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The Concepts of Odious Debt and Illegitimate Debt: How Useful are they in the Framework of International Responsible Lending?

The present debate on types of sovereign debts and the legal quality of claims may be interpreted as re-visiting the past. Before WWII basic legal principles had been observed in the case of Southern Countries (SCs), which present “debt management” has refused to respect. The occasional military intervention, such as in Venezuela 1903, or the Roosevelt Corollary not withstanding, SCs were once treated much better. Mostly, economic mechanisms prevailed before 1945. Generally recognised legal principles were readily observed vis-à-vis SCs. Even debtor protection and debtor rights were generally accepted. After some negotiations and feet-dragging, claims were usually reduced by agreement. Sovereign Southern debtors were treated very differently before the Bretton Woods Institutions (BWIs) became “debt managers”. Without the BWIs and the Paris Club, creditor control and pressure was weaker, due to the dispersion of creditors (bondholders), and the high costs and limited results of military interventions.

But these are certainly not the only reasons. Especially during the 19th century international tribunals held that states were not bound by contracts made by someone without proper authority, so-called *ultra vires* contracts. When Venezuela’s President Páez had his consul improperly enter into contracts that fell within the legislature's authority, claims were rejected. In 1922, Costa Rica refused to honour a contract by her President not approved in the constitutional way by both chambers on the grounds that those who had entered it had acted *ultra vires*. The new government also challenged odious debts entered into between Tinoco and the Royal Bank of Canada. Arbitration was invoked. While seeing Tinoco's government as a legitimate *de facto* government capable of binding the state to international obligations, Chief Justice Taft of the US Supreme Court, the sole arbitrator, held that the Royal Bank of Canada "knew" that the money was to be used for Tinoco's and his brother's personal expenses. Thus, Costa Rica could not be expected to repay (Adams 1991, pp.167ff). If the lender had been able to prove the use of its funds for legitimate government purposes, its claim would have been upheld. Comparing this decision with present debt management, one cannot help noticing stark differences.

Creditors once tolerated massive buy-backs by debtor-SCs, clearly recognising the economic fact that even strongest efforts cannot make unpayable debts paid. Many countries bought back substantial percentages (up to half) of their distressed bonds at secondary market prices. Bolivia in 1886 or Ecuador in 1898 stand out as especially successful. Chile even had special budget entries for buy-backs (Acosta 2001, p.25). Since the 1970s, public creditors abolished essentially equal treatment of SC-debtors.

After 1970 legal considerations lost importance. Sovereign debts were just that: debts, or an entitlement to be repaid fully, including interest, irrespective of circumstances and qualities of lending or fundamental legal principles. Having the task and duty to provide proper frameworks for markets and to uphold the Rule of

Law, Northern governments slowly started to establish the present legal double standard denying basic rights to SCs. Shifting all responsibilities onto sovereign debtors encouraged economically and ethically wrong behaviour. Over the past decades there has been a concerted effort to eliminate any lender responsibility, unduly burdening SC-debtors and eliminating market mechanisms in sovereign lending. By conferring the illusion of protected, riskless lending, the official sector set the course for future crises. OECD-governments have protected debts no decent legal system would allow to exist.

Encouraged by their governments, commercial banks thought that whatever flowed South would eventually flow back with fees and interest. Banks disregarded the most elementary rules of prudent banking and due diligence of lenders. A substantial misallocation of resources resulted, both directly within borrowing countries, and indirectly by preventing otherwise viable investments elsewhere. Commercial banks did not act irrationally, though, because OECD-governments signalled that they would protect them against the market (cf. Raffer & Singer 2001, pp.153, 161f). Not bothering about economic fundamentals was thus explicable, from a business administration point of view even rational. The perceived absence of creditor risk and the absence of liability, both grave market imperfections official creditors brought about, produced the debt debacle. Discrimination against SCs has distorted markets and infringed upon the Rule of Law, causing grave damages to debtors, but also losses to creditors that the mechanisms risk and liability would have prevented. Disdain for the Rule of Law and economic principles has aggravated debt problems, eventually triggering the discussion of insolvency models, and after this stalled, the discussion on concepts such as criminal, illegitimate or odious debts.

Global double standards are clearly illustrated by so-called “socialised” debts. These were not initially commercial debts voluntarily guaranteed by governments whose guarantees were eventually triggered, but debts for which there had never been any government guarantee in the first place, incurred without any government involvement, even while governments declared not to bail out private debtors. Official creditors did not criticise these “retroactive guarantees” of already defaulted private debt “granted” under pressure. Although this *ex post* socialisation made debt management more difficult, official creditors insisted on punctual service of these illegal debts too. One cornerstone of law in any jurisdiction is that obligations assumed under pressure - debts not freely entered into - are null and void. Uniquely in the case of SCs such “claims” were anointed with respectability. Rigging markets and giving patently wrong signals to private creditors, the official sector bears greatest responsibility for the debt debacle.

Public sector failure is the illness, of which various forms of incorrect debts are but symptoms. The issue of hold-out creditors, called “vultures” by NGOs, is just another sad effect of the official sector’s neglecting its very reason to exist: to safeguard the Rule of Law and sound economic principles. All categories of debts now discussed have to be seen before this background. While fighting symptoms makes sense, real change must cure the underlying illness. Unfortunately, the present discussion risks to detract from necessary real change.

Arguing that curing the illness is more important than curing its symptoms, this paper analyses how useful concepts of odious and illegitimate debts are in re-balancing creditor-debtor relations and in solving debt problems. Discussing odious and illegitimate debts is necessary, but would not be needed if Northern governments had complied with their duty to uphold a fair framework not fostering undue and unfounded discrimination of one group of debtors. The private sector remained more pragmatic, early on proposing insolvency-type solutions, as did David Suratgar, and the late Alfred Herrhausen.

Although elaborating concepts such as odiousness or illegitimacy further is helpful and necessary, this paper warns that focusing too strongly on complicated and not yet fully elaborated concepts may be suboptimal. Differentiating debts according to legal principles is in the interest of SCs and the poor, but even more so of *bona fide* creditors. As (il)legitimacy is so widely discussed, this paper wonders why clear and open breaches of statutory duties by IFIs, causing gravest damages to SCs, which are clearly illegal, illegitimate, indefensible, and destroying the very foundations of the Rule of Law and global peace, have not received proper attention. This neglected from of illegality must be addressed, and damage compensation must be awarded to IFI-victims. The main objectives to re-introduce risk and creditor liability in a market from which public creditors eliminated them, as well as meaningful relief can be achieved more quickly, though, by arguing that there is no justification whatsoever for present legal double standards. The paper warns that the present preoccupation with hold-outs, though probably rewarding in a moral sense, risks prolonging debt problems and will in all likelihood turn out to be a blind alley after quite some time and great efforts will have been wasted.

The Definition Conundrum

The lack of workable and useful definitions is most apparent with the very new concept of illegitimate debts. Apparently the first to attempt a definition, Hanlon (2006a, p. 112) points out that the "term 'illegitimate debt' seems almost never to have been used in legislation or court judgments." Unfortunately, the desire to subsume as many varieties of claims to which campaigners object, resulted in an inoperational und thus unuseful array of debts considered illegitimate. Summarising which debts NGOs have declared "illegitimate", Norway's Ministry of Foreign Affairs (2004, p.18, emphasis in orig.) concluded: "The sum of these criteria for 'illegitimacy' is a very finely-meshed net, in fact it is so finely meshed that it appears to catch all debt. If all these criteria are accepted …to advocate cancelling 'illegitimate debt' may easily be seen as a recommendation to *cancel all developing countries' debt*. This can hardly be regarded as either appropriate or desirable." The fact that some NGOs indeed demand the cancallation of all SC-debts supports this conclusion. Such broad defintion of illegitimate is technically useless. Furthermore, attemtps to cancel all debts skirt the main issue: equality of SCs. Declaring some debts unenforcable is perfectly compatible with creditor domination. So is "forgiving" all debts. There is no need to recognise SC-debtors as equals, as one party, just like creditors.

Hanlon's very broad definition reflects the Ministry's problem that "illegitimate" threatens to cover virtually anything. He subsumes odious debts, as well as lending "Where Lender Misbehavior Makes Loans Illegitimate" (Hanlon 2006a, p. 118). His illustrative examples include debts that could be subsumed under odious (lending to oppressive or self-enriching regimes), but also increases in interest rates, and generally loans made illegitimate by illegitimate conditions "even if the purpose of the loan is acceptable and proper" (*ibid.*, p.125), or "loans given where grants would have been more correct". While economists could at least explain "indicated", "correct" remains opaque at best. Unacceptable conditions making a loan illegitimate would be conditions that "ultimately increase the cost of the debt, such as dollar convertibility in Argentina, even if they are accepted by the elected government." (*ibid.*) Thus, his concept of illegitimacy prevails over perfectly democratic decisions taken without any duress. With Hanlon's criteria strictly applied a loan that is not illegitimate is a rare bird indeed, even though he argues more carefully elsewhere (see Hanlon 2006b). If such "all off" solutions are accepted, one implicitly declares SCs unfit for any legal transaction. Southern people and their governments would need guardians; institutions delighted to volunteer already exist.

I advocated a stricter and in my opinion more useful definition subdividing illegitimacy into two categories (Raffer 2007a). Inspired by the once respected principle that SC-debtors are party, just as any other debtors, I proposed to focus on a subset of illegitimate debts, *illegal debts*. These are debts whose existence violates the law, basic legal principles or that are legally null and void: debts incurred in violation of national laws, of international law, such as in breach of IFI-statutes and general universally accepted legal principles, especially debts, whose servicing violates human rights. Winters's (2004) "criminal debts" would also be illegal. These originated from loans IFIs disbursed to corrupt governments, such as Suharto's, knowing that high percentages would routinely disappear. There is no doubt that debts that can only be serviced if human rights are violated, are illegitimate. Socialised debts mentioned above are another example. The principle *ex turpi causa non oritur actio* was turned on its head as regards SC-debts. This must be redressed. Arguably, debts only existing because due insolvency relief removing the debt overhang of any other debtor continues to be denied to SCs should be included as illegal.

Such cases are easy to argue. There is no justification at all for tolerating double standards hurting the poorest of the globe, or what minds more critical than I might call legal apartheid. This stringent point gets lost if and when illegitimacy attempts to cover too many things. Stretching the word's meaning makes it meaningless.

Furthermore, in most if not all jurisdictions debts exist that might be legal by strictly formal standards, yet whose existence or servicing violates socially established norms. Servicing them can thus not be enforced or even expected, unless the debtor is a Southern sovereign. In some European legal systems gambling debts are legally existing (if paid they extinct an obligation and repayment cannot be demanded later) but nevertheless not enforceable (the winner-creditor cannot enforce payment) due to moral considerations reflecting societal disapproval. Considering internet gambling illegal, the US has pressured credit-card companies to reject gaming-related transactions. Violating its WTO obligations regarding internet gambling, it is now re-negotiating its WTO commitments. By contrast official creditors have never singled out claims as unenforceable, morally objectionable or void on comparable grounds until Norway's action regarding her ship exports. This encouraged German NGOs to commission a very thoroughly argued expertise by Reinisch (2008) on the legitimacy of German claims for exports of old warships to Indonesia that were used against the population. He concluded that these debts were odious in the classical sense and that general legal principles would render demands for payment extremely questionable. The British Money Lenders Act of 1900 enabled courts to reopen any money-lending transaction when interest or charges were excessive and the transaction harsh and unconscionable, or otherwise such that courts of equity would give relief. Debtors needed not pay more than what the court thought to be fairly due. The Consumer Credit Act replaced this Act in 1974, making resistance to demands for debt repayment much more difficult but nevertheless protecting borrowers on the grounds of equity. To develop a parallel theory and practice for sovereign debt will need a long time. Not least official creditors seem inclined to do what they can to avoid and hinder globally equitable treatment of debtors. Focusing on illegal debts is thus necessary and advisable.

Less diluted than “illegitimacy”, the term “odious” is imprecise too. Differences what it means exist. Sack defined odiousness so restrictively that it was even considered possible that he might have wanted to ensure “that none of the Tsarist bonds held by Sack’s French hosts could be deemed uncollectible” (Ben-Shahar & Gulati 2007, p.53). Taft’s arbitral decision reflects different criteria. He simply applied the general rules of contract law to Costa Rica, a behaviour then obviously considered normal, though unthinkable nowadays, at least for official creditors. Taft’s reasoning concurs with my concept of illegal debts.

Iraq’s case is highly instructive for two reasons: the US revived its odious debt doctrine, and Iraq showed how quickly the problem of hold-outs, used by the IMF when proposing its SDRM to allege the necessity of amending its statues, can be solved if this is wanted.

Unfortunately, it cannot serve as a precedent. Once the US realised what it had done by reviving its own odious debt doctrine, it back-pedaled vigorously. The damage of giving credibility to the doctrine was done, it could only be limited. All Paris Club creditors claim odiousness not to have been the reason for Iraq's treatment. The word is shunned. The Paris Club decision does not use it. It cannot even be found on its homepage. Not identifying odiousness as the reason for US efforts to achieve debt relief for Iraq a CRS Report for Congress (Weiss 2005, p.6) introduces odious debts as follows:

> "Proponents of a doctrine of 'odious' debt assert that some of Iraq's debt's could potentially be classified as non-legitimate under international law since they were undertaken during the Hussein regime and that international law should be able to expunge these debts. The concept of 'odious' debt does not appear to be well established in international law."

Absolutely at odds with truth, Weiss presents Iraq's case as though no US official had ever even mentioned the O-word. Denying odiousness as the reason poses logical problems the Paris Club is obviously glad to live with: "Under traditional Paris Club guidelines, Iraq's petroleum and gas reserves would render it ineligible for debt relief." (Weiss 2005, p.4)

The problem of defining odiousness has brought about a tendency in recent literature to use national legal principles as the measuring rod for evaluating the legal quality of sovereign debts (e.g. Buchheit, Gulati & Thompson 2006, or Raffer, 2004, 2007b). Presenting the concept of partially odious debts Ben-Shahar & Gulati (2007, p.48) borrow from "a rich private-law tradition to explore the treatment of odious debt as a problem analogous to allocation of liability in private law." Identifying different shades of fault, they argue that liability should be divided and shared according to "blameworthiness". Norway has adopted a highly pro-active role in international efforts to reduce the debt burden of poor countries. She also triggered two expertises on the legal foundation of claims that, unfortunately, did not go beyond the concept of odious debt. Howse (2007, p.10) seconds Buchheit, Gulati & Thompson (2006) and Raffer (2004), recalling "a rich case law in the common law world concerning the limits of contractual freedom, whereby contractual obligations have been found unenforceable or partly enforceable." These limits have "not prevented the growth of sophisticated and well-functioning financial markets."

The IBRD's *Policy Research Working Paper* (Nehru & Thomas 2008) seems set to render the term odious as diluted and thus ineffective as "illegitimacy" already is. The authors (*ibid.*, p.16) subsume definitely not odious debts under "odious": "the literature has spawned several other categories of odious debts, including 'unpayable' debts, 'onerous' debts, 'unsustainable' debts, 'dubious' debts, 'honorific' debts, etc." Apparently for good reason, no citations are provided.

While honorific seems linguistically disconnected from anything that could be odious, the other examples are plainly wrong. "Unpayable" simply refers to the fact that debtors are incapable of paying. This has nothing to do with origins or legal titles of debts. Every day even perfectly legal and legitimate debts become unpayable. Insolvency procedures exist for this contingency. The platform of Jubilee2000-UK demanded unpayable debts to be determined by arbitration in order to cancel them. This became an essential demand of Jubilee. Onerous debts might be legitimate, neither odious nor unsustainable. As unpayable, sustainable or not simply refers to facts.

Criminal debts, too, are described misleadingly. In contrast to Winters (2004, p.1), who defines them as ""distinct from 'odious debt'", Nehru & Thomas (2008, p.17) include them under odious, "defining" them as money "stolen by officials or businessmen, or where the debt is incurred to rescue an economy ravaged by corruption." IBRD-loans, Winters's prime example, are not mentioned at all, nor the fact that the Bank continued lending over decades, knowing that a third – "only 20-25%", as IBRD-employees protested loudly at a Conference at Northwestern University in 1999 – would routinely be embezzled. This is not simply "not being aware", but much more serious than the Royal Bank of Canada's "knowing". Any normal creditor would be legally compelled to stop lending or suffer the consequences. The IBRD increased its profits – one appallingly brutal case of double standards.

Multilateral Claims: Tolerating Illegality, Illegitimacy, and Abuse

In spite of the discussion on illegitimacy and odiousness, and numerous proposals to reform the BWIs, one clear case of perfectly illegal and indefensible debts seems to have largely escaped NGO-attention: grave, routine breaches by IFIs of their own statutes inflicting considerable damages on SC, of which criminal debts is one variety. It is impossible to say why debts originating from obvious, illegitimate, and illegal abuse are practically not discussed. Damage is done to SC-members by open breach of statutory duties and grave negligence (occasionally one would even be tempted to speak of wilfully inflicted damage).

Surreptitiously defending IFIs, Nehru & Thomas (2008, p.22) tackle financial accountability of IFIs, describing it in a virtually unrecognisable way. They identify a "more sophisticated reasoning" to declare "ineffective" debts as "odious", pursuant to which "advisers to governments should be held legally accountable for their advice" and "the liability of the adviser for a failed project should be the non-payment of the loan itself." No sources are quoted. As, to the best of my knowledge, I am the only one propagating anything one could misrepresent in this way, they must apparently refer to Raffer (1993, 2004, 2008).

Not to describe my proposal too correctly, the paper speaks of "making advisers culpable for failure (i.e. considering them to have undertaken an obligation of result", of "making non-payment an outcome of financing a failed project", and of the "moral hazard" caused by encouraging "the reckless use of loans" as others (logically: creditors) would carry the costs. (*ibid.*, p.23)

To put things straight: my idea is applying tort law as intended by the founders of IFIs to multilaterals. Just to quote one of many clear passages explaining it:

> "Naturally, the mere occurrence of damage or errors would not be sufficient to receive compensation. Even the most conscientious and cautious work cannot always avoid negative outcomes. It would have to be shown that the IFI did not act

> with appropriate care or that it failed to observe the professional standards that are applicable to comparable services. As in tort theory, some form of negligence or irresponsible behavior would be necessary. Risks arising from events beyond the parties' control would remain with the client. A conscientiously planned and executed project that goes wrong would not give rise to compensation."

(Raffer 2004, p.73).

Briefly, I have advocated linking decisions and risk, introducing liability, the mechanism to which the success of market economies is based: no "obligation of result", but paying for unlawfully inflicted failure.

If found liable of tortuous or unlawful behaviour, such as violating their statutes, by a neutral court or panel, IFIs "would have to pay damage compensation. Normally, compensation should be paid directly to the injured parties." (*ibid.*) This is most clearly not a "non-payment". If the borrowing member country wins, the obligation to pay damages would exist as well as the country's obligation to repay. In such situations, the law allows and suggests simplifying procedures: instead of X paying 100 to Y and Y paying simultaneously 90 to X in connection with the same contract, the law allows just settling the difference. This is an offset, a clearing process, definitely **not** non-payment of any sorts. Both claims are settled and paid. A simplifying netting transaction is suggested as one possibility: "If the borrowing country itself files complaints, the IFI could simply waive a percentage of the loan to cover damages for which it is responsible."

The moral hazard "argument" is particularly absurd. As my proposal regards multilateral lending, the authors' argument would only hold if IFIs, say, the IBRD, were willingly fuelling the "reckless use of loans", i.e. do what they have done so far – succinctly, if moral hazard prevailed with lenders, such as the IBRD. One may assume this to stop if IFIs would actually lose such loosely lent money. As long as IFIs, not debtor countries decide whether loans are granted, this kind of "moral hazard" is impossible unless IFIs finance it.

In spite of the impression created over years, the tools to keep IFIs financially accountable exist. IFIs are by no means legally exempt from this principle of the Rule of Law. The statutes of Multilateral Development Banks (MDBs) know legal liabilities comparable to private consultants, which are indeed a necessary part of any civilised legal system and any market economy: whoever causes damages by tortious action must pay financial redress. Their statutes are simply not obeyed. Thus, a high rate of IFI-failures renders adjustment programmes necessary administered by IFIs for a fee, just as failed programmes are likely to result in new programmes, as long as unconditional repayment to IFIs is upheld. No protection granted by contract or tort law to anybody else applies to the poorest of the world. Even wilfully and unlawfully inflicted damage does not presently confer any right to compensation. Victims are forced to pay. Multilateral debts accumulate illegitimately and illegally.

At Bretton Woods normal legal redress was seen as a matter of course. Article VII.3 of the IBRD's Articles of Agreement explicitly allows actions against the Bank except by members or persons acting for or deriving claims from members. Years later, IDA's statutes (Article VIII.3) mirrored the IBRD's.

Members are not allowed to sue the IBRD but referred to arbitration, obviously for the same the reason waivers of immunity stipulate courts in OECD jurisdictions for settling disagreements with private creditors: the Bank's founders might well have been concerned about sufficient neutrality of national courts. But they guaranteed full legal relief. Like the IBRD's former *General Conditions* (Section 10.04) its present *General Conditions for Loans* (of 1 July 2005, Section 8.04) stipulate that "Any controversy between the parties to the Loan Agreement or the parties to the Guarantee Agreement, and any claim by any such party against any other such party … not … settled by agreement … shall be submitted to arbitration by an arbitral tribunal".

The IMF differs from MDBs. Art. IX.3 of its Articles of Agreement grants it total immunity "except to the extent that it expressly waives its immunity for the purpose of any proceedings or by the terms of any contract". Obviously, this is explained by the fact that initially the Fund was to help member countries to overcome short-term dollar/gold-parity problems by unconditional short-term drawings (=loans). It would be difficult to perceive any need for legal procedures and redress in the case of an emergency helper unconditionally giving money, except cases such as criminal debts. Probably such eventuality made the IMF's founders insert this waiver to provide for proper legal dispute settlement. When conditionality became enshrined in the IMF's statutes in 1969, the appropriate change regarding immunity was not made for whichever reason, although its founders would doubtlessly have stipulated the possibility of legal redress as with the IBRD if they had approved conditional drawing. Arguably, this was the first step to establish legal double standards globally. Nevertheless, the IMF may not only submit to arbitration or courts, but contractual clauses stipulating this remain expressly allowed. Nothing in its statutes prevents the Fund from applying civilised legal standards. On the contrary, the existence of this waiver may be seen as an encouragement to do so if and when appropriate.

Preferred creditor status is alien to IFI-statutes. It cannot prevent losses of loans, let alone damage compensation. Over decades, IFIs have successfully nurtured the completely unfounded perception that IFI-claims would be entitled to preferential treatment. Contrary to what they assert, the technical concept of preferred creditors does not apply to IFIs. No IFIs, including the IMF, are preferred creditors, as their own homepages document (*v.* Boughton 2001, pp.820f; Raffer 2005a; Articles of Agreement of all IFIs). The founders of all IFIs stipulated an obligation to reduce or subordinate multilateral claims (Raffer 2005a, 2007a), which is no longer explicitly enshrined in the IMF' statutes though. Their founders wanted BWI-claims subordinated to other claims. Their function as international institutions safeguarding public interests explains this subordination.

In contrast to the IMF's, the IBRD's and IDA's statutes clearly subordinate their claims. Article IV.4.c of the IBRD's statutes confers a right onto members suffering "from an acute exchange stringency [=threatening default], so that the service of any loan contracted by that member or guaranteed by it or by one of its agencies cannot be provided in the stipulated manner" to demand relief. Any such member "may apply to the Bank for a relaxation of the conditions of payment. … (ii): The Bank may modify the terms of amortization or extend the life of the loan, or both." Article IV.4.c specifically demands taking both the Bank's and the member's interests into account. No conditions are stipulated for such relief, except the member's urgent need for help.

IDA's Articles of Agreement are somewhat vaguer. Pursuant to Article V.3 ("Modifications of Terms of Financing") IDA may "agree to a relaxation or other modification of the terms on which any of its financing shall have been provided". IDA, too, must take "the financial and economic situation and prospects of the member concerned" into account. Maturities of thirty-five, forty, or even twenty years with ten year grace periods and "no interest charge" (IDA prefers to call its 0.75% interest rate a service charge, apparently in line with Islamic banking principles) leaves little realistic alternatives but outright reductions.

Uniquely vis-à-vis IFIs countries have the right to request debt relief. The IBRD may but need not grant it. While this does not mean that the Bank has to grant relief whenever asked, it certainly constitutes a general obligation to grant relief when and where appropriate, an obligation hardly reconcilable with the purported preferred creditor status and the Bank's behaviour in the past. Other creditors, most clearly the private sector, have no such obligation. The often heard "argument" that relief for multilateral debts cannot be granted or would make development finance inoperable, was not shared by their founders formulating their respective Articles of Agreement. Steadfastly denying debt relief and claiming to be a preferred creditor, the IBRD is definitely at severest odds with its statutory duties and the truth. This has made "debt management” much more difficult, illegally inflicting damages on SCs. It is patently unfair to debtors and private creditors.

Finally, both IBRD and IDA have violated their statutes by programme lending. Article III.4.vii of the Bank’s Articles of Agreement stipulates that loans “shall, except in special circumstances, be for the purpose of specific projects“. Art.V.1(b) of IDA's statutes repeats this restriction literally. Both increased the percentages of "programmes" in violation of their statutes, apparently to increase their influence. During the recent past, the IBRD’s shares of present nonproject lending, now called development policy lending, have clearly been beyond what “except in special circumstances” could be stretched to mean. Over one third of all lending, even 64.5% in 2002, is definitely not the odd-out special circumstance. Originally, the IMF too was not to do any programmes but provide unconditional emergency finance. The BWIs were not meant to engage perceptibly in programme lending. Rightly so, as their record proves.

Fully in line with responsible and good governance, the BWIs’ founders foresaw no preference and stipulated the necessary statutory preconditions for applying tort law and compensation for damages, especially those caused by breaches of statutory duties. Over decades, however, the BWIs have continuously laboured to undo this cornerstone of good governance, creating a perverted incentive system where they benefit financially and institutionally from tortiously, even wilfully done damage. This is the very opposite of sound economic and legal principles, and at severest odds with the market mechanism. As long as this fundamental abnormality is allowed to continue, the IFIs' main governance problems will continue. Unless they are made obey their own statutes and respect the Rule of Law, any reform is meaningless.

The original statutes of all IFIs clearly subordinated multilateral claims. Their founders obviously wanted them to grant relief well before others because of their tasks of fostering development and public interest. Over the years, MDBs have reversed this decision in violation of their own statutes. Refusing to use statutory debt relief mechanisms and obligations, they wrongly assert that this would make development finance inoperational. This is clearly false. Having no SC-clients, the European Bank for Reconstruction and Development (EBRD) writes off losses and submits to arbitration. If properly managed, MDBs can survive financial accountability and market risk. Unlike private creditors statutorily obliged to reduce debts in case of default, MDBs have preferred breaching their statutes by not granting debt relief, both to the detriment of debtor member states and of other creditors forced to accept much larger haircuts than legally necessary. Nevertheless, they have charged their clients the costs of default.

Eventually, things have started moving. In Argentina, an initiative by Moisés Resnick Brenner, the president of the Economic Commission of the Centro Argentino de Ingenieros, demands the IMF to pay damage compensation. At present his proposal is studied by the Secretaría de Finanzas of the Ministerio de Economía.

Bird Hunting Not Problem Solving: The Dead End "Vulture Issue"

Vulture hunting has become a popular pastime. This must be welcome to official creditors because it detracts from the real problem. Criticising these hold-outs, unpleasant as some may be, allows critics to feel moral outrage and the satisfaction of fighting evil. Yet they bark up the wrong tree. Hold-outs use the legal framework governments provide. This fundamental difference between private creditors subject to laws and official creditors making them and obliged to defend decent legal standards must not be obfuscated. A few facts need be recalled:

1) Buying debts at discounts is not at all unique to SC-debts, but common practice. Legally, vultures exercise their rights in a way no different from what happens every day in practically any country. Risk-averse creditors sell claims at a discount. New owners try to get full repayment, with varying success. But insolvent debtors are protected. Human rights and human dignity take unconditional priority. Recognising that full payment to all *bona fide* creditors is or may be impossible, insolvency proceedings automatically stay individual lawsuits to safeguard fairness to anyone affected. Vultures are grounded. Whenever the right of creditors to payments (*pacta sunt servanda*) collides with the principle recognised generally (not only in the case of debts) by all civilised legal systems that fulfilment must not be enforced at the cost of inhuman distress, of violating human rights and human dignity, debtor protection enjoys unconditional priority. Unlike present attempts to make litigators not use their right, this is correct and fair. All creditors are party, can defend their interests, thus influencing the outcome. No one is forced to accept what has been decided without their participation, e.g. by the Paris Club. Some official creditors have occasionally sold their claims to vultures, all have prevented SC-debtors from buying back themselves at secondary market prices. One wonders why they suddenly show great compassion for debtors in litigation.

Just exempting SC-debts after and because of Paris Club decisions would violate constitutional rights in any jurisdiction. Constitutional amendments would be needed in all creditor countries; the UK without a written constitution is a special but not an easier case. This would fundamentally change the foundation of Western legal systems. It is a no-starter. But even if all creditor governments were willing to amend their constitutions, this process would take quite long. Notably the US constitution is technically difficult to change. Citing an officially non-existent "institution", the Paris Club, as justification, is unlikely to make things easier.

2) The Paris Club has violated other creditors' basic rights. These have not even been heard. There is no perceptible legal procedure at all on which duties to reduce claims could be based. Private claims remain perfectly valid and enforceable. This shows clearly when debtors are sued in a Paris Club country: they must pay. The legal problem described above seems to explain why Club-members force debtors to get "comparable treatment" from other creditors: to avoid exerting direct pressure, which would result in lawsuits. Logically, debtors are denied any legal protection against dissenting creditors.

Ten of the 44 cases of litigation listed by IDA & IMF (2007, p. 32; p.105) were filed within HIPCs themselves. Barring miscarriage of justice, creditors are bound to win, although not necessarily the whole amount. Incidentally, eight of these 44 cases were "in arbitration". Litigating creditors – *the* pariah group at the moment – are prepared to accept fair arbitration, unlike official creditors destroying the very foundation of any legal system that one must not be judge in one's own cause.

Official creditors have done anything possible to avoid giving up their present dominating role in debt management.

3) Economically and legally, enforcing “comparable treatment” by governments would in essence be a taking as prohibited by the 5^{th} Amendment of the US Constitution. It would be a case of private property subject to unbridled, uncompensated qualification by government, without just compensation, not to mention the denial of anyone’s most basic right to defend one’s interest. While constitutions differ, this unjustified expropriation would violate any constitution of Paris Club member countries.

4) While this may be morally less gratifying, basing debt cancellations on the fact that debts are unpayable (“odious” only in the IBRD-sense), on the Rule of Law, and equal rights to all debtors globally will not only bring relief sooner but largely in an economically equivalent way. Whether x billions go because of odiousness, illegality by whichever definition, or because they cannot be paid, the result is always x billion less. The point is which way Southern debtors are likely to get meaningful relief more quickly. The arguments that there must not be two different standards between debtors depending on geographical location and that the foundations of the Rule of Law as well as human rights have to be respected whatever the passport of those affected, are absolutely unbeatable. There is no counterargument, and certainly no “counterargument” any politician would dare voice.

All Kinds of Debts and their Economic Effects

Table 1 illustrates the effects of unfounded claims (classified as odious, illegitimate or in whichever way), unpayable debts, and preferred creditors. Let us assume that country A has total debts of 100, but is only able to service a debt stock of 50 (50 is unpayable), and that A actually gets insolvency protection, no doubt a heroic assumption still when it comes to SCs. To simplify we only consider a one-off debt stock reduction.

Table 1: Haircuts of *Bona Fide* Creditors under Different Assumptions

Differentiation of Creditors	*Haircuts of Private Creditors*
None	
No preference, all debts fully recognised	50%
Claims amounting to 40 null & void	16.67%
IFIs exempt	
All other debts fully recognised	83.33%
40 null & void, 40 (IFIs) exempt	50%
IFIs Treated Lawfully	
40 plus 10 of IFI claims null & void	100%
40 plus all IFI claims null & void*	100%

*in this extreme case, debtor country still has the money left that would be needed to service 30

If all debts have to be honoured and no creditor is preferred, the haircut would be 50. With 40 null and void, A’s remaining debt stock is 60, of which 10 still have to go in order to align A’s capacity to pay to debt service due. Economically, this would not matter for A: 50 would go one way or another, although based on very different legal titles. For A’s creditors, though, the results differ strongly. In the former case every creditor would receive half their claims. In the latter case, those whose claims are voided would receive nothing, while recognised creditors would receive 83.33%. As economic facts eventually assert themselves – what cannot be paid goes unpaid - denying debtors the Rule of Law has considerable effects on creditors, both unduly discriminated *bona fide* creditors, and unduly protected ones (cf. Raffer 2005a, 2005b). Official creditors allowing or supporting violations of the Rule of Law cause substantial negative effects for *bona fide* creditors. Treating perfectly legal and legitimate debts like debts lacking such solid foundation inflicts grave injustice. Classifying and differentiating debts may thus be seen as more in the interest of *bona fide* creditors, even though the application of universally recognised legal principles would have avoided substantial damage to debtor countries and their peoples. In an insolvency procedure respecting existing legal principles, private *bona fide* creditors would recover more than under present public creditor domination.

Quite noteworthy distributional effects are exacerbated by IFIs securing themselves privileged treatment as *de facto* preferred creditors, in breach of their own statutes (for details *v*. Raffer 2005a). This undue privilege is especially problematic in the poorest countries where large percentages of sovereign debts are multilateral, and IFIs have influenced economic policies substantially. Official creditors have repeatedly attached conditionalities to debt relief that are not connected to economic necessities and have quite often worsened crises.

The haircut necessary for discriminated creditors to align capacity to pay and debt service would be 83.33% if IFIs were allowed to continue breaking the law. If 40 were voided but no IFI-claims, a stock of 20 of non-IFI-debt would remain, but only 10 could be serviced (servicing capacity 50, IFI-stock 40). Treated "comparably" non-IFIs would lose half their face values, unless they chose to litigate. Under fair and equal treatment, they would only lose 16.67%. If they win, as likely at present, they lose nothing. Considering mathematics and IFI-statutes, even private creditors without "vulture-intentions" may be induced to litigate. Paying insurance against loan losses also remains more costly as long as IFIs remain unduly preferred. Instead of attacking vultures one should attack illegal and illegitimate, self-serving IFI-behaviour and those governments aiding and abetting it. Breaches of law by IFIs have cost the poor much more dearly than any sum recovered by "vultures". Inexplicably, this problem gets practically no attention.

Conclusion

While exploring legal titles of creditors is necessary, welcome, and has "had a dollars and cents effect on recent sovereign debt workout" (Buchheit & Gulati 2008, p.485) one may expect to continue, it must not deflect from the main problem. A new assertiveness of debtors, as shown by Argentina, Nigeria and Ecuador, is a positive change. But one has to redress the real problem, not its symptoms. The discussion of illegitimacy must focus on obviously unjustified double standards, in particular on damages inflicted illegally and illegitimately by IFIs, which make payments obtained by hold-outs pale in comparison. Since elaborating and establishing odiousness or illegitimacy as juridical terms will take time, a quicker solution must be envisaged. This is equal treatment of all debtors irrespective of geographical location and enforcing IFI-statutes. Upholding the Rule of Law is most important for *bona fide* creditors.

Advocating this quick solution does not mean that long term perspectives need be disregarded. Quite on the contrary, once these changes are brought about, it will be easier to work on codifying a legal framework of international financial relations as proposed by Acosta & Ugarteche (2003), and to refine concepts such as odiousness or illegitimacy.

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