains that for practical purposes successor governments to illegitimate regimes do not invoke the odious debt doctrine, out of fear that doing so would deprive them of necessary access to global credit markets.

Odious debt is a moral issue, as it is manifestly unfair to demand that a population repay what are basically the personal debts of its former captors—loans that were in many cases used to actually fund the machinery of public repression. But beyond purely ethical considerations, there are significant prudential reasons for the international community to reform the treatment of odious debts. Successor governments to fallen dictatorial regimes are often placed in the position of rebuilding a shattered nation with scarce resources. This scarcity is severely compounded when the meager resources of a successor government are diverted toward servicing the odious debts of the prior regime rather than invested in constructing a secure and sustainable platform for national development.

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This is a problem of economic development, but it is also a problem of national security. Failed states are increasingly recognized as posing significant threats to the security of the global community through such vectors as destabilizing broad neighboring regions, hosting potentially hostile nonstate actors, and providing breeding grounds for infectious diseases outside the reach of coordinated medical intervention. It is in the security interest of the global community to forestall state failure where possible and to facilitate the rebuilding of failed states in an expedient manner. A properly designed policy on odious debts can help to prevent state failure by limiting the spoils available to a potential autocrat from looting the state—thus hopefully discouraging some would-be state destabilizers at the margin—and it can also free resources for the use of postauthoritarian governments. These additional resources might in some cases make the difference between sustainable democratic redevelopment or a relapse into chaotic autocratic state failure.

Most supporters of reforms in the area of odious debt believe that such debt should be challenged in courts and other judicial-style fora. While this would likely be preferable to the status quo, there are several reasons why another type of reform model would yield superior results. The determination of whether a certain regime does or does not enjoy popular consent for its actions is at least as much a political issue as a legal one, and thus the judiciary may be an inappropriate venue for implementing an odious debt policy. Second, it is critical to secure as much ex ante certainty for potential creditors to sovereign governments as possible; that is, creditors should be highly confident in the legal enforceability of their rights before loans are made. The importance of global capital flows to developing countries in today's globalized financial environment is significant, and any policy that curtailed legitimate lending to sovereigns due to unnecessary ex ante uncertainty might cause more harm than good.

As an alternative to the traditional reform program, which will be referred to as the Classical Model, this paper proposes a Due Diligence Model for the resolution of odious debts.[1] The Due Diligence Model requires that a country be officially declared "odious debt–prone" in order for debts to potentially fall within the scope of invalidity, and, crucially, only debts incurred after the declaration would be eligible.[2] This safeguard, and the anticipated rarity with which countries would be placed on such a list, ensures that the vast bulk of sovereign lending to developing countries would be securely outside the scope of any potential interference. Under the Due Diligence Model, lenders to countries declared

odious debt–prone would be required to cite the specific legitimate ends that the funds are intended for and the due diligence monitoring plan that the lender intends to implement to ensure that the funds go toward these stated uses. A loan would only be invalidated if the funds were diverted toward illegitimate ends and the lender failed to make a good faith effort to comply with its own preapproved due diligence plan. This policy structure is a promising way not only to achieve most of the objectives of odious debt reform in a manner which should be largely acceptable to creditor countries, global financial intermediaries, and sovereign debt investors.

REASONS TO RETHINK THE STATUS QUO

Can it truly be fair to demand responsibility of a population for debts that were incurred not only against its will but were in many cases used to fund the mechanisms of its prior torment? Debt incurred by a governing regime for personal benefit or nefarious purpose should be considered the private debt of the illegitimate regime and the country's citizens should not be held responsible for its repayment.[3] Individuals do not have to repay money that others fraudulently borrow in their names, in the same way that a corporation is not liable for contracts that the chief executive officer enters into without the authority to bind the firm. Basic logic and justice demand that a corresponding rule exist for sovereign borrowing. While this moral argument is a strong and sufficient case for reform on its own, there are additional rationales for a new policy approach toward odious debts that are directly rooted in the national interests of the developed world powers.

The Economic Rationale for Reform

A precondition to the proper functioning of financial markets is a stable body of legal rules governing the full investment cycle from initial due diligence through liquidation. Without a known and transparent playing field of legal governance, the risk premium for making any investment is too high to qualify as anything but speculative gambling.

In the aftermath of the 2003 invasion of Iraq, there were widespread calls across the political spectrum to eliminate what commentators openly declared Iraq's "odious debts."[4] For example, House Resolution 2482, introduced but not passed by the 108th Congress, with twenty-eight cosponsors from both the Republican and Democratic parties, called for the cancellation of loans made to Iraq by the multinational financial organizations. The bill argued for the

necessity of canceling debts incurred by dictators not only on grounds that such debts impede a successful rebuilding of post-authoritarian states, but also because those debts were never legitimate inheritances of the new government due to the doctrine of odious debts.

House Resolution 2482 should serve as a warning call to the international financial community that the status quo of traditional sovereign lending law could be radically reformed by legislative action with possible retroactive impact. While the resolution failed to pass, its existence with nontrivial bipartisan support should alert lenders that the prospect of future legislative reforms in this area are far from negligible. It is therefore in the interest of the international financial community to embrace the issue head-on and work to develop a fair body of prospective rules governing sovereign lending that address the issues raised by odious debt and cause minimal disruption of beneficial lending to developing nations. Purely prospective rules will not solve the problem of existing debts, but they will establish a stable framework to assure present investors in new loans that there is not a contingent danger to their capital in the form of future retroactive legislative actions.

Financial intermediaries and investors should consider that eventual odious debt reform is sufficiently likely and that any small loss of profits from a slightly curtailed scope of lending activities would be more than offset by the decreased risk that future reforms with possible retroactive effect could place a broader swath of investments made today in jeopardy. By way of analogy, in the past several years, increasing numbers of companies in the energy industry have recognized the economic merits of coming to a regulatory solution to the problem of carbon emissions sooner rather than later. The energy sector is highly capital-intensive and projects can have multi-decade timelines. These firms realize that eventual carbon emission regulation is a sufficiently likely scenario and that it is better for them if these rules are established now, when they can be incorporated into prospective planning. The benefits from delaying any regulation are outweighed by the potentially catastrophic financial impact if tomorrow's regulations eviscerate the value of large investments made today. Forward-looking capital market participants should take a similar attitude toward odious debt reforms.

The National Security Rationale for Reform

National security is rarely cited as a motivating factor behind campaigns to reform existing policies on odious debts. Yet changes in Western strategic doctrine

in the post–Cold War era offer an opportunity for traditional civil society advocates of odious debt reform to forge an alliance with the national security community. This shift in doctrine concerns a renewed focus on failed states as a source of national security threats to the developed world.

In truth, the concept of a linkage between state failure and national security did not suddenly materialize on September 11, 2001; failed states were identified by the Clinton administration as a significant threat to U.S. interests.[5] Domestic opposition to U.S. military casualties stemming from failed state interventions, however, and a lack of bipartisan support for what was viewed in some quarters as "global social work" rather than defense policy, limited the consistent application of failed state doctrine as a core pillar of U.S. national security policy. But following September 11, 2001, the threats failed states pose to national security have been widely recognized and well documented. Indeed, the dominant security concern of the West with Iraq today is how state failure can be forestalled given the catastrophic waves of regional destabilization that event would trigger.

This strategic concern with the causes and consequences of state failure has several connections to odious debt. First, the ability of autocrats to loot the proceeds of foreign borrowing provides an incentive to seize power in the first place.[6] If we are able to design new institutions that dissuade creditors from making such loans, we can reduce the incentives for potential autocrats to destabilize fragile regimes.

Second, by limiting the enforceability of odious debts in postauthoritarian environments, we can bolster the chances that emerging representative governments will sustain the path toward stable governance. For example, a Congressional Budget Office study released in January 2004 noted that servicing a reasonable estimate of outstanding Iraqi debt would "leave no funds in the Iraqi budget for capital investment and produce substantial shortfalls in the government's ability to meet its day-to-day operating expenses."[7] This is hardly a fiscal position conducive to rebuilding a conflict-torn country and establishing the popular credibility of a new government as an effective provider of basic state services. As the rebuilding of failed states has come to absorb a tremendous proportion of available Western defense resources, severely straining the strategic flexibility of the military, proposals that would assist in the rapid reconstruction of failed states are likely to gain a receptive ear in the national security community.

FROM THEORY TO PRACTICE

This section outlines a new policy approach to the problem of odious debts. Whether there is already a right for debtor countries to repudiate odious debts under an existing doctrine founded in customary international law or established principles of common law is not discussed. Rather, the focus is on what an optimal doctrine of odious debts ought to look like were it brought into force by a positive act. Accordingly, while this proposal envisions reforms with solely prospective application to debts incurred subsequent to enactment of the new policy, the present-day rights and obligations of creditors and debtors regarding preexisting debts are in no way impacted. This prospective focus is guided by several factors. First, as a matter of justice, rules with retrospective application to situations in which parties acted within what they believed was a settled legal framework should only be enacted in the most severe circumstances. Second, as a practical matter, it will be far easier to gain "buy in" from key governments and interest groups, such as the financial community, with a solely prospective proposal. By separating the issue of debts made prior to and following the enactment of reforms, the chances of reaching a solution to the latter is dramatically increased without much impact on the chances for resolving the former.

Principles of Design

This proposal will charge an international institution, either already in existence or created de novo, with implementation of the new odious debt doctrine. This institution will have two primary responsibilities: first, declaring ex ante which countries are odious debt–prone, and second, regulating new loans to those states.

There are three general principles that should guide our selection or design of that institution. First, care must be exercised to develop arrangements that strike an appropriate balance between realizing the benefits of a more logical approach toward the resolution of odious debts and the corresponding potential for a chilling impact on legitimate sovereign borrowing. Extreme diligence must be devoted to ensuring that the new incentive structure does not discourage beneficial capital flows to the developing world. Any new odious debt policy will be sharply circumscribed in the frequency of its application. Global capital flows to the developing world, on the other hand, can be a force for the alleviation of poverty faced by billions of men and women. In light of this imbalance, new policies

must pass a test that any impairments of beneficial capital flows to the developing world are minimal to nonexistent.

Second, new arrangements should be informed by a practical view toward their implementation by global financial institutions. This is in part a corollary of the first guiding principle, as arrangements that place unworkable implementation burdens on financial institutions will raise the costs of sovereign lending beyond a point where even wholly legitimate loans can earn a sufficient rate of return. It is also realistic to say that the chances for a new policy toward odious debts to make the leap from theory paper to implementation are much greater if the opposition of powerful interest groups, such as the financial services industry, is not needlessly provoked. The primary interests of lenders are in clear ex ante rules of the road and the potential costs of compliance. If lenders can be assured that a new policy both makes clear what they must do to ensure that their loans are granted legitimate status and demonstrates that the costs of that process are not so burdensome as to unreasonably impact the return on capital earned in sovereign lending, then resistance to the reforms should be relatively muted.

The third major principle to consider is the matter of bias. Recall that declaring a debt odious requires that the borrower regime lack public consent for its actions and that the loans be utilized for nonpublic purposes. No matter how well the conditions necessary to satisfy these categories are defined, as with any other matter of law, application of these rules to specific situations will always call for some degree of discretion—and with discretion comes the possibility of bias.

One possible vector of bias is creditor-debtor bias at the level of the institution charged with overseeing this policy.[8] No legal rule is so precise that the biases of the implementing institution—be it a judicial or political forum—are not highly relevant. In this case, political ideology, external geostrategic and economic relationships, or lobbying by affected interest groups could affect an institutional bias in favor of either creditors or debtors. To mitigate these risks, the institution could be empowered to invalidate sovereign loans only if the borrowing regime had been declared odious debt–prone prior to the loan's issuance. This will substantially increase ex ante certainty for lenders.

Another possible vector of bias is regime bias. This leads from the rather cynical yet factual observation that questionable regimes often have many more friends while in power than after they have been deposed. This is simply the fact

of a world ultimately governed by realpolitik.[9] While some ability for the major powers to exert a level of protection for certain regimes on the basis of economic or geopolitical interest may be an inevitable if distasteful cost of building sufficient support to enact policy reforms, one should aim to design a system that at least mitigates the most egregious abuses of this discretion. Similarly, our institution should establish checks and balances to prevent this tool from being invoked against disfavored nations for purely political reasons.

Critique of the Classical Model

Whether or not there presently exists a right to repudiate the enforcement of odious debt under international law is a subject well debated by other scholars. If such a right does exist, then it takes the form described, for example, by Jeffrey King in a recent essay.[10] The legal structure described by King is referred to in this essay as the Classical Model. Under King's formulation, odious debts are debts contracted with an absence of consent, an absence of benefit, and subjective creditor awareness of the above two conditions. It is presumed that claims under the Classical Model would be pursued in some form of judicial venue.

There is a serious, if ultimately unpersuasive, argument that the Classical Model states what the law is. But serious problems with the Classical Model approach make it difficult to accept that it is what the law ought to be. First, the Classical Model contemplates that judicial institutions would be empowered to make the determination that a population did not consent to the debt transaction in question. In cases where the basis for this claim is that the debtor regime lacked sufficient institutional capacity to ensure that the proceeds of loans entered into by elected officials were not excessively squandered via corruption, a judicial forum might be able to evaluate the appropriate evidence and rule accordingly. In cases, however, where the claim rests upon allegations that the debtor regime's structure of government was insufficiently democratic to form a basis for popular consent to government policies, then the capacity of a judicial forum is far more questionable. There are simply no legal definitions of democracy with sufficient clarity for a judicial forum to consistently make predictable and solidly grounded rulings.

Consider some of the difficulties posed by contemporary political structures: Iran holds popular elections, but candidates for office are strictly screened by unelected religious authorities who circumscribe the scope of the elected officials' powers. The United States holds elections, but the authority of elected officials is limited by lifetime-appointed judges whose decisions in some areas can only be

overridden by a process (constitutional amendment) so difficult and rare as to render it almost impossible. Certainly one of these models seems more democratic than the other, but explaining why evades categorical, rule-based legal classification. One is reminded of the words of Justice Potter Stewart, who in a Supreme Court decision on pornography famously declared of the movie in question, "I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description [of pornography]; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that."[11] Unfortunately, the "I know it when I see it" standard of judicial review is hardly the ideal basis for a system with sufficient ex ante clarity to prevent excessive interference with legitimate sovereign lending.

King defines four types of regimes—democratic, quasi-democratic, quasi-dictatorial, and dictatorial. Where the debtor is dictatorial or quasi-dictatorial, we may presume that a given loan is not beneficial to the population. A quasi-dictatorial regime is a government that operates primarily without the consent of the population, but which may have a strictly limited franchise or highly limited forms of public representation. A quasi-democratic regime is defined as a government that is generally representative and accountable under regular elections, but which may have a poorly informed electorate, monopolistic party system, limited franchise, or substantially unrepresented minorities. With due respect to King, who at least tries to tackle head-on a question that most proponents of the Classical Model evade, these classifications remain too broad for clear application to the manifold political-institutional structures of the world's nations.

King is certainly right to interpose the categories of quasi-democratic and quasi-dictatorial between a simple binary classification of democracy and dictatorship. While a regime wholly unaccountable to elections is de facto lacking in public consent, elections alone without other aspects of institutional support for popular accountability are an insufficient sole proxy for public consent. But the form and legitimacy of every state's political institutions is so rooted in a nation's unique social, historical, economic, and religious path that it may be impossible to develop clear, predictable rules with universal applicability.

It is well possible that thinkers with more legal ingenuity than myself are capable of developing clear and precise rules to sort national governments into these categories. Yet, until someone does so, I must conclude that—as Stewart said of the effort to define pornography—defining democracy and dictatorship with

adequate legal clarity may be "trying to define what may be indefinable."[12] Some might argue that judicial forums have long been charged with the task of applying vague and general rules to specific situations, but this doesn't quite work in the context of international adjudication, where there is insufficient customary practice or other sources of authoritative reference to guide courts in their determination on the matter.

This indeterminacy would leave lenders floundering as to which of their loans are at risk of subsequent odious classification. In the absence of clarity, lenders will pursue one of two options: either they will withdraw from all lending that might possibly fall within the classification of odious debt, with a very wide margin of error, or they will substantially increase interest rates on sovereign lending to compensate for the risk of uncertainty. Either path will result in the significant curtailment of legitimate capital flows to developing nations. Given the importance of those capital flows for global economic development, the cure for odious debt might be more painful than the disease. In light of an anticipated tightening of sovereign credit, one would also expect an absence of widespread support for implementing the odious debt agenda among the developing countries of the world.

Finally, under the Classical Model, lenders must have subjective awareness that their loans lack either consent or benefit. King understands this definition to encompass actual knowledge, willfully shutting one's eyes to the obvious, and willfully and recklessly failing to make such inquiries as an honest and reasonable person would make.[13] This standard is too lenient on determining whether a creditor has awareness that a loan will not benefit the debtor nation's population. Where a creditor has awareness that a regime is odious debt–prone, it should be required of the creditor to perform a higher level of due diligence. It is simply too easy to disguise fraud with sufficient camouflage to evade a willful and reckless standard of due diligence.

THE DUE DILIGENCE MODEL OF ODIOUS DEBT RESOLUTION

In this section, the Due Diligence Model is advanced as an alternative policy approach that hopefully rectifies many of the shortcomings in the Classical Model. The basic contours of the Due Diligence Model are as follows: An international organization will have the power to declare that specified regimes are prone to odious debt. If, and only if, a regime has been so designated in advance, creditors

to that government must employ reasonable best practices of due diligence to ensure that the proceeds of subsequent lending will be utilized for prespecified public purposes.

Determining Proneness to Odious Debt

This model proposes that an international organization should be enlisted or designed to declare ex ante that a specific government is odious debt–prone—which is to say that the targeted government is either unwilling or unable to provide for a reasonable modicum of public consent to its policies and where the likelihood that levels of sovereign borrowing material to the nation's economy will be used for illegitimate purposes crosses an unacceptable threshold. While the organization would be required to justify its decision on the basis of international law, it is envisioned that diplomatic political appointees from member states to the organization will make this decision.

This decision-making structure resolves several issues with the Classical Model. While the organization would justify its decision according to international legal standards, this model recognizes that the decision to declare a nation odious debt–prone will be, in part, a political decision. It is highly unlikely that any odious debt proposal without this safeguard would ever make the transition to reality. There are nations whose credentials on grounds of popular consent are tenuous at best, but where their economic or geopolitical importance is so massive that any proposal threatening capital flows or diplomatic relations with them as a matter of automatic application without political safeguards would be a nonstarter. While this level of discretionary application is not ideal from the perspective of a pure legal construct, in this imperfect world an actually implemented system alleviating the suffering of the citizenry in most odious debt–prone nations is superior to a theoretically perfect system never put into place due to insurmountable political resistance. This system also resolves a key flaw with the Classical Model, the indeterminacy of trying to classify governments as democratic or dictatorial by strictly formal legal logic. In such a condition of formal legal indeterminacy, a political organization is far better positioned to make legitimate decisions than a judicial forum.

The ex ante structure of the Due Diligence Model also minimizes the impact of the policy on legitimate sovereign lending. Only loans made to countries that were specifically targeted by the implementing organization prior to the loan's issuance would be at risk for possible invalidation. Since designating a nation as

odious debt–prone would be a rare event, reserved for the most egregious violators of legitimacy standards, the vast bulk of sovereign lending would be unaffected by the policy and, accordingly, lenders will require no additional risk premium for sovereign loans to nondesignated regimes.

There is a question of whether lenders might demand an additional risk premium for loans to nondesignated regimes if they feared that subsequent designation would trigger a liquidity crisis in the debtor country. The policy should therefore permit the refinancing of predesignation loans as a legitimate transaction for odious debt–prone governments.[14] Also, the risk premium for loans to nondesignated regimes should be lower under this proposal than under the current status quo, as today there exists some possibility that a court might find that the classical doctrine of odious debts exists under international law, whereas the due diligence proposal makes clear that loans to nondesignated regimes are entirely safe from the odious debt standard.

Reasonable Best Practices of Due Diligence

Under the Due Diligence Model, the designation of a government as odious debt–prone does not bar lenders from extending credit to it. Rather, lenders are placed on notice that, in order to guarantee that their loans will be enforceable in the event of regime change, they must utilize reasonable best practices of due diligence to ensure that the borrowed funds will only be utilized for prespecified, legitimate purposes.[15] Due diligence refers to the structures utilized by the lender for ongoing monitoring over the life of the loan to ensure that the loan proceeds are being used for their stated purposes. It is not enough to simply perform due diligence at the time the loan is originated; rather, it is necessary that structures of continuous monitoring are put in place to limit opportunities for funds to be diverted from legitimate purposes via corruption or intentional fraud.

How would lenders comply with such a standard? The term "best practices" makes this a ratcheting standard that evolves over time as innovative techniques of auditing technologies and deal structuring are developed. But this requirement is modified by a secondary rule of reasonableness. Factors that would weigh upon whether a given plan of due diligence is reasonable in a specific situation should include the cost of compliance relative to the importance of the public purpose underlying the loan, the degree of corruption in the debtor government, and the potential harm that the debtor could cause through illicit diversion of the funds (for example, a government engaged in a war of aggression

not supported by its citizens could purchase additional weapons). Mechanisms of implementation might include the employment of certified outside auditors, escrow accounts, offshore special-purpose vehicles, or numerous other deal-structuring technologies to lower the risk of illicit funds diversion.

To ensure that lenders have sufficient ex ante certainty that their loans comply with the requisite level of due diligence for the circumstances, the international organization implementing the agreement should establish a mechanism to issue "no action" letters. No action letters are a device utilized by administrative agencies of the U.S. government to reconcile the broad language of many American regulatory statutes and rules with the need for ex ante certainty in specific situations. For example, the U.S. Securities and Exchange Commission describes a no action letter as "[a letter] in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated."[16] In this system, the implementing organization would establish a system whereby prospective creditors could submit a detailed analysis of their loan proposal, including the intended uses by the debtor government and the due diligence structures to be put into place to monitor the fund flows. If both the use of funds and the due diligence plan are approved, the enforceability of the loan in a regime change situation would be assured so long as the creditor has sufficient evidence that it made a good faith effort to comply with its preapproved due diligence structuring.[17]

There are several advantages of the due diligence standard over the legal standard embedded in the Classical Model. First, ex ante certainty for lenders is increased by the preapproval process for due diligence plans, and an emphasis on monitoring good faith compliance with that plan, rather than, as the Classical Model calls for, trying to ascertain whether a lender had subjective knowledge that their funds were being put to illegitimate purposes. Were the Classical Model brought into force, it is likely that most creditors would cease any lending to odious debt–prone regimes, or they would demand exorbitant rates of interest to compensate them for their risk. The Due Diligence Model, however, establishes a secure channel for creditors to make legitimate loans to odious debt–prone regimes, for even the worst of regimes may from time to time consider the public interest. So long as creditors make good faith efforts at compliance with their preapproved due diligence plans, they are not penalized for outcomes that lie outside of their control. It is true that this places the potential cost of

fraudulent evasion of due diligence structures upon the populations of odious debt–prone regimes rather than creditors, but this is a necessary allocation of burdens to keep lines of credit open to odious debt–prone regimes seeking loans for authorized public purposes.

The problem of the fungibility of funds exists and is a difficult issue. For example, even if loan proceeds are used solely for prespecified legitimate purposes, this may nevertheless free up general state revenues for illegitimate use. Still, the Due Diligence Model would at least improve upon the status quo. Currently, a given government has the capacity to spend its full fiscal resources, composed of internal fiscal resources and available borrowing capacity, on illegitimate purposes. Under this proposal, access to credit would be conditioned on at least some proportion of the government's full fiscal resources going toward legitimate public spending. Thus, the total available fiscal resources that can be devoted to illegitimate ends are reduced. Consider the case of an odious debt–prone government with internal fiscal resources of $100 all devoted toward legitimate purposes, which in the absence of debt reforms would borrow $200 for illegitimate purposes. That government might be able to borrow $200 for approved legitimate purposes, but because money is fungible, this would free the $100 of internal resources previously allocated to legitimate spending for the illegitimate purposes. Still, on a net basis, there is $100 less of illegitimate spending, leaving the population in an improved position. Furthermore, as a practical matter, the supervising organization could require covenants holding the borrower regime to aggregate fiscal expenditure guidelines (for example, no more than a certain percent of the total budget may be applied toward defense) as a requirement for giving approval to any lending. In reality, there are many variables that impact the determination of the risks from fungibility in specific situations, and it makes sense to leave these decisions to be made on a case-by-case basis, which the no action procedure would allow. Of course, in some cases the fungibility problem might be judged too difficult to overcome, and no no action letter would be issued.

Second, the Due Diligence Model will be more effective than the Classical Model in situations where the debtor government is highly corrupt. The "willful and reckless failure to make inquiries" requirement of subjective knowledge for creditors under the Classical Model establishes incentives for lenders to make only the most glancing inquiries into the actual usage of their funds. The trivial level of due diligence required to meet the willful and reckless standard would

almost certainly fail to check anything more than the most brazen cases of corruption, while lenders would be discouraged from going much deeper with their inquiries for fear that they might actually acquire the subjective knowledge that would imperil their lending relationship. Alternatively, the Due Diligence Model will require lenders to take reasonable best practice safeguards proportionate to the known corruption level of the debtor government. This may even have positive spillover effects for the debtor nation. Because the implementing organization may deem that certain debtor governments are so corrupt that any reasonable deal structuring to safeguard the borrowed funds is extremely onerous (an expense that will presumably be factored into the rates charged by the lender), the debtor government may have some incentive to improve its institutions of governance to access lower-cost credit.

Venues for Implementation

There is a range of possible ways that an institution could be established to assess the odious debt–prone nature of regimes, from unilateral implementation to a system inclusive of all the world's countries. From the standpoint of effectiveness, there are two key dimensions to consider: critical mass and legitimacy. Critical mass refers to the aggregate quantity of credit controlled by the country or countries that implement this proposal. Universal adoption of the proposal is not necessary to achieve much of the anticipated benefits from the policy. Consider a world in which countries controlling half the world's credit supply adopted this proposal and half did not. Odious debt–prone regimes would still have full access to credit from the nonparticipating nations of the world. Nonparticipant countries would know, however, that should the odious debt–prone regime collapse, the successor government in that country would have full access to the credit markets of participant countries if it repudiated its predecessor's illegitimate debts. Since access to credit markets is a primary reason why successor regimes do not repudiate odious debts, if the participant countries control a sufficient percentage of the world's credit supply that the successor government could safely meet its financing needs from participant nation creditors, it is most likely that even nonparticipant nations would sharply restrict the supply of potentially odious credit to odious debt–prone regimes.[18]

While it is possible that one entity, such as the United States or the European Union, might have the critical mass to implement this proposal unilaterally, to maximize global perceptions of legitimacy a multilateral implementation may

be preferable. One possible venue for implementation is the United Nations. The UN has the advantage of preeminent global legitimacy and a preexisting institutional architecture. The Security Council currently has the authority to impose trade sanctions, and one can envision the Security Council also being the body that declares regimes odious debt–prone and supervises compliance, assisted by a dedicated bureaucratic staff. It is the UN's universal inclusiveness, however, that raises questions over its suitability as an implementing venue. This is again a consequence of the legal indeterminacy in adjudicating whether a government falls into the category of being odious debt–prone. So long as there is enough indeterminacy that this decision calls for some subjective value judgment, a coordinated odious debt policy is only possible among nations with sufficiently similar worldviews and interests. Gaining such a consensus at the level of the UN, even in the Security Council, could be problematic. Not all of the permanent or rotating Security Council members place equal priority on the goal of democracy promotion. That said, in some important historical cases, such as apartheid-era South Africa or Tudjman-era Croatia, it might well have been possible to gain necessary consensus for action at the Security Council level, so the UN should not be viewed as a wholly impossible implementation venue.[19]

A more practical alternative to the UN might be implementation among the advanced industrial democracies that comprise the G-7 or the OECD (although the implementation need not occur through these bodies themselves). These countries encompass a sufficient quantity of the world's credit pool that the aims of a coordinated odious debt policy would be realized. In addition, while the interests and worldviews of the member countries are clearly not identical, there remains enough of a shared fundamental outlook that implementing an odious debt policy would be more feasible at this level than at the level of the UN. There are precedents for the advanced industrial democracies to coordinate external policies on financial matters without universal inclusiveness of all the world's governments. For example, the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions makes it a crime for citizens of convention signatories to offer, promise, or give a bribe to a foreign public official in order to obtain or retain international business deals.

The actual structure of the organization should be designed with an eye toward minimizing the problem of regime bias. Negative regime bias, whereby some

governments might falsely target a country as odious debt–prone to advance an unrelated diplomatic agenda, would be mitigated through the necessity of gaining some form of supermajority approval from the member countries in order to place a debtor government on the odious debt–prone list. No doubt this would allow certain participant countries leverage to shield their favored strategic allies. As a partial mitigation against this risk of positive regime bias there should be a parallel policy of disclosure along the lines of the Extractive Industries Transparency Initiative (EITI)—a movement to increase the transparency of transactions between governments and extractive industries. The EITI calls for "Regular publication of all material oil, gas and mining payments by companies to governments ('payments') and all material revenues received by governments from oil, gas and mining companies ('revenues') to a wide audience in a publicly accessible, comprehensive and comprehensible manner."[20] Similarly, financial institutions of participant countries could be required to disclose the quantity and nature of their sovereign lending to a publicly accessible repository. Furthermore, it could be required that financial institutions disclose in their financial reports whether they have any subjective knowledge that the proceeds of their lending are being used for illegitimate purposes. Merely shining light on the financial relationships between lenders and sovereign governments might be sufficient to mitigate some of the most extreme situations where positive regime bias protects the debtor government from more formal monitoring.

CONCLUSION

This essay advances a Due Diligence Model of dealing with the problem of odious debts that achieves most of the goals one would seek to accomplish in this area, but does so in a conservative manner that won't impact the vast bulk of global capital flows to the developing world, prove politically infeasible, or unreasonably curtail the legitimate borrowings of even autocratic regimes. The model is structured so that its use will be rare. Curtailing the most abusive cases of odious sovereign borrowing would be a significant achievement and is achievable through a policy that is moderate enough to win broad support for implementation. A more sweeping, universal policy model would likely face much greater obstacles to move from academic discussion to policy adoption.

Much work remains to be done in translating the Due Diligence Model into the basis for actual policy. First, this essay does not discuss differences

among the several types of sovereign lending. Sovereign lending can be bilateral (government to government), multilateral (that is, World Bank), or private sector. The basic model presented in this paper assumes that all types of debt should be treated in the same manner, but this is obviously an assumption that demands further analysis. Second, much work will be necessary to translate the concept of due diligence into real world deal-structuring and auditing guidelines. Finally, advances in financial technology from privatization to credit default swaps raise the question of whether the concept of odious debt must be extended to other types of financial securities and derivatives to be relevant in the twenty-first century.

Odious debt arises as a topic of public debate on occasions when some particularly egregious example of a dictator's borrowing and the consequences of servicing that debt for a successor government are revealed. In the past several years, there was a dramatic upsurge in interest on the topic of odious debts in response to the collapse of Saddam Hussein's regime. It was one of the fortuitous and rare instances where both the Right and Left came together to argue that Saddam's odious debts should not be bequeathed to the newly emerging Iraqi government. Yet, even with all of this attention, while Saddam's debts were mitigated through several rounds of global diplomatic arm-twisting, the broader doctrine of odious debts gained little real traction. One reason for this is that once a dictator has fallen and the impact of his borrowing on the reconstruction of his country is revealed, it is largely too late to help that specific case. For very good reasons, the norm against retroactive application of legal rules, such as changing terms for creditors after loans have been disbursed, is quite strong.

The first question many advocates of odious debt reform face is often, to whom would this apply to right now? While there are certain governments today who might be candidates for odious debt–prone designation, it is also the case that the fiscal position of many developing nations is highly correlated to commodity prices, and with those prices as high as they are today the dependence of many nations on external financing is cyclically low. Yet it is exactly because odious debt is not being incurred on a major scale today that it is the perfect time to put in place prospective mechanisms to forestall the otherwise almost certain tragic consequences of the next turn of the cycle.

NOTES

1 Two important contributions in this literature are Thomas Pogge, "Achieving Democracy," *Ethics & International Affairs* 15, no. 1 (2001), pp. 3–23; and Ashfaq Khalfan, Jeff King, and Bryan Thomas, "Advancing the Odious Debt Doctrine" (Quebec: Centre for International Sustainable Development Law, 2003). See also Anna Gelpern, "What Iraq and Argentina Might Learn From Each Other," *Chicago Journal of International Law* 6, no. 1 (2005), p. 391; Kevin Anderson, "International Law and State Succession: A Solution to the Iraqi Debt Crisis?" *Utah Law Review* 2 (2005), p. 401; and Anupam Chander, "Odious Securitization," special issue, *Emory Law Journal* 53 (2004), p. 923.

2 See Seema Jayachandran and Michael Kremer, "Odious Debt," *American Economic Review*, March 2006.

3 See Lee C. Buccheit, G. Mitu Gulati, and Robert B. Thompson, "The Odious Debts of an Odious Regime: Piercing the Governmental Veil," *Duke Law Journal* (forthcoming).

4 Admittedly without extensive empirical investigation, it is unlikely that there are many other policy initiatives for which Joseph Stiglitz and Oxfam on one side, and the Cato Institute and Heritage Foundation on the other, would unite in advocating. See Joseph Stiglitz, "Odious Rulers, Odious Debts," *Atlantic Monthly* 292, no. 4 (November 2003), pp. 39–45; Patricia Adams, "Iraq's Odious Debts," Policy Analysis 526, Cato Institute, Washington, D.C., September 28, 2004; Nile Gardner and Marc Miles, "Forgive the Iraqi Debt," Executive Memorandum 871, Heritage Foundation, Washington, D.C., April 30, 2003; and Oxfam, "A Fresh Start for Iraq: The Case for Debt Relief," Oxfam Briefing Paper 48, Oxfam International, Washington, D.C., May 2003.

5 White House, "A National Security Strategy for a New Century" (December 1999), p. 2; available at clinton4.nara.gov/media/pdf/nssr-1299.pdf.

6 See Jayachandran and Kremer, supra at note 2.

7 Congressional Budget Office, "Paying for Iraq's Reconstruction," CBO Paper, prepared for the Senate Budget Committee and the House Budget Committee, January 2004, p. 13.

8 See Jayachandran and Kremer, supra at note 2.

9 One need only observe the fact that no matter what was thought of the merits of the Iraqi war, Saddam Hussein's regime had many more international friends prior to his fall than afterward. The same can be said for nearly any fallen authoritarian regime.

10 Jeff King, "The Doctrine of Odious Debt under International Law: Definition, Evidence and Issues Concerning Application," in Ashfaq Khalfan and Jeff King, eds., *Odious Debt Doctrine in International Law and Policy* (New York: Cambridge University Press, forthcoming).

11 *Jacobellis v. Ohio*, 378 U.S. 184 (1964).

12 Ibid.

13 King, "The Doctrine of Odious Debt under International Law."

14 See Jayachandran and Kremer, supra at note 2.

15 In the case of a bond debt rather than bank credit, this monitoring role would be assigned to a servicer.

16 *Procedures Utilized by the Division of Corporation Finance for Rendering Informal Advice*, Securities Act Release No. 6253, 21 S.E.C. Docket 320 n. 2 (October 28, 1980).

17 It is true that determining whether a lender complied with their due diligence plan is to a limited degree an ex post decision, which raises the previously discussed issue of a potential institutional bias against creditors or debtors. Since, however, the scope of the institution's ex post inquiry will be limited to the empirical question of whether a creditor adhered to its set plan of due diligence rather than the more open-ended and subjective Classical Model questions of whether loans were made with proper public consent and for legitimate public purposes, the potential that creditor-debtor biases will significantly affect outcomes in this system is acceptably low.

18 One recent problem for advocates of responsible sovereign lending has been the emergence of lending nations with very different interests and worldviews from the traditional sources of developing world capital. For example, the president of the World Bank recently complained that Chinese banks were flouting social and environmental principles in their developing country lending activities. While China has full rights to make loans as it sees fit, other nations equally have the right to decide if a successor's repudiation of those loans is valid and thus should not be punished by curtailing access to fresh capital. Odious debt reform could give nations who believe in the importance of certain lending standards some leverage against perceived "rogue lenders" and alleviate pressure to engage in a regulatory race to the bottom since a critical mass of nations following such a policy would lower the ex ante risk-adjusted returns to nonparticipating creditors. That said, in cases where rogue lenders are driven more by geopolitical than economic incentives, it is unclear how much actual impact this would have.

19 See Jayachandran and Kremer, supra at note 2.

20 Extractive Industries Transparency Initiative, "EITI Principles and Criteria"; available at eitransparency.myaiweb15.com/principlesandcriteria.htm.

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