Sovereign borrowing without odiousness: legal instruments to substitute the odious debt doctrine in the repudiation of sovereign debt

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Sovereign Borrowing without Odiousness

Legal Instruments to Substitute the Odious Debt Doctrine in the Repudiation of Sovereign Debt

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Abstract

Where sovereign debt was found unjustified, occasionally attempts were made to declare this debt null and void. In order to facilitate this repudiation of debt in situations that are considered gravely unjust, Alexander Nahum Sack proposed the odious debt doctrine according to which debt is odious for the people of the entire state, when a despotic regime contracts and utilises a loan in ways that are not in the interest of the state or the population, but rather to strengthen itself, to suppress a popular insurrection, etc..[1] The common denominator of all cases in which attempts were made to put the odious debt doctrine into effect is the unconscionable character of the loan agreement and its fulfilment but a successful application of the odious debt doctrine has yet to happen. Even in cases where governments publicly committed the gravest human rights violations, such as Saddam Hussein's regime in Iraq[2] and the South African Apartheid regime, the sovereign debt was not declared odious.[3]

The thesis clarifies why the odious debt doctrine has never been applied in practice and what legal options exist instead to repeal any kind of sovereign debt that is considered unjustified. To this end, the thesis analyses first the circumstances that influence sovereign debt and the deficiencies of Sack's proposal, after which it becomes clear that debt repudiation does not depend on the perceived legitimacy of the government. Therefore, the thesis examines the use of legal principles to repudiate debt, independent of the form of government in the following chapters. Since rule of law principles, human rights law, case law of a variety of jurisdictions, the legal analysis of economic practice and contract law offer sufficient means to legally repudiate sovereign debt where necessary, this thesis suggests that the odious debt doctrine is redundant.

Due to the increased importance of private lending, this thesis focuses on loan contracts between private lenders and ruling powers and their impact on the states' population.

1 A. N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières I. – Dettes Publiques* (Recueil Sirey, Paris 1927), 157 § 26

2 Presidential envoy James A. Baker III pushed for as much as 90 percent of the USD 130 billion debt to be forgiven or rescheduled by several states, in particular China, Russia, France and Germany, according to Esther Pan, 'IRAQ: The Regime's Debt', Backgrounder of the *Council on Foreign Relations* (16 February 2005)

3 ibid

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First Chapter: Introduction

"When Dictators Borrow, Who Repays the Loan?"[4] is the question that the odious debt doctrine seeks to answer. In 1927, Alexander Nahum Sack stated that "(…) if a despotic power incurs a debt not for the needs or in the interest of the State, but to strengthen its despotic regime, to repress its population that fights against it, etc., this debt is odious for the population of the State", and therefore could be repudiated.[5] After Saddam Hussein was overthrown, the New Yorker claimed emotionally "[a]sking the Iraqi people to assume Saddam's debts is rather like telling a man who has been shot in the head that he has to pay for the bullet."[6] The Iraq war rekindled the interest in the odious debt doctrine among economists, journalists, politicians and lawyers alike but members of the international financial establishment warned that if Iraq defaulted on its debts, it could jeopardize its future credit rating and impair its ability to attract foreign direct investment.[7] At the end, Iraq agreed with several states including the Paris Club members on a major debt cancellation in order to give Iraq a better start, but the debt was not declared odious.[8]

The warnings of the international financial establishment seem to have convinced South Africa, however, which still pays the debt of the Apartheid regime which ended in April 1994 with the first South African elections with universal suffrage.[9] In 2018, the South African treasury stated that the Republic of South Africa did not cancel any debt since 1994 and therefore "(…) in essence, (the) government has been refinancing debt – borrowing debt to pay back debt – for the past 23 years."[10] After more than forty years of apartheid, a crime against humanity,[11] South Africa, would have had every justification to make use of the odious debt doctrine which, according to Alexander Nahum Sack could be used to annul debt incurred by despotic regimes.[12] The African National Congress' decision to honour apartheid debt was made in order to demonstrate South Africa's commitment to

4 Michael Kremer and Seema Jayachandran, 'Odious Debt: When Dictators Borrow, Who Repays the Loan?' (Spring 2003) The Brookings Review, Vol. 21, No. 2, 32-35

5 A. N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières I. – Dettes Publiques* (Recueil Sirey, Paris 1927), 157 § 26

6 James Surowieck, 'A Clean Slate for Iraq', *The New Yorker* (New York City 7 April 2003) <https://www.newyorker.com/magazine/2003/04/07/a-clean-slate-for-iraq> accessed 11 October 2022

7 Esther Pan, 'IRAQ: The Regime's Debt', Backgrounder of the *Council on Foreign Relations* (16 February 2005)

8 An 80% reduction of Iraqi debt was granted by the member states of the Paris Club, see http://www.clubdeparis.org/en/traitements/iraq-21-11-2004/en; http://www.clubdeparis.org/en/communications/press-release/debt-relief-on-iraq-21-11-2004; Raphaeli N., 'Western Countries Cancel Iraqi Debt, Gulf Countries Don't', *Probe International* (15 May 2008)

9 South Africa National Assembly, 'Elections Held in 1994' Historical Archive of Parliamentary Election Results <http://archive.ipu.org/parline-e/reports/arc/2291_94.htm> accessed 10 October 2022

10 Statement by South African treasury representatives Alfred Tau and Sinovuyo Mpakama (personal email correspondence 12 April 2018 and 15 August 2018)

11 Article 7 section 1 (j) Rome Statute of the International Criminal Court, A/CONF.183/9 (adopted 17 July 1998 entered into force on 1 July 2002)

12 A. N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières I. – Dettes Publiques* (Recueil Sirey, Paris 1927), 157 § 26

establishing itself as a credible borrower.[13] South Africa is not the only state that recognized old debt despite successful liberation: As former Special Rapporteur to the International Law Commission, Mohammed Bedjaoui states in his Ninth Report on Succession of States in Respect of Matters Other Than Treaties, many freshly independent states agreed to assume debt of their former colonizers in return for recognition.[14]

These two examples show that sovereign debt is shaped by a variety of unpredictable economical and political decisions that borrowers and lenders take in a wide legal and financial environment. But the attempts to apply the odious debt doctrine to Iraq and South Africa also reveal that many believe that the doctrine is to be applied in cases where democracy follows a dictatorship. The odious debt doctrine was never applied in reality, and its definition is not precise. But at least it can be stated that “the essence of an odious debt claim is that it is concerned with the purpose of the loan, and not with the consequences of repaying it.”[15]

This gives raise to the research questions, why the odious debt doctrine was never applied and what can be done to reach the desired result, the repudiation of claims against the state?

This thesis postulates that the structure of the odious debt doctrine hinders its application in practice and that it fails to offer a legal solution for the complex problems arising in the field of political economy which influences sovereign debt in many ways. Yet, national and international law, as well as human rights law allow for a legal debt repudiation where governments have incurred debt that could be considered illegal, no matter if anybody considers the borrowing government a dictatorship or a democracy.

The complex nature of sovereign debt requires an analysis of the various factors influencing the creation of sovereign debt first and as a second step an inquiry into the defects of the odious debt doctrine that prevent its use. After that, this thesis studies cases that could be linked to odiousness before focusing on the state obligation to protect human rights as the actual basis for the repudiation of unjustified sovereign debt, regardless of its creation, be it through contracts or regulatory policies.

13 Statement by South African treasury representatives Alfred Tau and Sinovuyo Mpakama (personal email correspondence 12 April 2018 and 15 August 2018)

14 ibid 79-82; Mohammed Bedjaoui, *Neuvième rapport sur la succession dans les matières autres que les traités*, UN Doc A/CN 4/301 & Add 1, 1977, annuaire de la Commission du droit international

15 Jeff King, *The Doctrine of Odious Debt in International Law – a Restatement* (Cambridge University Press 2016) 28

1. Motives Influencing Sovereign Debt

As mentioned above, the borrower is either motivated by a reduction of debt that was incurred by the preceding ruler, or the new government decides to live up to market expectations in return for a better reputation and therefore pays contentious debt, such as South Africa, who's debt was created to a large degree during the *ius cogens* violation of apartheid.[16]

The lenders' interests, on the other hand, are just as important a factor in influencing the legal approach to sovereign debt: In case the lender pursues not only profit but political leverage it is worth discussing if this use can be in the interest of the citizens at all or if it is rather a hostile act. Tomas G. Paterson describes in his book "Soviet-American Confrontation" the use of credits as a diplomatic weapon in the years after the second world war.[17] At that time, allied nations as well as China, the Soviet Union and the former enemies Germany and Japan were in dire need for financial support in order to start reconstruction and to feed their population. In March 1944 later United States ambassador to the Soviet Union William Averell Harriman wrote: "I am impressed with the consideration that economic assistance is one of the most effective weapons at our disposal to influence European political events in the direction we desire and to avoid the development of a sphere of influence of the Soviet Union over Eastern Europe and the Balkans."[18] Likewise, president Truman endorsed the basic premise that economic power was a valuable weapon in the growing confrontation with the Soviet Union.[19] The United States seemed to have demanded the abortion of British-Soviet trade negotiations in 1947 in return for a credit to Great Britain, as a strengthening of the Soviet sphere was considered a threat to the United States. Together with export controls funnelling goods to Marshall Plan countries, western trade with the Soviet Union plummeted from US$ 358,069,000 in 1946 to US$ 700,000 in 1950. But according to Paterson the United States refrained from an embargo against the Soviet Union at the same time due to its dependence on the Soviet supply of vital metals such as manganese, chromium and platinum. In December 1948 the Soviet Union retaliated by stopping the shipments of such raw materials during the Berlin blockade and began exploiting its European neighbours.[20]

16 International Law Commission, Peremptory norms of general international law (jus cogens), UN Doc A/74/10, Report of the seventy-first Session Chapter V (Geneva 2019) 206

17 Thomas G. Paterson, *Soviet-American Confrontation – Postwar Reconstruction and the Origins of the Cold War* (The Johns Hopkins University Press 1975) 33

18 ibid 36

19 ibid 46

20 ibid 70 - 74

In a comparable fashion, loans were already used by the patricians in ancient Rome as a means of governance. In his book on capitalism in ancient times,[21] Prof. Salvioli explains that loans among patricians were a matter of honour without legal recourse and state enforcement and available at an interest rate of 0%. Unlike that, loans to lower classes were used by patricians as a tool directed against the rural population and plebeians. It was not rare that borrowers had to offer themselves as collateral and at interest rates of up to 100% they were frequently sold into slavery. As Salvioli describes, it was the relentless usury committed by the patricians for the economical exploitation and political suppression which led to the grave social tensions and repeated revolutions in Rome.[22] Based on economist and winner of the Nobel Memorial Prize in Economic Sciences, Joseph Stiglitz, this problem of extreme inequality exists also today because the top 1 percent of society want it that way. Lowering tax rates on capital gains, lax enforcement of anti-trust laws, the manipulation of the financial system enabled by changes in the law paid for by the financial industry itself, regulators that ignore lack of transparency and conflicts of interest: these policies are “of the 1%, by the 1%, for the 1%”. It fits the picture that

> [t]he Supreme Court, in its recent *Citizens United* case, has enshrined the right of corporations to buy government, by removing limitations on campaign spending. (…) Virtually all U.S. senators, and most of the representatives in the House, are members of the top 1 percent when they arrive, are kept in office by money from the top 1 percent, and know that if they serve the top 1 percent well they will be rewarded by the top 1 percent when they leave office.[23]

That university education is used as a profit-making machine, running young Americans into debt for decades with harsh collecting practices and the sole focus on access to school loans has been the subject of wide criticism, such as Matt Taibbi’s “Ripping Off Young America: The College-Loan Scandal”.[24] In his book *Governing by Debt*, sociologist Maurizio Lazzarato goes beyond merely criticising the indebtedness of students. He focuses on the American university as the “ideal realization of the creditor-debtor relationship” and the American student who “embodies the condition of the indebted man”.[25] Lazzarato’s analysis describes a re-organisation of society without democratic decision-making but by governance via debt, instead: “the substitution of social rights for access to credit” – by forcing the student to obtain a loan, the right to education as a claim vis-a-vis the state is turned redundant, similarly home loans replace the right to housing.[26]

21 Joseph Salvioli, *Der Kapitalismus im Altertum: Studien über die römische Wirtschaftsgeschichte* (Verlag von J.H.W. Dietz Nachf. G.m.b.H. 1912) 22

22 ibid 24

23 Joseph E. Stiglitz, ‘Of The 1%, By The 1%, For The 1%’ *Vanity Fair* (New York City, 31 March 2011) <https://www.vanityfair.com/news/2011/05/top-one-percent-201105> accessed 08 October 2022

24 Matt Taibbi, ‘Ripping Off Young America: The College-Loan Scandal’ *Rolling Stone* (New York City, 15 August 2013) <https://www.rollingstone.com/politics/politics-news/ripping-off-young-america-the-college-loan-scandal-186926/> accessed 09 October 2022

25 Maurizio Lazzarato, *Governing by Debt* (Semiotext(e) 2015) 64

26 ibid 66-67

Since even the rich and developed states are equally dependent on the access to credit, sovereign debt is used to influence their decision-making in international fora, too. But where sovereign debt becomes a leverage point for outside and therefore undemocratic influence, governments could be tempted to contest the validity of debt.[27]

2. Dictatorships Reducing Sovereign Debt, Questionable Debt in Democracies – Governmental Impact on Sovereign Debt

Not only motives of international or national politics have an impact on sovereign debt and its validity, also the form of government influences debt, sometimes in a different way than expected. It seems to be settled, for example, that the average dictator plunders the state as much as possible and transfers the ill-gotten gains to a number account in a tax haven. But not every dictatorship automatically incurs debt, let alone that it does it for its own enrichment. Neither the Greek military junta, also called the Regime of the Colonels,[28] nor the Portuguese Estado Novo, Salazar's authoritarian regime,[29] increased the countries' debt-to-gdp ratio.[30] Instead, in both cases public debt was reduced to similar levels as Western Germany's. On the other hand, the world's largest democracy, India, is suffering from corruption to such a great degree that its judiciary barely manages to fight it due to government interventions undermining the judiciary's independence while suppressing the media. This led to un 138 of the 2018 Reporters Without Borders index, after Afghanistan and Myanmar.[31] As of March 2018, the Indian state is liable for at least US $ 48 billion because of state guarantees for non-performing loans as the money disappeared in a variety of fraudulent schemes involving politicians and banks.[32] As a result of the Indian corruption epidemic, money parked by Indians in Swiss banks rose over 50% to Swiss Francs 1.01 billion in 2017 alone.[33] According to Sack's odious debt doctrine, debt could be repealed if the previous government was 'despotic'[34] but his doctrine does not explain when governments are to be considered despotic. Is it enough that the government of a

27 An analysis how borrowing as well as lending countries try to capitalize on sovereign debt, see for example: Central Intelligence Agency – Directorate of Intelligence, 'The Cartagena Group: Politicizing Debt in Latin America', *An Intelligence Assessment* (Langley, VA?, 01 December 1986?, Approved for release April 2022)

28 1967-1974

29 1933-1974

30 IMF online data mapper

31 On 12 January 2018 four judges of the Supreme Court stated publicly that their supervisor, Dipak Misra, preferred the court to deal with cases that were in the interest of the Modi administration: Kolonko G., 'Indien: Die Entlarvung des Heilsbringers', *Heise Telepolis* (Hannover, Germany, 23 January 2018)

32 Gilbert Kolonko, 'Milliarden-Dollar-Bankenschwindel versetzt die indische Politik in Aufregung', *Heise Telepolis* (Hannover, Germany, 31 March 2018); Press Trust of India, 'Court issues public notices for appearance against Nirav Modi, family under fugitive act', *The Economic Times* (Mumbay, India, 11 August 2018)

33 Press Trust of India, 'Money parked by Indians in Swiss banks rose over 50% to ₹7000 crore in 2017', *the Hindu* (Chennai, India, 28 June 2018)

34 A. N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières I. – Dettes Publiques* (Recueil Sirey, Paris 1927), 157 § 26

democratic state such as India contributes to endemic corruption by suppressing the freedom of the media? Patricia Adams describes in her 1991 book "Odious Debts" a wide variety of borrowing that consisted in disadvantageous and hardly legal lending practices that governments and private as well as public lenders were involved in and that lead to the pressing weight of debt that the developing countries suffer from today.[35] If despotism is a constituting factor of odiousness, as Sack seems to claim, then how is debt of this kind supposed to be treated legally? Equally problematic is the legal evaluation of the British Slave Owner Compensation Loan. This loan of 1835 compensated British slave owners for losing their slaves in the course of abolitionism – there was no compensation for slaves or their descendants.[36] The victims of slavery and the British citizens were forced to pay off the loan, the last instalment of which was paid only in 2015. Historian David Olusoga argues that people of the 1830s would not have seen compensation as a matter of national pride but rather as a way to end slavery, "a system that millions of people had come to regard as abhorrent, and a national disgrace." Not only did the abolitionists agonise over the compensation then. Based on the modern-day reactions that he mentions in his article for the Guardian,[37] the British public was not aware of this loan to compensate slave owners for their losses, and it is unlikely the British citizens would have supported it at any time. As reported by Olusoga, "[t]he only people who saw the payment of compensation as a positive were the people who had spent three decades campaigning for it and would be the beneficiaries of it – the slave owners." Apart from the lack of public agreement then and now, the payments were meant as a remedy for the loss of slaves, meaning a remedy because Great Britain ended this *ius cogens* violation[38]. But by paying compensation to slave owners, rather than making them pay for compensation to their victims, the British government supported those who were the perpetrators of the *ius cogens* violation in the first place. Ever since slavery is prohibited as *ius cogens*, however, any act supportive of it constitutes a *ius cogens* violation in itself. Modern day Britain should instead have adhered to its international obligations and refused further payment, instead of acting as an accomplice.[39]

35 Patricia Adams, *Odious Debts – Loose Lending, Corruption, And the Third World's Environmental Legacy* (Earthscan 1991)

36 That compensation was payable under the Slavery Abolition Act 1833, see Naomi Fowler, 'Britain's Slave Owner Compensation Loan, reparations and tax havenry', Tax Justice Network (Bristol, UK 09 June 2020) < https://taxjustice.net/2020/06/09/slavery-compensation-uk-questions/ > accessed 25 March 2022

37 David Olusoga, 'The Treasury's tweet shows slavery is still misunderstood', *The Guardian* (London 12 February 2018) < https://www.theguardian.com/commentisfree/2018/feb/12/treasury-tweet-slavery-compensate-slave-owners > accessed 25 March 2022

38 Slavery is a ius cogens violation, see International Law Commission, *Peremptory norms of general international law (jus cogens)*, UN Doc A/74/10, Report of the seventy-first Session Chapter V (Geneva 2019) 206

39 As for treaties that conflict with a peremptory norm of general international law that emerges subsequent to the conclusion of the treaty, see International Law Commission, Peremptory norms of general international law (jus cogens), UN Doc A/74/10, Report of the seventy-first Session Chapter V (Geneva 2019) 176; if this principle is applied to treaties, it has to be applied to loan contracts as well, since a private contract cannot enjoy a privilege in comparison to a treaty between sovereign states.

In all the above cases, governments as well as lenders were co-operating either in the irregular creation of debt or utilized sovereign debt for other purposes but for the public need, or both, and payments were upheld although the political environment had changed. Under these circumstances, it seems unjustified that the odious debt doctrine would not cover this kind of debt while the doctrine's typical area of application seems to remain limited to despotic governments that are not clearly defined. Therefore, the thesis comes to the conclusion that the perceived legitimacy of governments cannot be relevant for the repudiation of sovereign debt.

3. The Influence of State Succession and Changes of Government on Sovereign Debt

Where the government changed or in cases of state succession, the evaluation of sovereign debt can become just as elusive for the new governments and lenders. Some say, for example, "profligate Argentina couldn't repudiate its debt, because it's a democracy."[40] This not only sounds like a punishment for democratic struggles, it obviously discounts that Argentina used to be a military dictatorship and that it would be necessary, at minimum, to see how much of the dictatorship's debt is still being paid for by the democratic Argentina. But, just like in the case of India, this viewpoint ignores the problems arising from the attempt to determine if a state was already sufficiently democratic to be entitled to invoke the odious debt doctrine, or whether the state should have lost this ability due to its deterioration of its democracy. There is also no guidance as to what to do with entities like Hong Kong or Macao, state associations like the European Union, the states with different variations of governments such as the Holy See, Singapore or the People's Republic China. This one-party socialist republic has been criticised for being insufficiently democratic, yet it "has contributed close to three-quarters of the global reduction in the number of people living in extreme poverty."[41] Since there is no universal definition of a "despotic government", its interpretation depends on the political standpoint. But a single-sided re-evaluation of the legal status of a government could lead to consequences, unforeseen by the odious debt doctrine, for example that the lenders of one nation will lose their claims against another nation, once their government decides that the other is illegitimate.

40 James Surowieck, 'A Clean Slate for Iraq', *The New Yorker* (New York City 7 April 2003)
41 World Bank, 'Lifting 800 Million People Out of Poverty – New Report Looks at Lessons from China's Experience' *World Bank Press Release No: 2022/072/EAP* (Washington, 01 April 2022) <https://www.worldbank.org/en/news/press-release/2022/04/01/lifting-800-million-people-out-of-pverty-new-report-looks-at-lessons-from-china-s-experience> accessed 30 March 2023

4. Construction Problems of the Financial Architecture and their Effect on Sovereign Debt

Regulation, herd behaviour, moral hazard and contract law – a lot of factors can influence sovereign debt. Therefore, it is worth investigating all areas of sovereign debt creation, to clarify if the odious debt doctrine would be applicable at all and in which cases, or if other legal means would be more expedient.

4.1. Regulatory Problems

The odious debt doctrine is not aware of design problems in the financial market itself, yet the rules of the market can increase sovereign debt without the government being aware of it. In general, the market is perceived as a natural and neutral forum for commercial exchange functioning by itself. But the financial market is highly regulated by national law and international agreements, such as the Basel Accords, which are decided upon by the G20 and then adopted in national law. These regulations have a major impact on how the market participants act and therefore poorly designed regulation can cause poor ratings and loan shortages. For instance, rating agencies do not publish detailed information on how their ratings are made.[42] This lack of transparency lead to unjustified triple-A ratings contributing to the financial crisis of 2008.[43] But if there are false AAA ratings, lower ratings can also be incorrect. Wrong evaluation based on an erroneous methodology could result in unjustified low ratings that would increase the prices for loans and therefore that state's debt levels, without the state being responsible for its financial burden, in particular where the rating contains the overall economic situation, not only the state's. This phenomenon could be observed in 2010 when Standard & Poor's downgraded several states such as Greece, Portugal and Ireland, a decision that worsened the European sovereign debt crisis.[44] As the OECD states, the necessary large guarantees for the rescue measures on EU level (from the EFSF/European Stability Mechanism, ESM) increased the credit rating risk for all, meaning also those states that were not affected by the crisis faced poorer ratings. These poorer ratings then lead to higher interest rates which increase sovereign debt without the governments and states being economically responsible.

42 Peter Derleder, Kai-Oliver Knops & Heinz Georg Bamberger eds., 'Deutsches und Europäisches Bank- und Kapitalmarktrecht', *Springer* (Berlin 2017) 712

43 For an example of wrong ratings that lead to massive losses for the public and to court cases, see Editorial 'Crisis in ratings land? The greater-fool defence takes a blow' the Economist (London 10 November 2012) <http://www.economist.com/news/finance-and-economics/21565983-greater-fool-defence-takes-blow-crisis-ratings-land> accessed 25 April 2018; The Federal Court of Australia held Standard & Poor's jointly liable with ABN AMRO for the losses suffered by local councils that had invested in derivatives that were designed to pay a high rate of interest yet were also meant to be very safe. According to the court, S&P blindly adopted inputs provided by ABN AMRO and gave them a AAA rating. This meant Standard & Poor's claimed, "they had about as much chance of going bust as the American government".

44 "(…) the downgrading of the credit rating of a bank or sovereign will exacerbate the situation by requiring new collateral (…) and larger haircuts (…), thereby further increasing the cash pressure (….)." in: Adrian Blundell-Wignall, 'Solving the Financial and Sovereign Debt Crisis in Europe' (January 2012) OECD Journal: Financial Market Trends, Paris 9

Additionally, the proposed Eurobonds would lead to an increased cost and eventually lower ratings for sound countries.[45] In these cases, the market discipline hits also prudent market participants.

4.2. Herd Behaviour

Herd behaviour is an additional problem of financial market design. One can speak of herd behaviour when investors follow other market participants, either since they believe those had superior information or simply because they could justify their investments because also others had done the same. This results in a lending pattern where rapid credit expansion is followed by a cessation of new lending and even a contraction of credit. This reversal can lead to a financial crisis causing sovereign defaults, the defaults of investors, or both.[46] In these cases, a default and poor rating have nothing to do with the state's economic policies or the debt it incurred. Yet, incidents of this kind will increase the debt burden because of the financial market's design problems that demand a poorer rating in this situation.

4.3. Moral Hazard

Even more problems and debt are caused by moral hazard: The savings and loan (S&L) crisis led to the bankruptcy of approximately one third of roughly 3,200 savings and loan associations in the United States between 1986 and 1995. As a result, "prosecutors convicted over 1,000 S&L insiders of felonies" while the S&L debacle led to a loss of USD 150 billion,[47] or every U.S. - American USD 70,000, according to the San Francisco Fed.[48] It took the US economy a decade to recover from the S&L crisis, which is why the G10 decided to investigate the roots of the crisis in order to prevent similar catastrophes in the future. Besides deregulation and imprudent real estate lending, their report "The Resolution of Sovereign Liquidity Crises"[49] points out "moral hazard" as the third major cause for the S&L crisis. The working party for this report, composed of members such as Mario Draghi, Jürgen Stark, Mervyn Allister King and Larry Summers, defines moral hazard as "distorted incentive structures that induce borrowers and/or lenders to engage in risky financial behaviour, or inadequately monitor the risks they assume, in the expectation that they will be insulated from the adverse consequences of their activities by the public authorities." David I. Levine, the executive director of Chase Manhattan gave a

45 ibid 3 Table 1 lines 9 and 3

46 Lex Rieffel, *Restructuring Sovereign Debt* (Brookings Institution Press 2003) 10-11

47 William K. Black, *The Best Way to Rob a Bank is to Own One – How Corporate Executives and Politicians Looted the S&L Industry* (2nd edn, University of Texas Press 2013) 59, 75

48 Regis Barnichon, Christian Matthes, and Alexander Ziegenbein, 'The Financial Crisis at 10: Will We Ever Recover?' FRBSF Economic Letter (San Francisco 13 August 2018) <https://www.frbsf.org/economic-research/publications/economic-letter/2018/august/financial-crisis-at-10-years-will-we-ever-recover/ > accessed 23 May 2019

49 Mario Draghi, 'The Resolution of Sovereign Liquidity Crises', Report for the Group of Ten (hosted by BIS, May 1996) <https://www.bis.org/publ/gten03.pdf> accessed 10 October 2022

practitioner's definition of moral hazard: He assumed that defaults among the developing countries seemed technically inevitable, but unlikely since "[t]he World Bank, IMF and the governments of major industrialized nations (…) would step in rather than watch any default seriously disrupt the entire Euromarkets apparatus with possible secondary damage to their own domestic banking systems, which in many cases are already straining under their own credit problems."[50] In consequence the G 10 report stressed, "that provision of official funds to limit private losses raises serious moral hazard risks and could interfere with market discipline." Market discipline is considered necessary for the stability of the financial system as it imposes prudent economic behaviour on borrowers. Imprudent behaviour which is characterized by taking excessive risk that could endanger markets would lead to lenders either demanding higher risk premiums from borrowers in order to offset the higher risk or not to extend loans to risky borrowers at all in extreme cases. Hence, Mario Draghi and his co-authors recommended: "The official community has several objectives in this respect, including: (…) (iv) discouraging expectations that large-scale official financing packages will be available to meet debt service obligations to the private sector."[51] This means, as long as governments and international financial organisations enforce bail-outs, bail-ins or similar solutions that are to be borne by the public and not by the ones responsible, moral hazard will continue to encourage risky behaviour as well as to fuel unjustified sovereign debt growth.

Moral hazard has been a central factor of the financial crisis of the early 21st century as well during which banks had to be saved with trillions of US dollars, euros and yen.[52] According to Ryszard Kokoszczynski, Chief Economist of the National Bank of Poland, moral hazard has influenced political decisions in the financial crisis, it has not been eliminated to-date and will probably remain at the core of financial crises for the time being.[53]

In the years leading up to September 2008, American authorities ignored the crisis developing in the housing market, and on Wall Street, where bankers were selling millions of junk-quality housing loans on to investors in the form of mortgage-backed securities, reports John Cassidy in the New Yorker.[54] By 2006, this was the case for seven out of every

50 As quoted in: Patricia Adams, *Odious Debts – Loose Lending, Corruption, And the Third World's Environmental Legacy* (Earthscan 1991) 217-218

51 Mario Draghi, 'The Resolution of Sovereign Liquidity Crises', Report for the Group of Ten (hosted by BIS, May 1996) 2 nr. 3 and 5 nr. 5 <https://www.bis.org/publ/gten03.pdf> accessed 10 October 2022

52 For one of the many estimates, see John Cassidy, 'The Real Cost of the 2008 Financial Crisis' *The New Yorker* (New York City 10 September 2018) <https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis> accessed 15 October 2022

53 In his speech at the Center for Social and Economic Research (CASE) 25th Anniversary Conference "The Future of Europe", Warsaw 16 November 2016

54 The following section on the subprime crisis and the euro crisis draws largely on John Cassidy, 'The Real Cost of the 2008 Financial Crisis' *The New Yorker* (New York City 10 September 2018) <https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis> accessed 15 October

ten new mortgages. Close to 30% of these high-risk mortgage-backed U.S. securities were held by foreign investors such as Credit Suisse, Deutsche Bank and HSBC. When the crisis struck, neither these banks nor their central banks held enough U.S. dollars in order pay the dollar-denominated debt. To reduce the disaster, the Fed agreed to give the Bank of England (BoE), the European Central Bank (ECB) and the Swiss National Bank (SNB) access to roughly ten trillion U.S. dollars through currency swaps, as well as giving European private banks access to emergency lending as well as to guarantees close to five trillion dollars in liquidity and loan guarantees, plus a seven-hundred-billion-dollar bailout for domestic banks, turning the U.S. Fed into the global lender of last resort.[55] As economic historian Adam Tooze writes, by extending help to other central banks,

> "[t]he reality, as all those involved understood, was that the Fed was providing preferential access to liquidity not to the "euro area" or "the Swiss economy" as a whole, but to Deutsche Bank and Credit Suisse. Of course, the justification was "systemic risk." The mantra in Washington was: you have to help Wall Street to help Main Street. But the immediate beneficiaries were the banks, their staff, especially their highly-remunerated senior staff and their shareholders."[56]

As the ECB preferred to help private banks instead to supporting its EU-member states, the Baltics, Poland and Hungary had to rely on the IMF.[57] This meant that the ECB protected the relevant private actors from accountability for their poor investment decisions instead of fostering solidarity between the EU's member states. In the Eurozone, bailouts and austerity resulted in the "euro crisis", which hit Greece, Portugal and Ireland particularly hard but also Italy and Spain were seriously affected. Frequently, this crisis is misunderstood as a sovereign debt crisis caused by spendthrift governments "but the real sources of the trouble were underlying faults in the euro system and the creation of too much credit by private-sector banks—the same phenomenon that led to the subprime-debt crisis in the United States."[58] By the end of 2009, for example, Greece had issued nearly three hundred billion worth of bonds, of which more than two hundred billion were foreign owned, that means debt created by foreign banks who treated Greek bonds as if they were backed just as if they were Austrian or German bonds. When Greece became insolvent in 2009, she had to negotiate with her lenders to give up some of their claims. But with the

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55 John Cassidy, 'The Real Cost of the 2008 Financial Crisis' *The New Yorker* (New York City 10 September 2018) <https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis> accessed 15 October 2022

56 Adam Tooze, 'The secret history of the banking crisis' *Prospect* (London 14 July 2017) <https://www.prospectmagazine.co.uk/magazine/the-secret-history-of-the-banking-crisis> accessed 19 October 2022

57 Adam Tooze, 'The secret history of the banking crisis' *Prospect* (London 14 July 2017) <https://www.prospectmagazine.co.uk/magazine/the-secret-history-of-the-banking-crisis> accessed 19 October 2022

58 John Cassidy, 'The Real Cost of the 2008 Financial Crisis' *The New Yorker* (New York City 10 September 2018) <https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis> accessed 15 October 2022

backing of a massive German press campaign depicting the Greeks as lazy tax fraudsters[59], the German and other European governments were hesitant to help Greece and the other states affected most by the crisis. In May 2010, the European Union and the International Monetary Fund (IMF), lent Greece a hundred and ten billion euros, which were used to pay some of the debt that was owned by foreign banks and investors. Since the debt was paid at or near its face value,[60] this constituted a disguised bailout—not for Greece, which merely substituted one form of debt for another, but for the foreign banks that had bought Greek bonds.

This was moral hazard, just as Draghi had defined it in his report to the Group of Ten called 'The Resolution of Sovereign Liquidity Crises'.[61] And the EU had a legal tool to prevent moral hazard from happening: its no-bailout clause. The no-bailout clause in article 125 nr. 1 TFEU states the Union or a member state "shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project." In order not to violate this clause, the institutions have opted for a different approach: To buy claims against distressed states with public money with a financial vehicle called European Stability Mechanism (ESM). Originally, the no-bailout clause was supposed to ensure the budgetary discipline of the member states. Irresponsible behaviour should not be rewarded by transferring the risk of default or debt to other member states, as this could lead to losses for uninvolved states, which the Federal Republic of Germany in particular feared. In its decision *Thomas Pringle v Government of Ireland,*[62] the European Court of Justice (ECJ) decided that the European Stability Mechanism did not violate the no-bailout clause because it was the ESM purchasing bonds and handing out emergency loans, not the European Central Bank (ECB) and because Greece, Portugal and other indebted states remain debtors.[63] The risk must now no longer be borne by the investors who participate in extremely risky and therefore highly profitable transactions, but by states that were not involved in the creation of this debt in the first place. Through the ESM, these states become creditors of highly indebted states and try to secure payment through "memoranda

59 A list of some rabble-rousing propaganda spread by the German press with headlines from tabloid "Bild" to business publication "Handelsblatt" covering claims such as Greeks did not pay taxes and were lazy while recommending poorly planned solutions while contrasting these claims with real figures can be found in Stephan Kaufmann, '«Schummel-Griechen machen unseren Euro kaputt» Beliebte Irrtümer in der Schuldenkrise' *Reihe «luxemburg argumente»* (Berlin, March 2012)

60 John Cassidy, 'The Real Cost of the 2008 Financial Crisis' *The New Yorker* (New York City 10 September 2018) <https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis> accessed 15 October 2022

61 Mario Draghi, 'The Resolution of Sovereign Liquidity Crises', Report for the Group of Ten, hosted by BIS, May 1996 <https://www.bis.org/publ/gten03.pdf> accessed 10 October 2022

62 ECJ Case C-370/12 *Thomas Pringle v Ireland*, judgement of 27 November 2012

63 ECJ Case C-370/12 *Thomas Pringle v Ireland*, judgement of 27 November 2012 139-141

of understanding", imposing austerity. The rescue money, however, does not end up in the target country that should benefit from it. A study shows more than 95 percent of the rescue money for Greece were used to pay for claims and interest, instead of benefiting the country.[64] According to this study, it is “[t]he resulting risk transfer from the private to the public sector and the subsequent risk transfer within the public sector from international organizations such as the ECB and the IMF to European rescue mechanisms such as the ESM [which] still constitute the most important challenge for the goal to achieve a sustainable fiscal situation in Greece.” Market discipline is necessary in order to force states to control their budgetary spending prudently, as pointed out by Draghi, and it constitutes one of the few available tools to prevent moral hazard in finance and politics. But the Troika and the spokespersons in the Eurogroup have so far failed to explain to what extent market discipline should be applied to states and financial investors. Based on art. 125 nr. 1 TFEU one would expect that market discipline should apply equally to all. Even the ECJ, which declares itself a supporter of market discipline,[65] does not explain why its decision subjects EU-Member States to this discipline, while it protects financial investors from market discipline entirely with the Pringle ruling.

“Using taxpayers’ money to bailout greedy and incompetent bankers was intrinsically political. So was quantitative easing, a tactic that other central banks also adopted, following the Fed’s lead. It worked primarily by boosting the price of financial assets that were mostly owned by rich people.” In combination with austerity measures and languishing salaries the bailout strengthened populist movements in the affected economies, leading to a geopolitical crisis by 2017 while not improving the euro system.[66] Despite some reforms, banks are highly indebted and interconnected and a similar crisis would probably make government intervention necessary again, in order to save private lenders. On top of this, mergers that took place during the financial crises further concentrated the finance industry, creating larger banks that were even more too-big-to-fail than before.[67] According to Deborah Lucas of the Massachusetts Institute of Technology, many economists believe that the programmes helped avoid the worst, while many others claim that more institutions should have been allowed to fail. But the main question to be asked about bailouts is whether and when their benefits justify the expenses or if the

64 Jörg Rocholl, Axel Stahmer, ‘Where did the Greek bailout money go?’ *ESMT White Paper No. WP-16-02* (Berlin 2016), the ECB has declined in an email to the thesis-author to comment on prices paid and claims purchased in the asset purchase programme.

65 ECJ Case C-370/12 *Thomas Pringle v Ireland*, judgement of 27 November 2012, 135-136

66 John Cassidy, ‘The Real Cost of the 2008 Financial Crisis’ *The New Yorker* (New York City 10 September 2018) <https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis> accessed 15 October 2022

67 John Cassidy, ‘The Real Cost of the 2008 Financial Crisis’ *The New Yorker* (New York City 10 September 2018) <https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis> accessed 15 October 2022

benefits could have been achieved at a lower cost?[68] Based on her research, Deborah Lucas is supportive of bailouts, in particular, since she claims they were not as expensive as commonly thought. Using fair value methodology, Lucas estimates total expenses of USD 498 billion.[69] She writes about the fair value methodology:

> For a bailout cost measure to be economically meaningful, it has to be evaluated as of a fixed point in time on a market or fair value basis. In most cases, the natural choice is the year the bailout is initiated, for instance, when new legislation is passed or administrative policy changes are announced or implemented, or shortly thereafter. The cost is then the net present value of associated stochastic future cash flows, evaluated using a market or fair value methodology. This is the preferred approach when it is feasible to apply it. It takes into account the full distribution of possible future cash flows to and from the government, time value and the cost of the associated risks.[70]

The market value, on the other hand, is the observed actual value for which an asset or liability is traded on the market. Market value, therefore, reflects the current value of the investment as determined by actual market transactions, and can fluctuate more frequently than fair value.[71] There appears to be no legal obligation to adopt either of the two approaches. In order to figure out which one is to be preferred legally, it is necessary to analyse the task for governments and (inter-)governmental institutions such as central banks or the IMF in times of financial crisis, as well as their legal obligations according to national and international standards.

First of all, the financial market has to be stabilized in such a situation by containing the risk that one or few institutions pose to the rest of the system. Otherwise, the collapse of one institution might lead to the bankruptcy of an unpredictable number of other institutions. If an institution such as a central bank purchases liabilities and assets, as well as guarantees and loans in such a case, the situation will be stabilized since market participants are able to protect themselves from the consequences of holding risky papers at that moment. As the market price is plummeting, institutions might not be able to use their assets for other business, such as collateral for further loans as these assets might not provide for sufficient coverage the next day which could force lenders into default or bankruptcy. Stabilizing the financial system by preventing one lender from collapsing and

68 Deborah Lucas, ‘Now We Know How Much the Financial Crisis Cost’ *Barron’s* (New York City 16 March 2019) <https://www.barrons.com/articles/how-much-the-financial-crisis-cost-51552690751> accessed 17 October 2022

69 Deborah Lucas, ‘Measuring the Cost of Bailouts’ paper prepared for the *Annual Review of Financial Economics* (Cambridge, Massachusetts February 2019) <https://gcfp.mit.edu/wp-content/uploads/2019/02/BailoutsV12.pdf> accessed 17 October 2022

70 Deborah Lucas, ‘Measuring the Cost of Bailouts’ paper prepared for the *Annual Review of Financial Economics* (Cambridge, Massachusetts February 2019) 5 <https://gcfp.mit.edu/wp-content/uploads/2019/02/BailoutsV12.pdf> accessed 17 October 2022

71 James Chen, ‘Fair Value: Its Definition, Formula, and Example’ Investopedia – Dotdash Meredith (Des Moines, Iowa, United States 30 August 2022) <https://www.investopedia.com/terms/f/fairvalue.asp> accessed 17 October 2022

from taking down an unpredictable number of other lenders like dominoes can be achieved by buying the problematic assets.

Secondly, the rescue has to be performed according to household or budgetary principles, like any other economic activity of the government and state entities. German Law, for example, demands that the household be managed with prudence and frugality.[72] Switzerland's budget principles demand that fluctuations in economic growth are to be avoided, while "[r]evenue shall be raised in an efficient and cost-effective manner, funds shall be used sparingly and market processes shall be distorted as little as possible."[73] The European Union's (EU) Financial regulation applicable to the general budget of the Union demands that "[t]he budget shall be established and implemented in accordance with the principles of unity, budgetary accuracy, annuality, equilibrium, unit of account, universality, specification, sound financial management and transparency (...)."[74] According to article 2 (59) of this financial regulation, "sound financial management" means the implementation of the budget in accordance with the principles of economy, efficiency and effectiveness. Also the US budget is supposed to be drawn up by the President in a way that improves the economy and efficiency[75] in the United States Government, it even has a budget ceiling: "Congress reaffirms its commitment that budget outlays of the United States Government for a fiscal year may be not more than the receipts of the Government for that year."[76] According to 31 U.S. Code § 1105 - "Budget contents and submission to Congress", "[t]he President shall include in each budget as supplementary materials, a separate analysis of the budgetary effects (...), including (C) an estimate of the current value of all assets purchased, sold, and guaranteed under the authority provided in the Emergency Economic Stabilization Act of 2008 calculated on a cash basis." A budget calculated on cash basis means that a sale or purchase of an asset is

72 Article 114 of the Grundgesetz - GG (German Basic Law or Constitution) reads: "Der Bundesrechnungshof, dessen Mitglieder richterliche Unabhängigkeit besitzen, prüft die Rechnung sowie die Wirtschaftlichkeit und Ordnungsmäßigkeit der Haushalts- und Wirtschaftsführung des Bundes." which can be translated into "The Federal Court of Audit, whose members have judicial independence, audits the accounts as well as the efficiency and regularity of the budgetary and economic management of the Federation."; § 6 (1) of the Haushaltsgrundsätzegesetz – HGrG (act on budgetary principles for the federal government and federal states) reads: "Bei Aufstellung und Ausführung des Haushaltsplans sind die Grundsätze der Wirtschaftlichkeit und Sparsamkeit zu beachten.", meaning "The principles of economy and thrift shall be observed in the preparation and implementation of the budget."

73 Eidgenössische Finanzverwaltung, 'Finanzleitbild. Ziele, Grundsätze und Instrumente für die Finanzpolitik des Bundesrates' *Swiss Federal Council* (Bern 4 October 1999) 8 <https://www.efv.admin.ch/efv/de/home/themen/finanzpolitik_grundlagen/leitbild_ziele.html> accessed 17 October 2022; the original reads: "Die Einnahmen sind auf effiziente und kostengünstige Weise zu beschaffen, die Mittel sind sparsam zu verwenden, und die Marktprozesse sind so wenig wie möglich zu verzerren."

74 Article 6 'Respect for budgetary principles' in European Commission, 'Financial regulation applicable to the general budget of the Union – July 2018' (Brussels 11 October 2021) 57 <https://op.europa.eu/en/publication-detail/-/publication/25153ebc-2b06-11ec-bd8e-01aa75ed71a1> accessed 17 October 2022

75 31 U.S. Code § 1111 - Improving economy and efficiency <https://www.law.cornell.edu/uscode/text/31/1111> accessed 18 October 2022

76 31 U.S. Code § 1103 - Budget ceiling <https://www.law.cornell.edu/uscode/text/31/1103> accessed 18 October 2022

realized in the budget when the transaction is made. Such a budget uses market value. In the case of the financial crisis, this would be the moment when investors and banks are selling their toxic papers to the state and other institutions in order to rescue themselves. The prices are plummeting in such a situation because most investors are selling at that moment. Therefore, the few remaining market participants can buy cheaply. Just because some buyers are states and their institutions does not mean that the principle of valuation should be changed to their detriment.

Lucas prefers the fair value definition in this context, but this valuation opens the opportunity to manipulate the value of assets or liabilities by taking into account future cash flows as well as other factors, while the market value is the result of price discovery, the free agreement of seller and buyer, which is the basis of the free market. Even the Group of 30, a group of international bank managers and academics, found it problematic that Swedish banks focused on collateral that counted on future value increase. This access to risk management is in line with fair value but too optimistic and therefore a threat to macro-economic stability in times of stress: “Banks are keen to take the cue, often basing lending decisions on the value of the collateral rather than on the payment capacity of the borrower. Sometimes the loans are even structured so that the amortizations and interest payments are derived from expected future increases in house prices.”[77] At the same time, her approach ignores the inflationary effect of Quantitative Easing (QE) which leads to additional expenses for the public due to the loss of purchasing power when large amounts of currency are produced in order for the central bank or another institution to purchase risky assets. In the past years, the M2 money supply of US dollars has increased drastically. From January 2008 to December 2015 M2 grew from 7,505.5 to 12,346.8 billions of dollars, which is an increase of 65.5 percent.[78] This increase will cause inflation and drive up prices, which is the opposite of price stability, which is the core mandate of central banks.[79]

Fair value collides with budgetary laws as it increases the expenses of the state despite budget ceilings and other legal obligations for thrifty government. Market value, on the other hand, is not only more in line with the current economic system, in particular with price discovery, but also corresponds with the budgetary principles that all governments have to adhere to. Market value is therefore the legally preferred method of valuation. This

77 Stefan Ingves, Göran Lind, Masaaki Shirakawa, Jaime Caruana, Guillermo Ortiz Martínez, ‘Lessons Learned from Previous Banking Crises: Sweden, Japan, Spain, and Mexico’ *Group of Thirty Occasional Paper No. 79* (Washington D.C. April 2009) 9

78 FRED Economic Data, *M2 money supply*, St. Louis Fed (27 June 2023)

79 For an overview on the economic importance of price stability and central bank mandates, see Heather Hennerich, ‘Why Stable Prices Are Important’ St. Louis Fed (17 February 2021) and Dieter Gerdesmeier, ‘Price Stability: why is it important for you?’, European Central Bank (April 2009); the primary mandate of the ECB is price stability, Article 127 (1) TFEU: “The primary objective of the European System of Central Banks (hereinafter referred to as ‘ESCB’) shall be to maintain price stability. (...)”

means that rescue measures have to meet budgetary principles at market value and since the budget is traditionally passed as a law, violations of the state's household are illegal.

Thirdly, even if governments and institutions managed to rescue the financial system, it seems that neither Lucas nor parties involved in the rescue mission discussed if the same result could have been achieved at a lower cost. One option would have been price guarantees for the problematic papers. If the state or any other institution would have guaranteed to pay a certain price for the assets in question, the pressure to sell them at any cost and even at a loss into a plummeting market would have reduced since a guarantee would have meant that they could have been sold at a higher price at any time. As not all market participants were in such bad shape as Lehman Brothers, this bank's problems could have likely been isolated from the rest of the financial system cheaply through guarantees rather than by purchases, since not everybody would have needed to rely on these guarantees, while buying time for the markets to cool down. This approach is also supported by the Group of Thirty's conclusion from the financial crisis in Sweden in the early 1990ies: "The general guarantee could be seen as a way to buy time (...)."[80] The resolution of the Swedish financial crisis is regarded by this international think tank comprised of senior figures of central banking, the financial sector, and academia as the blueprint for the resolution of the financial crises of 2008.[81] Also in this case a major factor for the solution is the bad-bank approach in which the bad assets are removed, while everything else – including frequently the management – remains. The problematic assets are sold, either in packages or piecemeal. Sometimes they are transferred to an Asset Management Company (AMC), which has the mandate and special expertise to manage such assets with the aim of recovering their values.[82] Yet, instead of saving the bank itself by shifting toxic papers to a different entity, the other way round would also be possible: instead of a bad bank a good bank could have been created by the bank's home state, to which the assets of the clients would be transferred, while the bad bank remains property of the stockholders who then would be able to deal with the toxic papers or who would have to wind-up the bank. This would offer the chance to remove the management, as far as necessary, and rid the bank of harmful influence of shareholders, both groups who did not fulfil their function properly but who lead the bank into disarray. If this would be

80 Stefan Ingves, Göran Lind, Masaaki Shirakawa, Jaime Caruana, Guillermo Ortiz Martínez, 'Lessons Learned from Previous Banking Crises: Sweden, Japan, Spain, and Mexico' *Group of Thirty Occasional Paper No. 79* (Washington D.C. April 2009) 12

81 Stefan Ingves, Göran Lind, Masaaki Shirakawa, Jaime Caruana, Guillermo Ortiz Martínez, 'Lessons Learned from Previous Banking Crises: Sweden, Japan, Spain, and Mexico' *Group of Thirty Occasional Paper No. 79* (Washington D.C. April 2009) 7-24

82 Stefan Ingves, Göran Lind, Masaaki Shirakawa, Jaime Caruana, Guillermo Ortiz Martínez, 'Lessons Learned from Previous Banking Crises: Sweden, Japan, Spain, and Mexico' *Group of Thirty Occasional Paper No. 79* (Washington D.C. April 2009) 13

combined with asset freezes and price guarantees, sudden contagious domino-effects bankrupting other market participants could be protected. In the meanwhile, the positive assets and the clients of the bank who have no possibility for influence or control over the management or the owners and therefore do not have to be held accountable by market discipline, would be protected.

An additional option to keep public expenditures low would have been an obligatory participation of the managers responsible for the financial crisis instead of letting them keep their salaries, in particular since the Group of Thirty found out that "not having a clue" seems to be just as important as moral hazard in many cases, which makes high salaries for the same people that caused the crisis questionable.[83] Compensation for the damage caused would have been an important public signal as well that would have shown that the right people would have been held accountable. Instead, the public had to foot the bill, although they had no means to control what was going on in the lead-up to or during the crisis. Most importantly, the public was not responsible for the crisis. All the legal safety measures like supervisory boards or governmental supervisory institutions failed, along with the evaluations of rating agencies whose ratings had to be used in order to make investment in certain papers at all.

Apart from these three points, 8.7 million homes were lost to foreclosure alone in the US and many more in the EU. These points show beyond mere sums that rescuing the financial system was too expensive, that the rescue did not meet with the legal requirements of budgetary principles and that it did not hold the people accountable who were ultimately responsible for the crisis.

The Group of Thirty sums up the way how crisis are to be resolved and can be prevented: "Shareholders and management should not be protected. In a market-based economy, shareholders assume risks and gain from successful operations. But if an investment fails, they will suffer. This is no different when the investment is in a bank. Removing unsuccessful owners and managers is also a prerequisite to gaining public support for using taxpayers' money to recapitalize banks."[84] This demand, coming directly from some of the most important people in banking and finance, clarifies that every action which is protecting market participants from the consequences of their actions is moral hazard.

83 Stefan Ingves, Göran Lind, Masaaki Shirakawa, Jaime Caruana, Guillermo Ortiz Martínez, 'Lessons Learned from Previous Banking Crises: Sweden, Japan, Spain, and Mexico' *Group of Thirty Occasional Paper No. 79* (Washington D.C. April 2009) 9

84 Stefan Ingves, Göran Lind, Masaaki Shirakawa, Jaime Caruana, Guillermo Ortiz Martínez, 'Lessons Learned from Previous Banking Crises: Sweden, Japan, Spain, and Mexico' *Group of Thirty Occasional Paper No. 79* (Washington D.C. April 2009) 12

Therefore, it is so important to find out how to use which legal tools for the right allocation of risk, which could ultimately result also in a full or partial repudiation of claims.

The Federal Reserve Bank (Fed) takes the position that banks such as Bear Stearns or AIG where not bailed out, rather the financial system was saved from a panic collapse.[85] The Fed was afraid that payment difficulties of one institution would take down others as well.

> As assets deteriorated, we began to hear a lot about counterparty risk. What if CDS sellers couldn't fulfil their obligation to insure assets against losses? (…) A significant number of troubled firms would trigger systemic risk. Credit default swaps and other financial innovations hadn't been tested under adverse conditions. What's more, they took off at a time when markets and the economy had become more globalized and technology-driven, factors that both made the financial universe more complex and increased uncertainty about how to respond to potentially widespread failures of these new instruments.[86]

According to the Fed, allowing companies to default in this situation would have triggered the first stress test of the fast-growing, interwoven derivatives market, an event that would have undermined the Fed's ability to meet its legal mandates for growth, price stability and financial stability.[87] The Fed's concern for its mandate is understandable but moral hazard poses the same threat to the mandate, simply from a different angle, as moral hazard will hamper growth by burdening private households through higher sovereign debt in the case of bail-outs. Moreover, moral hazard prevents market discipline for the actors that are responsible for the crisis and lets private households pay the bill. Moral hazard leads therefore to a wrong allocation of risk, burdening private households, a third party which was not involved in the creation of that risk. The Fed's position shows that the CDS (Credit Default Swaps) had not been tested under adverse conditions and therefore they could not be used safely in the crisis that was unfolding in 2008, either. But if these financial instruments can be used by market participants, they should be safe in any situation, otherwise they are not fit for purpose and then CDS merely represent additional costs clients have to bear as these expenses are regularly passed on to clients through banking fees. As the Fed decided to intervene because of the insufficient real experience with CDS, citizens without financial products paid through higher taxes or austerity measures, and so did the actual clients who had to pay the same way as the other citizens on top of the useless CDS fees. If less money is available for households, they will spend less, which

85 Harvey Rosenblum, Danielle DiMartino, Jessica R. Renier and Richard Alm, 'Fed Intervention: Managing Moral Hazard in Financial Crises' (Vol. 3 Nr. 10 October 2008) Economic Letter of the Federal Reserve Bank of Dallas 9-10 <https://www.dallasfed.org/~/media/documents/research/eclett/2008/el0810.pdf> accessed 14 October 2022

86 ibid 6-7

87 ibid 9

will affect the Fed's mandate negatively just the same. As the term "too big to fail" has entered everyday vocabulary and is connected to a variety of rescue packages that were used world-wide, not only by the Fed, it is likely that the criticism has merit, which is supported in a variety of research.[88]

Instead of holding the decision makers and investors accountable, the crisis management of the 2008 financial crisis has simply shifted the centre of gravity from the finance industry to state budgets. The adopted policies successfully removed the strain from the finance industry and stabilized it after the collapse of the investment bank Lehman Brothers but in doing so, the principles of democratic decision-making, the rule of law and of free market economies were violated. These violations, however, were not necessary. Any country has the necessary means to contain such a crisis in accordance with its domestic and international law, with market mechanisms and in a democratic fashion.

4.4. Agency and Unconscionability – Odious Debt Doctrine Ignores Contract Law

Where those mechanisms fail, the odious debt doctrine is regarded by some as a possible solution in order to repeal sovereign debt that is regarded as unjustified. Typically said to apply to debt of dictatorships, this doctrine justifies the default on sovereign debt if an investor intentionally extended loans to a previous "despotic"[89] government that embezzled funds in order to enrich government officials and other politically exposed persons, or using funds in another way not in the public interest, while eventually suppressing the population. So far, there is no international agreement resolving problematic debt of this kind. At times Ecuador and Iraq are mentioned as examples for the implementation of the odious debt doctrine in recent years despite the negotiating parties not calling the debt they defaulted on odious. And the attempt to apply it to a developed democracy, Greece, failed.[90]

Dictatorships and democracies normally incur sovereign debt by contract. Either the borrowing state enters into a loan agreement directly with a lender or – even more widespread - auctions off debt in the form of bonds.[91] Also supranational entities such as

88 Kevin Dowd, 'Moral Hazard and the Financial Crisis' Centre for Risk & Insurance Studies Discussion Paper Series (June 2008)

89 A. N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières I. – Dettes Publiques* (Recueil Sirey, Paris 1927), 157 § 26

90 Truth Committee On Public Debt, 'Preliminary Report' (2015) Hellenic Parliament, Athens, Greece

91 Typically bonds are issued in the borrowing states' national law but developing countries are frequently forced to use UK law or the law of New York: Daniel Munevar, 'Sleep now in the fire – Sovereign Bonds and the Covid-19 Debt Crisis' Eurodad, 26 May 2021 Brussels 13-16; the UK issues its bonds also through auctions, see homepage of the United Kingdom Debt Management Office "As outright auctions constitute the DMO's primary means of issuing gilts the outright auctions option below provides more information on auctions than is available in the summary report." < https://www.dmo.gov.uk/data/gilt-market/results-of-gilt-operations/ > accessed 18 April 2020; In the prospectus for the 0 ½ % UK Treasury Gilt 2029 on 05 April 2023 the UK Debt Management Office explains that

the European Union sell their debt through auctions, since they offer the possibility to issue "debt securities based on competitive bids through an auction platform on primary market".[92] Just like in ordinary auctions the best offer wins, only in this case the best offer consists of the lowest interest rate offered, not the highest price[93]. In general, the laws governing sovereign debt is the domestic law. Likewise, former Greek Finance Minister, Yanis Varoufakis, stated in a presentation that Greek debt was issued until 2015 based on Greek laws.[94] Also research conducted for UNCTAD has shown the same: civil and common law applies to sovereign debt.[95] In all these cases the debt is created once the authorized state representative declares that the state is going to be bound by the underlying contract. In consequence, the rules of national law apply to these contracts.

Auctions constitute an important civil and common law element in the creation of public debt. But auctions that lead to loan contracts between state and lender are based on contract law. If odiousness is supposed to help repudiate unjustified payment claims against states, it makes sense to look into unconscionability and agency because these two legal concepts deal with the questions if a loan contract could exist at all.

Odiousness could have its roots in the principle of unconscionability which can be found in both civil and common law. In civil law, the German "Sittenwidrigkeit" (a violation of generally accepted moral standards in civil law) of § 138 Bürgerliches Gesetzbuch (BGB, German Civil Code) opens the law to the influence of the principle of good public morals. In common law, unconscionability is based on the same principle.

the sale will be conducted through an auction: < https://www.dmo.gov.uk/media/lv4jfytl/prosp290323.pdf > accessed 18 April 2023; likewise, the German Finance Agency (Deutsche Finanzagentur GmbH) publishes rules for each issue of German Federal securities, according to which the securities are sold through an auction: "The Federal Republic of Germany ("Bund"), represented by the Federal Ministry of Finance, which in turn is represented by the Federal Republic of Germany – Finance Agency (GmbH), through Deutsche Bundesbank, offers Federal bonds, five-year Federal notes, Federal Treasury notes, Treasury discount paper as well as inflation-linked Federal bonds an inflation-linked Federal notes (together "German Federal securities") for sale by auction. (…) German law applies to these Auction rules and to the legal relationship between the members of the Auction Group and the Bund. The District Court in Frankfurt am Main shall have exclusive jurisdiction for any dispute between the members of the Auction Group and the Bund arising out of or in connection with the participation of the members of the Auction Group in the auction procedure." Deutsche Bundesbank, 'Auction rules for the issue of German Federal securities' Deutsche Finanzagentur 01 January 2021 Frankfurt am Main, nr. 1 and nr. 8 < https://www.deutsche-finanzagentur.de/fileadmin/user_upload/Institutionelle-investoren/bundesbank/auction_rules_2021.pdf >; For surprising contractual clauses in Russian bonds, see: Mark Weidemaier, Mitu Gulati, 'Russia's Perplexing Sovereign Bonds' Just Money (20 April 2022) < https://justmoney.org/mark-weidemaier-and-mitu-gulati-russias-perplexing-sovereign-bonds/ > accessed 18 April 2023; for further research on the difficulties states face if they use national law to issue debt, see: Mark C. Weidemaier and Mitu Gulati, 'Unlawfully-Issued Sovereign Debt', Duke Law School Public Law & Legal Theory Series No. 2020-49, 9 July 2020, <https://ssrn.com/abstract=3647283> accessed 23 May 2023

92 Article 2 (1) Commission Decision (EU, Euratom) 2021/625 of 14 April 2021 on the establishment of the primary dealer network and the definition of eligibility criteria for lead and co-lead mandates for syndicated transactions for the purposes of the borrowing activities by the Commission on behalf of the Union and of the European Atomic Energy Community, L 131/170

93 The German Central Bank, Deutsche Bundesbank, calls this procedure a monetary policy tool on its homepage reverse auctions within their open market operations

94 Yanis Varoufakis in an interview conducted by Katrine Marçal for Swedish TV station EFN, at minute 18:10 on youtube, 5 May 2017

95 Robert Howse, 'The Concept of Odious Debt in Public International Law', *UNCTAD Discussion Paper No. 185,* Geneva, July 2007, 1

Agency is the second point of contract law that comes into play because the government was entrusted by the citizens to represent them in the day-to-day business of government. Government business entails for example taxation or the provision of infrastructure but also the issuance of bonds or entering into law contracts in order to incur sovereign debt to finance public spending. A government can raise money either through mandatory taxation, which is an act of sovereignty, or through voluntary contracts with lenders. In the latter case the state acts as an equal partner to obtain a loan based on contract law, obliging the citizens of the state as a whole to pay for that loan. The government can do so, for in a democratic state the government is elected for a certain period of time during which it has agency to represent the state vis-a-vis third parties. The government acts as an agent of the state, or rather the citizens, when it enters into a contract with the lender or investor. The concept of governmental agency derived from the consent of the citizens is an old and widespread concept, reflected also in the Declaration of Independence, for example: “We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness.--That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed, (…).”[96] Also today the same is common on local or regional level in Germany since mayors are typically agents of their municipality. Should their agency be limited, as a rule only the internal relationship between mayor and municipality is affected, not between mayor and contract partner.[97] Agency also exists in common law and an agent “(…) is a person that has the power to create, change or terminate the legal relations of another, the principal.”[98] Should the agent exceed its authority, it will be liable to its principal for loss caused by the unauthorised actions.

Hence, the government enjoys a fiduciary position not only vis-a-vis the electorate but the citizenry as a whole and since it acts as a contractual party in loan agreements, its actions can be evaluated according to the law of agency.

5. Summary

The odious debt doctrine claims that moral imperatives override legal obligations and that this moral override would offer a quick solution for sovereign finance disputes over debt incurred under circumstances that could be conceived appalling by some. This way the

96 Thomas Jefferson et. al, ‘The Declaration of Independence’ (1776)
97 Palandt, 'Bürgerliches Gesetzbuch', *Verlag C.H.Beck* (Munich 2014) 180 nr 5
98 Practical Law Commercial, ‘Common Law of Agency’ *Thomson Reuters Practical Law* UK (2021) 6

odious debt doctrine shifts the focus to political negotiations and economic leverage points away from the application of law to sovereign debt and in doing so, this doctrine is an impediment to debt resolution, rather than help. The term "despotic power" used by Sack in his definition of the odious debt doctrine resonates with categories of criminal law but while crimes committed by government can be indicative for reasons justifying repudiation, contractual debt repudiation by no means depends on crimes only. This means that odiousness could be the same as unconscionability in national contract law, and as such it could be but one precondition for the repudiation of contractual sovereign debt. It is also conceivable to extend the ideas behind the odious debt doctrine to cases of corruption or comparable situations, when a state cannot fight the embezzlement of funds any longer because corruption has become endemic or because it goes beyond the legal authority of the state. But without guidance as to how odious debt can be applied to sovereign debt that is based on contracts and to what legal result this application would lead, it is essential to explore the available legal options for debt repudiation.[99] For if disputes over odious debts can be resolved with standard legal tools, then the odious debt doctrine is redundant.

Since its inception about 100 years ago, the odious debt doctrine suffers from one major problem: its lack of application. This suggests that the doctrine cannot serve as a useful legal basis for debt repudiation. In order to answer the question, why this doctrine has never been applied in a single instance, the next chapter will analyse the doctrine, its roots and its defects. The third chapter will analyse cases that are related to debt repudiation, including the cases of Iceland, Greece and Portugal, in order to understand if the repudiation of payment claims is only applicable to dictatorships or if there are circumstances where democracies can benefit from it. The legal review of the European crisis management has shown that the response to the financial crisis has differed from state to state. Portugal, one of the targets of Troika policies, implemented reforms differently than demanded by its creditors, with better results than Greece. While the Troika's "Bailout for Greece was a disaster",[100] Iceland chose an entirely different solution and refused to bail-out creditors because as a non-EU member, it was not subject to Troika policies. Iceland lifted capital controls on 14 March 2017, returning to the financial markets only eight years after the banking crash.[101] These three states represent three different policy options with different legal and economic outcomes. What makes these three cases comparable is their same root cause – their defective genesis of sovereign debt

99 For a contemporary attempt to modernize the odious debt doctrine, see: Jeff King, *The Doctrine of Odious Debt in International Law – a Restatement* (Cambridge University Press 2016)

100 Matthew C. Klein, 'Greece's "Bailout" Was a Disaster for Greece' *Barron's* (New York City 24 August 2018) <https://www.barrons.com/articles/greeces-bailout-was-a-disaster-for-greece-1535137822> accessed 24 August 2018

101 Omar Valdimarsson, 'Iceland Exits Krona Controls Eight Years After Banking Crash' *Bloomberg* (12 March 2017)

but the outcome of the rescue policies is very different. The thesis ends with the fourth chapter, summing up the legal means that could be used for the repudiation of claims.

Second Chapter: The Roots and Defects of the Odious Debt Doctrine

The odious debt doctrine is a legal theory that has been connected to sovereign debt, loan contracts, corruption and human rights infringements committed by the government against the population. As a result, notions of political theory, constitutional and international law, contract law, bankruptcy law as well as criminal law could all come into play with unclear weight and unknown outcome in legal and economic terms. What can be stated, though, is that odious debt is a special case of sovereign debt. That the doctrine has never been applied certainly does not speak for odious debt from a practical point of view. Yet, this does not mean that its application is impossible, it could also mean that the negotiating parties did not find it necessary to declare sovereign debt odious. The following chapter explores why the definition of odious debt impairs its practical application.

1. The Odious Debt Doctrine as Proposed by Sack

Despite the United States calling Cuban debt vis-a-vis Spain "odious" in 1898 already, most scholars agree[102] that Alexander Nahum Sack was the first one to use the term "odious debt". Sack used this term for sovereign debt that governments might default under certain conditions:

> If a despotic power contracts debt, not for the needs and in the interest of the state, but in order to fortify its despotic regime, to suppress the population, which fights that power, etc., that debt is odious for the entire population of that state. This debt is not binding on the nation; it is a debt of that regime, a personal debt of that power which contracted it and in consequence it falls with the collapse of that power. The reason why these "odious" debts cannot be considered as encumbering the territory of the state is that these debts do not correspond with any of the preconditions determining the regularity of sovereign debt, i.e. sovereign debts must be incurred and the funds derived from them must be used for the needs and in the interest of the state. "Odious" debts, contracted and used for purposes which, with the lenders' knowledge, are contrary to the interests of the nation, are not binding on the latter - in the event that it successfully overthrows the government which contracted them – except within the limits of real advantages which the

102 Jeff King, *The Doctrine of Odious Debt in International Law – a Restatement* (Cambridge University Press 2016) 27

> nation may have obtained from these debts (see supra, § 6). The lenders have committed a hostile act towards the people; they cannot therefore count on the nation freed from a despotic power to assume the "odious" debts which are the personal debts of that power.[103]

At the beginning of Sack's explanation of what constitutes odious debt stands a despotic power which contracts debt; then this debt is neither used for the needs nor in the interest of the state; instead, the debt is used to strengthen the power's despotic regime, to suppress the population, which fights that power, etc.

From these preconditions alone Sack draws the conclusion that this debt is odious for the entire population of that state, meaning it is not binding on the nation, but it becomes a debt of that regime, a personal debt of that power which contracted it and in consequence it falls with the collapse of that power.

After this statement, Sack explains these "odious" debts could not be considered as binding for the state as these debts did not correspond with any of the preconditions determining the regularity of sovereign debt. According to him, sovereign debt must be incurred, and the funds derived from them must be used for the needs and in the interest of the state. Furthermore, "[o]dious" debts, contracted and used for purposes which, with the lenders' knowledge, are contrary to the interests of the nation, are not binding in his opinion, except where the nation has obtained real advantages from these debts.

Sack claims the lenders had committed a hostile act towards the people[104]; after a successful revolution, the lenders cannot therefore count on the nation freed from the despotic power to assume the "odious" debts which are the personal debts of that power.

On p. 163 Sack attempts to expand the odious debt doctrine to debt incurred by regular governments: if the government can prove to an international tribunal that 1. a) the purposes for which the previous government had contracted the debt in question where "odious" and plainly contrary to the interest of the population of either the whole of the old territory or part of it and b) that the lenders had been aware of the loan's odious purpose at

103 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 157: "Si un pouvoir despotique contracte une dette non pas pour les besoins et dans les intérêts de l'État, mais pour fortifier son régime despotique, pour réprimer la population qui le combat, etc., cette dette est odieuse pour la population de l' État entier. Cette dette n'est pas obligatoire pour la nation; c'est une dette de régime, dette personnelle du pouvoir qui l'a contractée, par conséquent elle tombe avec la chute de ce pouvoir. La raison pour laquelle ces dettes « odieuses » ne peuvent être considérées comme grevant le territoire de l'État, est que ces dettes ne répondent pas à l'une des conditions qui déterminent la régularité des dettes d'État, à savoir celle-ci: les dettes d' État doivent être contractées et les fonds qui en proviennent utilisés pour lés besoins et dans les intérêts de l' État. Les dettes «odieuses», contractées et utilisées à des fins lesquelles, au su des créanciers, sont contraires aux intérêts de la nation, n'engagent pas cette dernière - au cas où elle arrive à se débarrasser du gouvernement qui les avait contractées - sauf dans la limite des avantages réels qu'elle a pu obtenir de ces dettes (v. supra, § 6). Les créanciers ont commis un acte hostile à l'égard du peuple; ils ne peuvent donc pas compter que la nation affranchie d'un pouvoir despotique assume les dettes "odieuses" qui sont des dettes personnelles de ce pouvoir."

104 That questionable debt is not caused by a hostile act but rather by a lack agency is clarfied by Grotius, below see section 2.2 of this chapter.

the time the loan was issued. Sack connected the two conditions with "and", while pointing out in nr. 2. that once these two points were established, it were up to the creditors to reject this position of the borrowing state by proving that their loans had benefited the population.[105]

To assign odiousness to debt incurred by regular governments, Sack demands an odious purpose, a use that is plainly not in the public interest and knowledge of the lender of the odiousness of the purpose. This would have to be proven in front of an international tribunal. There are two aspects that speak against the tribunal approach. Firstly, an attempt has been made to codify odious debt[106] but this was not successful. Secondly, a tribunal will not give those a voice, that have not been heard in the first place: the citizens.

Yet, it seems that Sack understood that the first limitation of his doctrine to despotic governments was too narrow.

2. The Predecessors of the Odious Debt Doctrine

Sack's definition of odious debt seems to combine elements of norms defining the unconscionability of contracts from various jurisdictions as well as from Aristotle's "Politics", Grotius' "The Rights Of War And Peace Including The Law Of Nature And Of Nations" and Plato's "The Laws".

2.1. Aristotle

Those, who refer to Aristotle[107] in support of odious debt in the context of state succession, seem to rely on the following quote from Aristotle's Politics as translated by W. E. Bolland in 1877 and quoted by Tai-Heng Cheng: "[When] a democracy tak[es] the place of an oligarchy or despotism ... some persons refuse ... to meet the contracts in hand on the ground that it was not the State, but the despot who entered upon them … ." Of course, this quotation looks as if the ancient Greeks had preferred democracies over oligarchy or

105 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 163

106 Friedrich Benjamin Schneider, 'The International Convention on the Prevention of Odious Agreements: A Human Rights-Based Mechanism to Avoid Odious Debts' Leiden Journal of International Law (2015) 557-578

107 Tai-Heng Cheng, 'Renegotiating the Odious Debt Doctrine' (Summer 2007) Law and Contemporary Problems, Vol. 70, No. 3, Durham, U.S., 12; Stephania Bonilla, *Odious Debt, Law-and-Economics Perspectives* (Gabler Research 2011); Yvonne Wong, *Sovereign Finance And The Poverty Of Nations – Odious Debt in International Law* (Edward Elgar 2012) 5, referring to Cheng

despotism and therefore had granted democratic governments the right to repudiate the odious debt of the previous governments.

This does not make sense for several reasons:

First, the quotation is incomplete because the full quotation shows that Aristotle did not say democracy was preferred in ancient Greece:

> For some raise the question, when is it the state that has been the agent, and when is it not the state; as, for instance, on a democracy taking the place of an oligarchy or despotism. For in that case some persons refuse either to meet the contracts in hand on the ground that it was not the State, but the despot who entered upon them, or to perform any similar obligation, on the ground that some forms of constitution exist purely in virtue of superior strength, instead of for the common good. Further, since some democratic governments rest on the same ground, we must say that the acts of a constitution of that sort are the acts of the state in which it exists, just as much as the acts of an oligarchy or despotism are the acts of their respective states. Akin to this difficulty appears to be the question, 'By what rule are we ever to call the state the same, or not the same, but different?'[108]

A comparison with later translations or translations into different languages does not permit an interpretation that democracy was the preferred state form according to Aristotle, either.[109] The above Bolland quote resembles the subsequent Rackham translation:

> For some persons raise the question, When is an occurrence the act of the state and when is it not? for example, when the government has been altered from oligarchy or tyranny to democracy. In such circumstances some people claim that the new government should not discharge public debts, on the ground that the money was borrowed by the tyrant and not by the state, and should repudiate many other similar claims also, because some forms of government rest upon force and are not aimed at the welfare of the community. If therefore some democracies also are governed in that manner, the acts of the authorities in their case can only be said to be the acts of the state in the same sense as the public acts emanating from an oligarchy or a tyranny are said to be. Akin to this controversy seems to be the subject, What exactly is the principle on which we ought to pronounce a city to be the same city as it was before, or not the same but a different city?[110]

Second, Aristotle clearly states that there are democracies which are run just the same way as other forms of government. From that it can be deduced that it was held justified in ancient Greece to refute debt incurred by poorly governed corrupted and suppressive democratic governments just the same as the debt of oligarchies and tyrants.

Third, a preference would be against the system of Aristotle's Politics, since he considered democracy a perverted forms of government, oligarchy and tyranny being the other two, increasingly perverted forms.[111] On the other hand, he considered royalty, aristocracy and

108 Aristot. Pol. 3.1276a in Aristotle, *Politics,* Bolland W. E. (tr), (Longmans, Green, And Co. 1877) 162-163

109 Also, a German translation does not show any preference for democracies according to Aristotle: Aristot. Pol. 3.1276a in Aristoteles, *Politik*, Schwarz F. F. (tr), (Philip Reclam jun. 1993)

110 Aristot. Pol. 3.1276a in Aristotle, *Politics*, Rackham H. (tr), (Harvard University Press 1944)

111 Aristot. Pol. 3.1279b in Aristotle, *Politics*, Rackham H. (tr), (Harvard University Press 1944) "Now tyranny, as has been said, is monarchy exerting despotic power over the political community; oligarchy is when the control of the

constitutional governments the true and valid forms of government. Apart from that, the argument only ancient Greek democracies would have repudiated odious debt, does not make sense, either. Obviously, each government, democratic or despotic, would have claimed to be better than the previous one. It is unlikely that an ancient Hellenic despot would have decided not to attempt any debt repudiation based on the grounds that he knew his rule was undemocratic or less legitimate than the previous government.

Finally, Schütrumpf's philosophical commentary on Aristotle[112] encompasses a similar translation and points out in the annotations that a government using force and not serving the public's interest, is seen by Aristotle as unjust and therefore not legitimate. In Aristotle's understanding democracy is a perverted form of government because it seeks advantage like a tyrant's despotism and an oligarchy exclusively for the ruling class, in the case of democracy that would be the poor. Democracy therefore lacks legitimacy.

Aristot. Pol. 3.1276a is an important section also for another reason: it becomes clear that state succession is not important in this context, according to Aristotle. After discussing the repudiation of debt, Aristotle asks "By what rule are we ever to call the state the same, or not the same, but different?"[113] This question probably has misled some authors to focus on discussions about odious debt in the case of state succession[114]. But this is not the same question, it is merely related. Also, Aristotle drew a distinction between the two, as the whole question reads: "*Akin* to this difficulty *appears to be* the question, 'By what rule are we ever to call the state the same, or not the same, but different?'"[115] Aristot. Pol. 3.1276b discusses the topics state succession and – identity in more detail but before turning his attention to citizenship Aristotle clarifies "But whether a state is or is not bound in justice to discharge its engagements when it has changed to a different constitution, is another subject."

In Politics book 3 Aristotle does not return to the question of sovereign debt and deals with the different forms of states and approaches to rule their people, instead. But in explaining that state succession and the repudiation of debt in Aristot. Pol. 3.1276a and 3.1276b are not necessarily dependent on each other, Aristotle is not a suitable basis for those who would like to use the odious debt doctrine in this context. Moreover, Aristotle does not

government is in the hands of those that own the properties; democracy is when on the contrary it is in the hands of those that do not possess much property, but are poor."

112 Aristoteles, *Politik*, Buch II, Schütrumpf E. (ed), (Wissenschaftliche Buchgesellschaft Darmstadt 1991) 402-403

113 Aristot. Pol. 3.1276a in Aristotle, *Politics,* Bolland W. E. (tr), (Longmans, Green, And Co. 1877) 163

114 Although he stresses that the overall discussion on odious debt lacks precision and adequate terminology (427), Paulus seems to support the standard approach to locate odious debt in the context of state succession (391-392 with further references), Christoph G. Paulus, 'The Evolution of the "Concept of Odious Debts"' (2008) Zeitschrift für ausländisches öffentliches Recht und Völkerrecht*,* Heidelberg, 391-429

115 Aristot. Pol. 3.1276a in Aristotle, *Politics,* Bolland W. E. (tr), (Longmans, Green, And Co. 1877) 163; emphasis added by the author

favour democracies in his theory on politics. He even adds that democracies could incur odious debt just as well as despotic tyrants. Therefore, Aristotle does not offer support for those who claim the precondition for the odious debt doctrine was a state succession from despotism to democracy, such as Sack. In theory this doctrine is supposed to help freshly established democracies by repudiating illegitimate debt of despotic regimes, because democracy is morally superior and therefore desirable. That goal, however, cannot be reached with the help of Aristotle.

2.2. Grotius

In "The Rights of War and Peace Including The Law Of Nature And Of Nations" Grotius not only laid the foundations for international law ruling armed conflict, but also analysed questions of sovereignty, property, contracts and engagements of delegates exceeding their powers, for example. Unlike Aristotle, Grotius is either ignored by contemporary researchers[116] and or mentioned in the context of state succession.[117] That is unfortunate, since Grotius' work offers more substance for the work on the odious debt doctrine than current literature suggests. Grotius appears to be the only scholar who attempted to give a definition of odiousness before Sack: "Treaties of an odious kind are those which lay greater burdens on one party than on the other, which contain penalties for non-performance, or which lead to an abrogation or infraction of former treaties."[118] Although this definition stems from the discussion on the varieties of treaties, it suits the odious debt doctrine, since the doctrine refers to contracts or treaties that burden the state's population is burdened while the other side benefits. Grotius also defines the term "Right" in the relationship of citizens and state:

> Right, strictly taken, is again twofold, the one, PRIVATE, established for the advantage of each individual, the other, SUPERIOR, as involving the claims, which the state has upon individuals, and their property, for the public good. Thus the Regal authority is above that of a father and a master, and the Sovereign has a greater right over the property of his subjects, where the public good is concerned, than the owners themselves have. And when the exigencies of the state require a

116 Grotius is not mentioned for example by Patricia Adams, *Odious Debts – Loose Lending, Corruption, And the Third World's Environmental Legacy* (Earthscan 1991); Stephania Bonilla, *Odious Debt, Law-and-Economics Perspectives* (Gabler Research 2011); Yvonne Wong, *Sovereign Finance And The Poverty Of Nations – Odious Debt in International Law* (Edward Elgar 2012)

117 Jeff King , *The Doctrine of Odious Debt in International Law – a Restatement* (Cambridge University Press 2016) 35 fn. 19; Christoph G. Paulus, 'The Evolution of the "Concept of Odious Debts"' (2008) Zeitschrift für ausländisches öffentliches Recht und Völkerrecht*,* Heidelberg 392 fn. 3; Howse states in one sentence that Grotius suggested to repudiate debt not used for the public good but does so also in a discussion about state succession, see Prof. Robert Howse, 'The Concept of Odious Debt in Public International Law', *UNCTAD Discussion Paper No. 185*, Geneva, July 2007 5-6

118 Hugo Grotius, *The Rights Of War And Peace Including The Law Of Nature And Of Nations*, M. Walter Dunne 1901, 180 nr. X.

> supply, every man is more obliged to contribute towards it, than to satisfy his creditors.[119]

Furthermore, Grotius explains that a state obligation to further business interest does not exist. Business interest is only a secondary factor because it furthers the economy, which is embedded in society. But as a private interest, it is subject to the superior claim of the state upon individuals. This is an important aspect when it comes to the consideration of claims: States are obliged to respect, protect and fulfil the human rights of their populations, meaning protecting the rights of the constituting element of any state. Therefore, human rights protection and fulfilment is the core exigency of the state and if funds are necessary to meet this main requirement, the state has a claim against its creditors to supply contributions, which can also take the shape of suspended payments or repudiated claims, instead of satisfying their claims.

In a modern democracy (not in the Aristotelic sense), the citizens are the sovereign represented by parliament. From this outside perspective, today's dictatorships or illegitimate governments exercise control over the property of the subjects instead of the sovereign, without authorization. In this paragraph, Grotius explains when someone is not obliged to satisfy his creditors. If the state needs to be supplied due to a pressing emergency, the subjects – natural and legal persons alike - are supposed to contribute to the state instead of satisfying their creditors. As foreign legal entities have no sovereignty over the state, the state's right to suspend payment also extends to them, since it would not be logical if foreign legal entities, which are not part of the state, would receive better treatment than domestic legal entities. In the context of odious debt, or rather debt repudiation in general, this segment means that the state is responsible for the well-being of its citizens and therefore all creditors of the state have to bear losses, thus contributing to the needs of the state.

Grotius' definition of "Right" is closely connected with another basic problem in the odious debt doctrine, the ruling power's lack of agency. According to Grotius "the Senate of Rome (...) judged very properly in passing a decree, that no treaty could be made without their consent and that of the people."[120] Sovereign debt is created by the state and lender entering into a loan contract. But where the parliament's control function is skirted, the constitutional budgetary rules are ignored and human rights protection and fulfilment become impossible due to the financial burden caused by such contracts, loans could be repudiated. "No subordinate magistrates have such a power of binding the people; nor will the acts of a smaller portion bind the greater, (...)"[121] This means one of the central

119 ibid 20 nr. VI.
120 ibid 167 nr. II. and III.
121 ibid 168

problems is the lack of the sovereign's will, expressed by the majority of citizens. This example of Grotius illustrates that odious debt is not a hostile act, as Sack proposed, it is rather a lack of agency. The same principle can also be found elsewhere:

> We are obliged to confirm the engagements made by others, acting in our name, if it is evident that they had special, or general instructions from us to do so. And in granting a commission with full powers to any one, it may so happen that we are bound by the conduct of that agent, even if he exceed the secret instructions which he has received. For he acts upon that ostensible authority, by which we are bound, to ratify whatever he does, although we may have bound him to do nothing but according to his private instructions. This rule, we must observe, applies to the promises made by ambassadors in the name of their sovereigns, when, by virtue of their public credentials, they have exceeded their private orders.[122]

Pursuant to Grotius, contract partners can rely on a valid agency agreement if it is evident that the agent was instructed by the principal to act in his name. Agency needs publicity in order to be legally binding: "If any one employ a slave, as his factor, to trade for him, he is bound by the acts of that factor, unless he has previously given notice that he is not to be trusted."[123] Secret instructions are not decisive for the limits. What counts instead, are the expectations of an uninvolved and objective third party that is aware of the agency. The same is true when it comes to representatives of government. It depends on the public credentials if the state is bound by the ambassador, not on the internal orders. What is true for the relationship between private parties as well as for the relationship between states must also apply for relationships between private lenders and state borrowers, otherwise this relationship would be treated differently for no apparent reason. A government contravening the interests of the majority of citizens as it rules against its agency conferred by elections and outlined in the constitution, cannot be considered as acting with full and valid agency. The same principle for binding agency is reflected in Grotius' example of the

> "convention made between Luctatius and the Carthaginians; to which the people refused to accede, as it had been made without their consent. A new treaty therefore was made by public authority. The next thing to be considered is, whether there may not be some act of consent besides silence. For without some visible act, silence is not of itself sufficient to warrant a probable conjecture of intention. But if certain acts are done which can be accounted for upon no other grounds than those of consent, they are supposed to ratify a treaty."[124]

Grotius analyses the character of agency on several occasions in his work. Noteworthy for the repudiation of sovereign debt are the cases where somebody represented the population without public authority becomes personally liable for damages and interest:

> "But it remains to be considered how far the acts of those, who have engaged for the people, without any public authority, are binding. Perhaps it may be said that

122 ibid 138-139 nr. XII.
123 ibid 125 nr. II.
124 ibid 175 nr. XIV.

> the contracting parties have discharged their responsibility when they have done all in their power towards the fulfilment of their obligation. That might be the case in promises, but the obligation in public contracts is of a stricter kind. For the party contracting requires something in return for the engagements he makes. Hence the civil law, which rejects all promises made by one person for the performance of some act by another, renders him who engages for the ratification of a thing liable to pay damages and interest."[125]

Another agency problem for odious debt cases is the situation in which the government who should be the factor of the citizens, cannot be trusted – and the citizens cannot give notice due to the oppression. Grotius illustrates this problem in Chapter X. XII. on restoring property or to pay damages when the will of the represented is distorted by extortion: "The case will be altered, if there be any thing iniquitous in the manner of acquiring the thing; as if, for instance, it be gained by extortion. This gives rise to the obligation of submitting to penalties, (…)."[126]

When it comes to the element of extortion, Grotius seems to consider the institution of Roman law, lex Rhodia de iactu mercium:

> Promises extorted by fear are a subject of no less intricate decision. For here too a distinction is usually made between a well founded and a chimerical fear, between a just fear and a bare suspicion, and between the persons who occasion it, whether it be the person to whom the promise is given, or some other. (…) There is some shew of reason in the opinion of those who, without taking into consideration the power of the civil law to annul or diminish an obligation, maintain that a person is bound to fulfil a promise which he has given under impressions of fear. For even in this case there was CONSENT, though it was extorted; neither was it conditional, as in erroneous promises, but absolute. It is called CONSENT. For as Aristotle has observed, those who consent to throw their goods overboard in a storm, would have saved them, had it not been for the fear of shipwreck. But they freely part with them considering all the circumstances of time and place.[127]

The particularity in the example of the potential shipwreck is the common fate of the participants. Their joint venture is in danger and in order to survive and maybe save a part of the goods, some of the cargo is thrown overboard and the loss will be shared by all participants accordingly. This is not applicable in the setting of odious debt, though: while the participants of the ship joint-venture are threatened by some event outside their sphere of control, either a storm or pirates, which could lead to a complete loss of life and goods, odious debt is generated by a conspiracy of government and investor exploiting the population. The threat in the case of odious debt stems from one party that has the means to exploit the other, meaning the loss is controlled within the sphere of influence of one of the parties. This means, there is no common threat coming from the outside endangering every party likewise in the case of odious debt.

125 ibid 168 nr. II. and III.
126 ibid 129-130 nr. XII.
127 ibid 137-138 nr. VII.

More suitable is Grotius' solution of cases in which the formation of the contract is defective in chapter XVII, nr. XVII.: "Contract, or promises obtained by fraud, violence or undue fear entitle the injured party to full restitution. For perfect freedom from fraud or compulsion, in all our dealings, is a right which we derive from natural law and liberty. With the same class of offenders we may rank all men in office, who are unwilling to discharge their duty without a bribe."[128] In the case of odious debt, there is no compulsion from the outside that is based on a real threat, like in the example of the imminent shipwreck. Instead, the contracting government officials and lenders create and control the exploitative circumstances connected to the loan. The full restitution Grotius proposes for these cases goes beyond the mere repudiation of odious debt because repudiation means only the immediate termination of current and future payment based on the legal objection of the underlying payment claim. On the other hand, full restitution means the state would have to be put into the same position as if the loan and the damage resulting from it would never have happened. This would encompass a stop of current and future instalment payments, a return of previous instalments and damages, where applicable. In order to claim full restitution as suggested by Grotius, the state would first need to prove duress or bribes and in a second step plea for nullity of the lender's claim and demand the damages caused by the acts of government officials and lenders. As the odious debt doctrine envisages only debt repudiation and not full restitution, the burden of proof for the debt repudiation must be lower. Consequently, it would be sufficient to demonstrate that the previous ruling power and lender benefited from the loan while the population did not. The new government or parliament would not have to show that this disadvantageous arrangement would not have been accepted by the public without undue influence. Grotius stated, "freedom from fraud or compulsion, in all our dealings, is a right which we derive from natural law and liberty".[129] There seems to be no constitution that would demand that the ruling power committed fraud or compulsion against the citizens, hence, it can be assumed that the population generally rejects any use of public funds for foreign purposes as misuse. Should the state decide to repudiate the loan, the lender will have to substantiate his payment claim by proving that the loan was used in accordance with the public interest.

Sack's work of 1927 contains nine references to the original Latin "De Jure Belli Ac Pacis" in the context of state succession. Since his home country, tsarist Russia had just been replaced by the Soviet Union his focus on state succession is probably understandable. But the original Latin also contains the same reference to odiousness that is reflected by the English translation of 1901 which seems to have influenced Sack's doctrine nonetheless:

128 ibid 199 nr. XVII.
129 ibid 199 nr. XVII.

"Odiosa sunt quæ partem alteram tantum, aut plus altera onerant, & quæ pœnam in se continent, & quæ actus faciunt irritos, & quæ de prioribus aliquid immutant."[130] Grotius offers an elaborate work on contractual obligations when it comes to sovereign debt, and historical case analysis, useful for a future development of this doctrine in the context of the law of contracts. Above all, Grotius clarifies that a prudent government, that tries to keep the damage for the state budget as low as possible, would under some circumstances be tactically better advised to follow Grotius' proposal in chapter XVII. nr. XVII.[131] instead of the odious debt doctrine, since the odious debt doctrine offers only debt repudiation instead of full restitution.

2.3. Plato

In his work on law, Plato describes a situation reminiscent of the modern-day concept of unconscionability and impossibility:

> Touching agreements, whenever a man undertakes and fails to fulfil his agreement —unless it be such as is forbidden by the laws or by a decree, or one made under forcible and unjust compulsion, or when the man is involuntarily prevented from fulfilling it owing to some unforeseen accident,—in all other cases of unfulfilled agreements, actions may be brought before the tribal courts, if the parties are unable to come to a previous settlement before arbitrators or neighbours.[132]

This situation of compulsion has been analysed in more detail above, in the section on Grotius. But it can help explain why the notion of odious debt seems to be so familiar and where Sack might have got his inspiration from.

2.4. Russian, German and Common Law, Soviet Influence

Finally, it is conceivable that some of the roots of the odious debt doctrine can also be traced back to Russian and German law, which belonged to Sack's legal background who had studied law in Moscow, Petrograd, Munich, Berlin, Paris and London.[133] Unconscionability, which could be described as the moral limit to contractual content is known to Russian and German law and could be compared to odiousness in the sovereign debt context where the government signs loan agreements that are against public interest.

130 Hugo Grotius, *De Jure Belli ac Pacis Libri Tres, in quibus Jus Naturæ & Gentium, item Juris Publici præcipua explicantur,* James Brown Scott (ed), (Carnegie Institution of Washington 1913) 278; The English version reads "Treaties of an odious kind are those which lay greater burdens on one party than on the other, which contain penalties for non-performance, or which lead to an abrogation or infraction of former treaties.", see Hugo Grotius, *The Rights Of War And Peace Including The Law Of Nature And Of Nations*, (M. Walter Dunne 1901) 180 nr. X.

131 Hugo Grotius, *The Rights Of War And Peace Including The Law Of Nature And Of Nations*, (M. Walter Dunne 1901) 199 nr. XVII.

132 Plat. Laws 11.920d in Plato, *Laws*, Plato in Twelve Volumes, Vols. 10 & 11 R.G. Bury R.G. (tr), (Harvard University Press, London, William Heinemann Ltd. 1967 & 1968)

133 Editor's Obituary, 'A.N. Sack, Taught International Law', Newsday (Suffolk Edition), 1 June 1955, Melville, New York 100

For example, article 966 of the Code of Civil Laws of the Russian Empire of 1832 states that "[a] contract is made by mutual consent of the contracting parties. The subject-matter of the agreement may be either property or persons' actions; it must not be contrary to the law, public decency, or social order." From this follows in article 967 that "[t]he contract is invalid and the obligation is null and void, if the motive for entering into it is the achievement of a purpose prohibited by law, such as: when the contract leads to: 1) to the termination of a legal contract; 2) to the fraudulent reassignment of property in order to avoid paying debts; 3) to usury; 4) to assign to a private person a right that he or she is not able to have by virtue of his or her condition; 5) to the detriment of the State Treasury."[134] The German Civil Code of 1896 is similar: "A legal transaction contrary to morality is void. In particular, a legal transaction is void by which someone, taking advantage of another's need, carelessness or inexperience, promises or grants himself or a third party pecuniary advantages for a service which exceeds the value of the service in such a way that, according to the circumstances, the pecuniary advantages are conspicuously disproportionate to the service."[135] Unconscionability is also an element of common law and renders the contract unenforceable because the consideration is inadequate or lacking, because the abuse of superior bargaining power, because of misleading misrepresentation of facts or contractual terms.[136] Similarities do not only exist in the same legal field in different jurisdictions. Similarities can even be found between legal instruments in various fields of law. For example, § 44 (2) 6. of the German administrative procedures act states, that an act of the administration is void, if it constitutes a violation of morality.[137] The peculiarity with odiousness, however, is not that it occurs in one field of law and that a similar tool exists in a different field or jurisdiction.

134 The original reads "966. Договоръ составляется по взаимному согласію договаривающихся лицъ (а). Предметомъ его могутъ быть или имущества или дѣйствія лицъ; цѣль его должна быть непротивна законамъ, благочинію и общественному по рядку", "967. Договоръ недѣйствителенъ и обязательство нич тожно, если побудительная причина къ заключенію онаго есть достиженіе цѣли, законами запрещенной, какъ-то: когда договоръ клонится: 1) къ расторженію законнаго су пружества; 2) къ подложному переукрѣпленію имѣнія въ избѣжаніе платежа долговъ; 5) къ лихоимственнымъ изворотамъ; 4) къ присвоенію частному лицу такого права, котораго оно по состоянію своему имѣть не можетъ; 5) ко вреду Государственной казны." Code of Laws of the Russian Empire / Volume X, Part I. Code of Civil Laws, 1832 <https://upload.wikimedia.org/wikipedia/commons/9/99/Свод_законов_Российской_империи._Том_X_%281832%29.pdf> accessed 21 October 2018

135 The original reads "§ 138 Ein Rechtsgeschäft, das gegen die guten Sitten verstößt, ist nichtig. Nichtig ist insbesondere ein Rechtsgeschäft, durch das Jemand unter Ausbeutung der Nothlage, des Leichtsinns oder der Unerfahrenheit eines Anderen sich oder einem Dritten für eine Leistung Vermögensvortheile versprechen oder gewähren läßt, welche den Werth der Leistung dergestalt übersteigen, daß den Umständen nach die Vermögensvortheile in auffälligem Mißverhältnisse zu der Leistung stehen." Bürgerliches Gesetzbuch vom 18. August 1896, Reichs-Gesetzblatt 1896 Nummer 21 vom 24. August 1896 Seite 195-603 <https://de.wikisource.org/wiki/B%C3%Bcrgerliches_Gesetzbuch._Erstes_Buch._Allgemeiner_Theil#%C2%A7._138.> accessed 23 May 2023

136 For a leading case in English law, see *Lloyds Bank Ltd v Bundy* [1974] EWCA Civ 8 (30 July 1974) <https://www.bailii.org/ew/cases/EWCA/1974/8.html> accessed 20 February 2018; for an example from the United States, see *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965) <https://scholar.google.com/scholar_case?case=9052480984854382590> accessed 23 May 2023

137 The original § 44 Abs (2) nr. 6 VwVfG reads "(2) Ohne Rücksicht auf das Vorliegen der Voraussetzungen des Absatzes 1 ist ein Verwaltungsakt nichtig, (…) 6. der gegen die guten Sitten verstößt"

There is no odiousness. But exactly because odiousness does not exist in law, it could be argued that odiousness is merely the technical term for unconscionability in the context of sovereign debt. Then the same legal problem in sovereign debt can be solved by way of analogy to the applicable contract law. This is also supported by the fact that sovereign debt is usually incurred with loan contracts that are based on national law.[138]

But not only civil and common law are likely candidates when it comes to the roots of the odious debt doctrine, also Soviet demands for debt repudiation become relevant upon closer inspection:

The St. Petersburg Soviet discussed in 1905 means to deprive the tsarist government of resources. Their Financial Manifesto advocated for exerting pressure on the gold base of the tsarist monetary system and by undermining government credit.[139] During a five-day meeting in November, where the delegates demanded the refusal to supply army recruits and a boycott of alcoholic beverages to reduce the tax revenue, also measures against the tsarist financial system were put forward: “Deprive the Government of resources! Proclaim abroad that no confidence should be placed in the tsarist Government and no money lent to it! Tell foreign capitalists to refuse postponement of interest payments on outstanding loans and warn them that, once in power, the people will refuse to pay any arrears. It was also recommended that peasants should withdraw deposits from privately owned banks.”[140] According to the Manifesto, the autocracy had lead Russia on the brink of bankruptcy, had ruined trade, agriculture and industrial production. Absent any accountability for state finances, the government has signed for loans that exceed Russia’s ability to pay by far. To obtain further loans from foreign investors, the tsarist government had engaged into accounting fraud while its officials were plundering what was left in the treasury. “Only the Constituent Assembly, after the overthrow of the autocracy, can halt this financial ruin. It will carry out a severe investigation of state finances and will draw up a detailed, clear, accurate, and verified estimate of state revenues and expenditures (budget).”[141] Here the demand for parliamentarian control of the state budget is echoed, as it is practised in the Assemblée nationale, the Bundestag and the House of Commons, for example.[142] According to the Manifesto, it is the government’s fear of popular control that could reveal Russia’s insolvency to the entire world, hence its attempts to prevent the convening of the

138 See above, the discussion on borrowing according to national law, chapter 1.4. Construction problems of the financial architecture and their effect on sovereign debt, fn 64

139 George Garvy, ‘The Financial Manifesto Of The St. Petersburg Soviet 1905’, (1975) International Review of Social History, Cambridge University Press, Cambridge, 20(1), 16

140 ibid 16-17

141 ibid 30-31

142 The scientific services of the German Parliament offer a short comparison of how these three parliaments are exercising their budgetary control: Wissenschaftliche Dienste, ‘Parlamentarische Haushaltskontrolle - Ein Vergleich zwischen dem Deutschen Bundestag, der französischen Assemblée nationale und dem britischen House of Commons’ WD 3 - 3000 – 254/14 (04 February 2015)

people's representative assembly. The autocracy was unwilling to cease its "rapacious" activities, consequently it violently suppressed any attempt of the citizens to rescue themselves, killing several hundred thousand. In this power struggle the Manifesto defines severing the government's financial supply as a vital tactical tool.

> We have therefore decided:
>
> To refuse to make land redemption payment and all other payments to the Treasury. In all transactions and in the payment of wages and salaries, to demand gold, and in the case of sums of less than five rubles, full weight coin.
>
> To withdraw deposits from the state savings banks and from the State Bank, and to demand payment of the entire amount in gold. The autocracy has never enjoyed the people's confidence and has never received any authority from the people.
>
> At the present time the government is behaving within the frontiers of its own country as though it were ruling a conquered country.
>
> We have there fore decided not to permit the repayment of loans which the tsarist government contracted while it was clearly and openly waging war against the entire people.[143]

This means, the St. Petersburg Soviet, consisting of Russian workers, peasants, social revolutionaries and the Central Committee of the Polish Socialist Party, published a Manifesto in 1905 which can be regarded as a predecessor of the odious debt doctrine. It even consists of the elements of the original definition: foreign debt was incurred by the autocratic government for personal enrichment while suppressing the popular uprising. One such event was the "Bloody Sunday" on 22 January 1905 when the Imperial Guard fired upon unarmed demonstrators who had planned to submit a petition to Tsar Nicholas II of Russia. Sack studied in St. Petersburg for some time and later taught law at the Petrograd Imperial University, the name of the St. Petersburg State University from 1914-1919. After the October Revolution, the All-Russian Congress of Soviets, called into being by the Bolsheviki as the lawgiving body of Russia, finally announced its approval of a repudiation of Russia's debts on 25 January 1918 which lead to the Decree on the cancellation of state loans.[144] There is no evidence for Sack's using the Soviet Financial Manifesto of 1905 for his doctrine, but for a professor of international law specialising in money and banking during in St. Petersburg during this period it seems unlikely that he had not analysed the Soviet's demands to cut off the tsarist government of its foreign funds.

143 George Garvy, 'The Financial Manifesto Of The St. Petersburg Soviet 1905', (1975) International Review of Social History, Cambridge University Press, Cambridge, 20(1) 31

144 UP Petrograd, 'All-Russian Soviet repudiates all of Russia's debts', United Press (25 January 1918), UPI Washington, D.C. <https://www.upi.com/Archives/1918/01/25/All-Russian-Soviet-repudiates-all-of-Russias-debts/2519718371401/> accessed 10 October 2018; Decree on the cancellation of state loans January 21 (February 3) 1918, Decrees of Soviet power. T.I.M., Gos. Publishing House Polit. Literature, 1957 <https://www.hist.msu.ru/ER/Etext/DEKRET/borrow.htm> accessed 21 October 2018

3. The Shortcomings of the Odious Debt Doctrine

After Sack's initial proposal has been analysed, as well as the work of the doctrine's predecessors, its shortcomings can be examined. The odious debt doctrine seems to contain elements of the works of Aristotle, Grotius, Plato, as well as of Russian, English and German law. Consequently, these elements sound very familiar, the discussed various legal elements are used in practice and are automatically expected to bring the desired result – the lawful repudiation of debt that is considered illegitimate. Yet, the way how this doctrine is constructed obstructs its own use.

3.1. The Odious Debt Doctrine is not Part of International Law

A variety of historic cases are cited to support the odious debt doctrine. Yet, the doctrine has not been invoked by the parties involved in the cases that followed Sack's definition from 1927. The United States of America, for example, declared Spanish debt secured by Cuban revenues "odious"[145] in 1898. It was argued that the debt was not contracted for the benefit of Cubans but to suppress them and therefore the loans were hostile. Cuba had not consented to the loans and the creditors knew that Spain had secured the loan with Cuban revenues in order to suppress the Cuban struggle for freedom. Therefore, the creditors "took their obvious chances of their investment on so precarious a security." The debt was not assumed by Cuba or the United States of America in the Treaty of Paris 1898 although Spain did not change its position.[146] A very similar test was applied in article 254 of the Treaty of Versailles 1919 to German debt incurred for the colonization of Poland before 1 August 1914, resulting in an exemption of Poland as a successor state from paying these loans.[147] Modern day examples are Iraq (2004) and Ecuador (2009). The Correa administration managed to renegotiate a large part of Ecuadorian debt: right after the elections, the president declared that Ecuadorian sovereign debt was illegitimate since it was contracted by juntas.[148] About a year later, Ecuador defaulted by not paying one instalment of interest and Correa declaring the debt "immoral".[149] Shortly after, Ecuador managed to buy back its bonds at one third of the face value, thus reducing its sovereign debt by about one quarter.[150] According to Eric Toussaint, the deciding conference took

145 Robert Howse, 'The Concept of Odious Debt in Public International Law', *UNCTAD Discussion Paper No. 185,* Geneva, July 2007, 11, even Germany had recognized Costa Rica although the Tinoco administration had declared war against Germany. The U.S.A., the U.K., France and Italy refused Costa Rica's recognition.
146 ibid 10-11
147 ibid 11
148 Lester Pimental, "Ecuador, Calling Debt 'Illegitimate,' May Repay 40%", *Bloomberg* (18 January 2007)
149 Anthony Faiola, 'Calling Foreign Debt 'Immoral,' Leader Allows Ecuador to Default', *The Washington Post* (13 December 2008)
150 Maria Eugenio Tello, 'REFILE-Ecuador plans "very large" cut in debt restructuring', *Reuters* (15 December 2008)

place on 10th and 11th April 2003 in Washington during which the United States administration had two objectives: declare the regime and its debt odious in order to legitimize a military campaign against Iraq, and to free the oil revenues from loan payments to France, Germany and Russia in order to finance Iraq's reconstruction.[151] Through this pressure and support of the international civil society[152], Iraq had its debt reduced by 80 per cent.[153] In the cases of Ecuador and Iraq alike, however, the odious debt doctrine has not been invoked, albeit the term has been widely used in the discussions leading up to the renegotiation of the payment terms and the overall debt.

Hence, due to the lack of application, the odious debt doctrine cannot be considered part of international customary law.

3.2. The Suppression of the Population is not Defined

The definition states that the loan has to be used to enrich the government or its entourage, or to suppress the opposition, for example. It remains unclear, if 100% of the loan have to be used for the suppression of a popular uprising in order to reach the threshold of odiousness, or if a smaller amount is sufficient. This is particularly important from a practitioner's point of view since loans and bribes will frequently be combined in the contract in one sum, out of which certain amounts constitute the loan itself and the other amounts the bribe, for example the 100% loan sum will contain 30-40% bribe – but the total of 100% supposed to be paid back by the state, although government and lender are aware of the fact that the 30-40% extra expenses serve as a catalyst for the government's signature. It is likely that it is not necessary to embezzle 100% of all loans, as the definition speaks of an embezzling of funds for personal enrichment and/or suppression of the opposition which then leads to an increase of the state's debt. This suggests a lengthy process since grabbing 100% at once is reminiscent of robbery rather than embezzlement.

3.3. Differences Between Bankruptcies, Defaults and Odious Debt

As stated above, this thesis focuses on sovereign debt derived from contractual obligations vis-a-vis a private lender. Under normal circumstances states will pay these loans with interest according to the contract. But occasionally states cannot meet their contractual obligations, so they end up in default or are forced to declare bankruptcy. Lex Rieffel defines default as the situation in which the state "(…) income is insufficient to meet a

151 Éric Toussaint, 'The Odious Iraqi Debt', CADTM – Committee for the Abolition of Illegitimate Debt, Liège, Belgium, 12 December 2017
152 Patricia Adams, 'Iraq's Odious Debts' (28 September 2004) Cato Institute, Washington D.C.
153 ibid 8

scheduled payment of interest of principal."[154] If the problem is only temporary and payments can be covered by new loans, the state has a liquidity problem. If the loans and other liabilities outstanding exceed the assets and revenue and therefore are impossible to be paid, the borrowing state is insolvent. Bankruptcy is the legal consequence, and it will be necessary to arrange for a reduction of principal and / or interest to restore that state's creditworthiness, to solve the solvency problem.[155] State bankruptcies are so common and widespread, that there are hardly any nations that did not have to declare bankruptcy already. Spain was among the first in the early modern period and declared bankruptcy three times in the 16th century[156], adding another three defaults in the 17th century. France defaulted eight times between 1558 and 1788, also the other emerging European powers of Austria, England, Portugal and Prussia defaulted during that era. In the past 200 years from 1800 up to 2008 bankruptcies have globally been rather the rule than the exception.[157] Noteworthy bankruptcies in the 20th century were the Soviet default of 1918 when the newly founded Soviet Union refused to pay for the tsarist debt. German bonds are regarded as one of the safest investments available, but Germany had to declare bankruptcy twice after the World Wars, in 1923 and 1945. The "Nixon-Shock" in 1971 was a de-facto default of the United States of America. On 15 August, the U.S. government decided unilaterally in breach of the Bretton Woods Agreement, that the U.S. dollar was not convertible into gold any longer. It was neither a liquidity nor a solvency problem but a third category besides Rieffel's definition – a default based on the unwillingness to pay.

Odious debt, however, does not mean a state is unable to pay due to a bankruptcy or a default. Independent from its financial capacity, the doctrine claims a state does not have to pay its lenders, because the state should have the legal claim that its debt is odious. Therefore, if odiousness were to become a legal and a valid reason to refuse payment, it would constitute neither a default nor a bankruptcy. Then its application should actually have no negative impact on the credit rating. On the contrary, ratings should improve, since the new government proved its adherence to the rule of law offering future lenders a stable and trustworthy legal environment. As Lord Chief Justice and Master of the Rolls Tom Bingham and former chairman of the Federal Reserve Bank Alan Greenspan put it: the rule of law is the single most important contributor to economic growth.[158]

Most importantly, however, Sack's suggestion does not explain if the odious debt doctrine systematically leads to a more or a less than a bankruptcy. If odious debt is not available

154 Lex Rieffel, *Restructuring Sovereign Debt* (Brookings Institution Press 2003) 13
155 ibid 14
156 1557, 1575 and 1596 all declared by Spanish King Philip II.
157 For an overview on the history of sovereign defaults see Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different – Eight Centuries of Financial Folly* (Princeton University Press 2009) 86 - 100
158 Tom Bingham, *The Rule Of Law* (Penguin Books 2011) 38

for Argentina because it is a democracy, then the classic tool for Argentina to repudiate debt would be bankruptcy. However, is this limitation of democracies to bankruptcies supposed to mean that invoking the odious debt doctrine would give the affected state a better legal tool than bankruptcy if a bankruptcy means that the state cannot and will not pay any of the remaining debt? In other words, would a state fare better with a default, a bankruptcy or a repudiation of debt based on the odious debt doctrine?

The Argentinian and South African cases also clarify that Sack's doctrine does not explain if the claim repudiation based on odiousness is subject to a statute of limitations in any way. If Argentinians and South Africans have lived in democracies for several decades already, would they still be able to repeal debt of their previous regimes now that they have been paying these loans ever since? Is there a point in time before which claims cannot be raised, yet, or a statute of limitations after which they cannot be raised any longer?

So far, each attempt to develop a legal framework for odious debt has failed just like any attempt to put state bankruptcy on a stable legal foundation. Only two permanent forums exist for the restructuring of sovereign debt between borrowing states and the member states, the London Club and the Paris Club with a so-called ad-hoc machinery[159] as described by Lex Rieffel.[160] And Kunibert Raffer's 1987 proposal to apply the basic features of the Chapter 9 U.S. bankruptcy law to international bankruptcies was not made use of by the international community although Chapter 9 would have offered a blueprint to solve this problem.[161]

3.4. No Clear Separation of Contract Law and Criminal Law

At a glance, odious debt could be confused with crimes, as the debt is created under circumstances that most people consider wrong and criminal. It contains aspects akin to slavery but is especially linked to corruption and the misappropriation of funds. Odious debt and corruption might seem to blend, in particular because it is possible that corruption leads to odious debt. In reality, however, both aspects have to remain separated as they belong to different bodies of law.

First of all, odious debt originally stems from a contractual obligation, a loan agreement between lender and borrowing government. Based on the odious debt doctrine it depends

159 See also the publications of the Paris Club on its homepage, such as http://www.clubdeparis.org/en/communications/page/the-six-principles http://www.clubdeparis.org/en/communications/page/standard-terms-of-treatment
160 Lex Rieffel, *Restructuring Sovereign Debt* (Brookings Institution Press 2003)
161 Kunibert Raffer, 'Odious, Illegitimate, Illegal, or Legal Debts: What Difference Does It Make for International Chapter 9 Debt Arbitration?' (Autumn 2007) Law and Contemporary Problems, Vol. 70 No. 4, Durham, U.S., 221-247

on a variety of factors whether a loan turns odious since not every loan contracted by a government that is called illegitimate by some is misused according to the definition.[162] Subject to the definition, the odiousness of the lender's claim serves as the ground for the annulment of the borrower's payment obligation.

Secondly, the purpose of payments and the money flows are different. For example, corruption in an arms deal could facilitate the purchase of tanks with the help of a bribe. In such a case the bribe money is the catalyst that helps one offer for tanks to prevail over the other once the money flows from the manufacturer to the government officials who control the tender. Just like the tank is the product of an arms producer, the loan is the product of a bank, and it is this loan and the interest rates connected to it which could turn odious under certain conditions. But the bribe that was used to enhance the chance of the bank to be able to sell that loan to the government instead of another bank is merely a case of corruption. This case of corruption doesn't mean that the loan can still remain a legitimate part of sovereign debt, if adequately used.

At a later point Sack also expressly includes credit claims into odious debt which are based on loans that were embezzled for the personal enrichment of the government's members and their supporters into odious debt.[163] This seems to constitute an explanation of the term "not for the needs or in the interests of the state" used in the original definition. Yet, when odious debt can also emerge from corruption or embezzlement and not only from the suppression of the opposition in order to fortify the ruling power's position, then the lender's "hostile act" against the population based on the lender's "knowledge" that the funds would be misused cannot be part of the definition, as semantics connect hostile acts via knowledge to a certain degree of violence in the form of antagonistic actions and attitude. Unlike that, corruption or embezzlement require secretiveness to deceive the public, while loans are not handed out as an act of hostility but for profit. The "hostile act" and "knowledge" of the lender therefore cannot be a constitutive factor of odiousness in the sense of the lender's condoning of any violence committed by the government against the citizens. If the lender's knowledge and hostility are not a precondition for debt to turn odious then knowledge and crimes play only a role in defining the likelihood of the public's approval of how the government used the funds.

162 See above fn 23-25, illustrating that neither the Greek Regime of the Colonels, nor the Portuguese Estado Novo, stole funds and impoverished the state but reduced the debt burden, instead.

163 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 158 "On pourrait également, ranger dans cette catégorie de dettes les emprunts contractés dans des vues manifestement intéressées et personnelles des membres du gouvernement ou des personnes et groupements liés au gouvernement - des vues qui n'ont au cun rapport aux intérêts de l'État."

In spite of that, this does not mean that debt cannot turn odious with the knowledge of the lender. If the lenders knows about the regime's abusive character but they enter into loan agreements nevertheless, odiousness of the contract is still likely.

As the odious loan contract benefits the government and the lender, while it exploits the population, the situation is in principle also comparable to two crimes related to slavery, human trafficking and debt bondage. Since human trafficking could be associated with the transfer of victims to a new environment, it is important to point out that relocation is not a precondition for human trafficking,[164] exploitation without consent of the victim is. Even where victims would consent to the exploitation, their consent is deemed irrelevant by the United Nations Protocol to Prevent, Suppress and Punish Trafficking in Persons, Especially Women and Children.[165] As the travaux préparatoires to this Protocol show, delegations to the Ad Hoc Committee on the Elaboration of a Convention against Transnational Organized Crime agreed in majority that consent of the victim is irrelevant for the question if the victim had been trafficked, particularly because the means of trafficking preclude consent. Additionally, several delegations wished to avoid the impression that consent in any way was possible at all. It was also pointed out that in practice consent or the ability to consent would change over time, therefore making it difficult to prove the lack of consent, while the crime was ongoing. Therefore the Committee agreed that the Protocol and legislation implementing it should reduce these problems for the prosecution and victims as much as possible.[166] This logic could be applied to odious debt, where the population is exploited because the government and the lender enter into a credit contract according to which the lender gives money to the government in the form of a loan in the name of the state and both agree that the citizens will pay for principal and interest. The regulation that consent is deemed irrelevant in human trafficking is an important parallel to odious debt where the population has to pay the loan against her will or it can be assumed that the population would not have supported the loan and its use, if they had sufficient information. In order to clarify if the ruling power acted in the public interest, an objective reasonable person could ask if it is likely that the population would have agreed to pay the lender principal and interest in order to let the ruling power use the borrowed money the way it did. If the spending was in accordance

164 United Nations Office on Drugs and Crime, Legislative Guide for the Implementation of the Protocol to Prevent, Suppress and Punish Trafficking in Persons, especially Women and Children (Vienna 2020) 29 nr 90

165 United Nations Protocol to Prevent, Suppress and Punish Trafficking in Persons, Especially Women and Children, of the United Nations Convention against Transnational Organized Crime A/55/383 (adopted 15 November 2000, 29 September 2003), Article 3 (a) and (b)

166 United Nations Office on Drugs and Crime, Travaux Préparatoires of the negotiations for the elaboration of the United Nations Convention against Organized Crime and the Protocols thereto, New York 2006, 344 fn 26

with human rights or furthered the fulfilment of Maslow's hierarchy of needs[167] of the population, it is likely that government spending was in the public interest.

It is the co-operation of the government with the lender for mutual benefit and to the detriment of the citizens which could be described as a collusion that makes this debt odious. In both, the crimes of human trafficking and debt bondage as well as in the case of odious debt, the victims have no decision-making powers while someone else is benefiting from their work and services. In the first case it is either the trafficker or a criminal organization and their clients while it is the government and its lenders in the second case. In order to prevent this kind of exploitation, a large variety of treaties have been developed:[168] for example, article 5 of the Charter of Fundamental Rights of the European Union prohibits all forms of slavery, forced labour and human trafficking. The 2000 United Nations Protocol to Prevent, Suppress and Punish Trafficking in Persons, Especially Women and Children defines in article 3:

> Trafficking in persons shall mean the recruitment, transportation, transfer, harbouring or receipt of persons, by means of the threat or use of force or other forms of coercion, of abduction, of fraud, of deception, of the abuse of power or of a position of vulnerability or of the giving or receiving of payments or benefits to achieve the consent of a person having control over another person, for the purpose of exploitation. Exploitation shall include, at a minimum, the exploitation of the prostitution of others or other forms of sexual exploitation, forced labour or services, slavery or practices similar to slavery, servitude or the removal of organs.

And EU directive 2011/36 section (11) on human trafficking states "when a child is concerned, no possible consent should ever be considered valid" - in the case of odious debt not only children, but the general public's formulation of consent is made impossible by the government. These treaties show a widely acknowledged practice in international law to prohibit the exploitation of humans. None of the relevant legal instruments limits the number of victims, therefore it is unlikely that the exploitation of a nation or parts of it would not match the preconditions of these crimes. If the victims lack decision-making power, it could be argued that there is a lack of agency in the representation of the population and therefore a loan contract should be voidable under similar circumstances. The above definition of exploitation contains "at minimum" practices such as forced labour or services, slavery and similar practices. Due to the lack of consent, the work necessary to

167 A.H. Maslow, 'A theory of human motivation' (1943) *Psychological Review*, 50(4), 370–396

168 Further international law on human trafficking and forced labour or services is included in the United Nations Convention on the Rights of the Child A/RES/44/25 (adopted 20 November 1989, entry into force 2 September 1990), the Council of Europe Convention on Action against Trafficking in Human Beings CETS No. 197 (Warsaw 16 May 2005), the International Labour Organization Forced Labour Convention No. 29 (C029, adopted 28 June 1930, entry into force 01 May 1932) and the OSCE action plan against human trafficking, Ministerial Council Decision MC.DEC/2/03 (02 December 2003)

pay off an odious loan seems to suit the description and it remains to be seen if a court will decide accordingly.

Debt bondage is a form of slavery. It is defined in article 1 (a) of the Supplementary Convention on the Abolition of Slavery, the Slave Trade, and Institutions and Practices Similar to Slavery, Geneva, 7 September 1956: "Debt bondage, that is to say, the status or condition arising from a pledge by a debtor of his personal services or of those of a person under his control as security for a debt, if the value of those services as reasonably assessed is not applied towards the liquidation of the debt or the length and nature of those services are not respectively limited and defined;" For any loan contract that creates sovereign debt, arguably the government pledges the taxes it can derive from the citizens' work as security for the loan. The yardstick for a reasonable assessment of the value of the citizens' work is the world market of goods and services. But in the context of potentially odious sovereign debt, it depends on whether or not it is possible to prove that the value generated is not used for the liquidation of the debt or that the duration of these services is not limited or defined. In some cases, loan contracts are constructed in a way that suggests the aim was to keep the state over-indebted in order to either extort a certain behaviour of the government, for example favourable votes in international fora and to obtain other political favours, which means the nature of those services are insufficiently defined and have nothing to do with the nature of the claim. The construction of the loans also ensures frequently that new loans have to be taken in order to pay off old debt.[169] That way, debt is continuously rolled over without the perspective of ever getting the state out of it. Company stores would be an example of a similar practice in labour relationships which have been banned for the same reason.[170] Company stores were an opportunity to redirect salaries back into the company and to make employees dependent on the company by paying them scrip issued by the company instead of legal tender: Changing the scrip into legal tender was either impossible, meaning the workers were forced to make their purchase exclusively at the company store, or the salary was decimated drastically by exchange rates and fees. As coal mines, railroads and other companies set up company stores in remote rural places, the limited competition led to a monopoly position for the company store which charged the employees high prices. No or limited competition combined with high prices frequently made workers dependent on company-credit. Once indebted to the company, workers were forced to work for the company until they paid their debt which is one type of debt

169 An illustration of contractual elements that cause over-indebtedness of states, see the legal analysis of the risk premiums in interest rates by Oliver Pahnecke, Juan Pablo Bohoslavsky, 'Interest Rates and Human Rights: Reinterpreting Risk Premiums to Adjust the Financial Economy' The Yale Journal of International Law Online [Vol. 46:1 2021]

170 The United States outlawed payment in scrip in the Fair Labor Standards Act of 1938: 29 CFR § 531.34 – Payment in scrip or similar medium not authorized; Great Britain in the Truck Acts of 1725, 1831, 1887, 1896 and 1940

bondage.[171] In case it were possible to prove that the case at hand was debt bondage – or human trafficking in the previous example – the loan would constitute a *ius cogens* violation because both examples are forms of slavery which is absolutely prohibited. Article 53 of the Vienna Convention on the Law of Treaties states under the headline "Treaties conflicting with a peremptory norm of general international law ("*jus cogens*"):

> A treaty is void if, at the time of its conclusion, it conflicts with a peremptory norm of general international law. For the purposes of the present Convention, a peremptory norm of general international law is a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character.

Although the Vienna Convention on the Law of Treaties applies to treaties between states, according to its article 1, there seems to be no argument for upholding a simple contractual obligation between state and investor under the same circumstances under which a treaty between sovereign states would be void. Because that would mean that a contract between a sovereign state and a private investor would enjoy a privilege that a treaty between states does not.

The Vienna Convention could therefore connect *ius cogens* with odiousness. As indicated above, several preconditions of the original doctrine are not clearly defined. For example, it is difficult to decide what level of force the loan contract of government and investor has to lead to, so the loan falls under the odious debt doctrine – at least according to the original odious debt proposal. But while profit from *ius cogens* violations should suffice if the classic doctrine would be superficially applied, military regimes such as the above-mentioned Estado Novo in Portugal and the regime of the Colonels in Greece are less likely to fall under this doctrine since they reduced public debt. Ruling powers that pledge the tax revenue for loans that are not going to be used in the public interest, profit from the citizens' work without offering any benefit in return. Such powers take unfair advantage of the citizens and their inability to control the spending, in particular if there is no or no efficient opposition, hence, their profit is the result of exploitation. As the misuse of funds makes higher financial burdens of the citizen unavoidable to cover the expenses for sovereign debt, such loans reduce private property. This violates the social contract, according to which the individual makes the rational choice to accept a useful government while it is protected from violence by others and oppression from the state, an idea which

171 The song "Sixteen Tons" released by Merle Travis in 1947 (and its 1955 cover-version of Tennessee Ernie Ford) describes the working conditions of coal miners and their dependency on company stores with famous lines such as "You load sixteen tons and what do you get? Another day older and deeper in debt." or "St. Peter don't you call me cause I can't go, I owe my soul to the company store".

has influenced law ever since Locke and Rousseau.[172] A ruling power that uses funds for its own interest, instead of protecting private property and well-being of the citizens, breaks the social contract and exploits the citizens. Although the abolition of slavery is nothing new,[173] Sack did not make this analogy to slavery. In spite of that, Sack underlines the abusive character of the activities of government and lender which should lead to a voidable contract since it violates international law is reflected in the attempts to combat slavery and the newer phenomena such as debt bondage, human trafficking and modern-day slavery. In her book on unconstitutional regimes and sovereign debt, Michalowski mentions slavery and forced labour in the context of *ius cogens*.[174] Unconstitutional regimes either aim at pursuing a political agenda or simply at exercising power. Therefore, dictatorships try to exercise absolute and unrestricted control. Political opposition threatens this control, and this is why dictatorships resort to the use of violence as this is the shortest way to suppress any opposition. *Ius Cogens* violations such as torture are therefore first and foremost a means to exercise political power while the economic exploitation of the citizens is only a by-product. But since Michalowski deals with the validity of sovereign debt of the Argentinian military regime of 1976-1983, infamous for torture, forced disappearances and other grave human rights violations, she focuses on the question if loans of the junta could be odious because of these *ius cogens* violations. In the light of the classic doctrine, this approach is promising as it seems feasible to connect serious crimes with a refusal to pay.[175] Focusing on torture and other crimes typical for dictatorships, however, combines crimes violating human rights with an obligation to pay loans but this does not appear to be common practice in international law. This dilemma can be approached also from another angle: what if a democratic government participates in *ius cogens* violations? Will that state's sovereign debt become odious because of these violations, or it cannot be repudiated because the government was democratically elected, or the odiousness of loans is to be evaluated on a case-to-case base? The Federal Republic of Germany participates in grave human rights violations by permitting the United States of America to use the Ramstein Air Base for their extrajudicial drone killings, for example. More importantly, these relationships result in different claims: crimes such as torture might lead to a claim of the individual citizen against the perpetrator state. But this thesis

172 John Locke, *Two Treatises of Government*, 1690; Jean-Jacques Rousseau, *Discours sur l'origine de l'inegalité*, 1755 and *Du Contrat social*, 1762; a predecessor was Thomas Hobbes, *Leviathan*, 1651.

173 Slavery was abolished in the British Empire in 1833 with the Slavery Abolition Act, in French colonies in 1794 and after a re-introduction by Napoleon again abolished in 1848, the North of the United States abolished slavery by 1804 and in 1865 throughout the U.S. with the 13th Amendment to the Constitution. Russia's Emancipation Reform of 1861 abolished slavery within the Russian Empire, all happening before Sack developed the odious debt doctrine.

174 Sabine Michalowski, *Unconstitutional Regimes and the Validity of Sovereign Debt – A Legal Perspective* (Ashgate 2007) 80

175 Yet, also Michalowski confirms that there is no unanimity as to whether or not the doctrine of odious debt is part of international law, see Sabine Michalowski, *Unconstitutional Regimes and the Validity of Sovereign Debt – A Legal Perspective* (Ashgate 2007) 43

examines under what circumstances a state can refuse the payment claim of lenders which is a different aim. As the exerted violence is a means to force the population into submission and acceptance of the political situation while it is taxed in order to pay off loans that are not used in the public interest, one could speak of an aggravated exploitation. As a consequence, one could argue that the proof of "odiousness" becomes easier, if the exploitation facilitated or at least was flanked by violent crimes and human rights violations. But the heinousness of some of these crimes diverts the analysis. Sack added the suppression of a popular uprising, as well as the knowledge and hostile acts of lenders to his proposal on odious debt although this does not offer a solution to the core problem: the lack of consent and the lack of benefit of the majority. Since there are two main parts of Sacks proposal, the one of a despotic power suppressing the population and on the next page the case of corruption, these cases could either be seen as two distinct cases of odiousness or the actions of a despotic power are seen as a qualification of the basic odiousness of corruption[176]. It seems to be better to speak of two different cases of odiousness with the same outcome – repudiation of debt - for various reasons: firstly, regarding the despotic power's violent suppression of the population as a qualification is reminiscent of criminal law, which could be misleading in the context of repudiating sovereign debt which only affects the legal relationship between lender and borrower, not the relationship state - citizen. Secondly, an aggravated case in the sense of a qualification is not going to lead to a more than the possible 100% of repudiation. It is a question how to reach the repudiation of debt at all, but the legal questions surrounding damage claims or punitive damages are settled questions in national law, so the latter do not require attention here. Thirdly, it is clear that violence can be used in order to achieve exploitation or that violence can lead to exploitation as a side effect. But if odiousness is possible also without violence, as the original text suggests, then loans can turn odious independently of violence and loans of dictatorships are only a special case. This makes sense, since it matches the systematic division of criminal law and contract law and odiousness, or any such means to repudiate contractual claims, is only concerned with the latter.

Apart from the effects of crimes on contractual relationships, it is helpful to look at the contractual obligations, too. This opens the analysis to the question of how the citizens could express their consent to governmental actions and if the ruling power had the necessary agency to enter a contract on the state's behalf, opening another approach to the odiousness of sovereign debt. Such a position was taken by the International Law Commission when the Vienna Convention on the Succession of States in respect of State

176 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 157-158, 163

Property, Archives and Debts (1983) was drafted. Special Rapporteur Mohammed Bedjaoui proposed the following draft definition of odious debt:

> For the purposes of the present articles, “odious debts” means: (a) all debts contracted by the predecessor State with a view to attaining objectives contrary to the major interests of the successor State or of the transferred territory; (b) all debts contracted by the predecessor State with an aim and for a purpose not in conformity with international law, in particular, the principles of international law embodied in the Charter of United Nations.[177]

Bedjaoui submitted a definition of odious which differs significantly from the original proposition of Sack’s. This definition does not require any knowledge on the side of the lender at all and is simply based on the violation of the interest of the majority population. This represents the minimum precondition for odiousness, all other elements are simply descriptions of the different stages of violence against the citizens. Bedjaoui showed that it is possible to base odiousness as a reason for debt repudiation on the concept of “the population’s interest”. The other elements that have been discussed over the years, such as knowledge of the impending misappropriation of funds and *ius cogens* violations, for example, are only explanatory or descriptive in nature. The analysis, therefore, has to concentrate on how the “population’s interest” can be violated to such a great degree that a repudiation of sovereign debt is justified.

As Sack proposed the odious debt doctrine in the context of a despotic power, the focus lies naturally on the suppression through crimes and other activities rather than on the financial side. The financial side is probably less graphic and does not evoke emotions as the actions of a dictator but in fact finance is of no less importance than the crimes themselves because finance is their *conditio sine qua non* for all the crimes of the perpetrator state have to be financed by somebody. If *ius cogens* violations such as slavery or torture and other crimes are used as tools to exploit the population, then the connection between crime and fulfilment of the loan contract could turn sovereign debt odious. Connecting the violation of *ius cogens* with loans could result in a mechanism combatting illegal use of lending in a way akin to the odious debt doctrine. After all, all human rights violations need financing in order to be committed. To avoid a mix of crimes and contracts, “the interest of the population” leads the legal discussion to the loan contract and its elements. “The interest of the population” needs to be formulated in some way and a defect in the formation of the contract could therefore be the actual legal base for odiousness and the repudiation of sovereign debt.

177 Mohammed Bedjaoui, *Ninth Report on Succession of States in respect of matters other than Treaties*, A/CN.4/301, 2 *Yearbook International Law Commission* 1 (1977) 74; Bedjaoui worked on State Succession in this report, therefore his definition of odious debt has to be seen in this context. It does not mean that State Succession is the only situation in which odious debt could emerge.

3.5. Lack of Further Definitions

Unfortunately, Sack's work lacks definitions, for example it does not contain a definition of "despotic power".[178] Is a government already despotic when it rigs election laws in a way that it becomes unlikely that it is voted out of office, hands over the decision-making to algorithms rendering elections redundant, or is it necessary to resort to physical violence? Is it then sufficient to injure protesters once, from time to time, or is it necessary to do it on a regular basis, or maybe forced disappearances, dark sites and torture are necessary for despotism?

Just as unclear remains if "fortify its despotic regime" and "to suppress the population, which fights that power"[179] are supposed to be used cumulatively or alternatively. "[E]tc.", however, seems to point to an open-ended enumeration of alternatives. Like with the definition of "despotic", Sack leaves undecided what percentage of the population needs to rise up to fight that power and if violence is necessary to form a resistance that would fulfil his criteria. Sack's uses the term "power", rather than "regime" or "government" which could mean that he considers that states are sometimes also obligated to contract debt by outside forces.

Sack also added another requirement to the doctrine: the lender's knowledge[180] that the loan's funds are going to be used contrary to the national interest. Some authors see the whole section as a definition which comprises three elements of odious debt: "absence of consent, absence of benefit, and creditor awareness of both."[181] But the definition's opening sentence clearly states that debt is already odious, when it is not used in the interest of the state but for strengthening the ruling power, which makes this provision of knowledge redundant. This reading is supported by the fact that Sack reiterates the non-binding character of odious debt with the preceding sentence without mentioning the creditor's awareness: "The reason why these "odious" debts cannot be considered as encumbering the territory of the state is that these debts do not correspond with any of the preconditions determining the regularity of sovereign debt, i.e. sovereign debts must be incurred and the funds derived from them must be used for the needs and in the interest of the state."[182] If

178 A.-N. Sack, Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières (Librairie Recueil Sirey, Paris 1927) 157 "(…) un pouvoir despotique (...)"

179 ibid "(...) fortifier son régime despotique, pour réprimer la population qui le combat, etc.(...)"

180 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 157 "Les dettes «odieuses», contractées et utilisées à des fins lesquelles, au su des créanciers, sont contraires aux intérêts de la nation, (...)"

181 Jeff King, *The Doctrine of Odious Debt in International Law – a Restatement* (Cambridge University Press 2016) 52-53

182 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 157 "La raison pour laquelle ces dettes «odieuses» ne peuvent être considérées comme grevant le territoire de l'État, est que ces dettes ne répondent pas à l'une des conditions qui déterminent la régularité des dettes d'État, à savoir celle-ci: les dettes d'État doivent être contractées et les fonds qui en proviennent utilisés pour les besoins et dans les intérêts de l'État (supra, § 6)."

the lender's knowledge were a constituting factor of odiousness, Sack would contradict his own description of how little information the lender has when debt is incurred: "At the conclusion of the loan, the creditors can only rarely foresee the destination or the use of the sums of the loan. Since the money from the loan is at the free disposal of the government, the latter can put it to whatever destination it pleases."[183] Therefore the second half is an explanation rather than a part of a definition.

He also writes[184] that the government had to be successfully overthrown in order for the debt to become non-binding unless there were real advantages obtained from the debt, which then would limit the level of debt that could be repudiated. Sack states that the contract becomes non-binding through a successful uprisal, only. In other words, Sack thinks that if the uprising is not successful, the payment claim remains binding. Sack sees a loan contract, that is intact and loses its binding force through the uprising rather than an invalid loan contract due to the lack of consent, where beneficial side effects could be approved by a different government later on or enforced through justified enrichment claims. He conflates the fact that the population can refuse payment only once its free will can be finally expressed when the danger for the nation is over and the fact that real advantages from the debt cannot be odious anyway since they benefit the population, such as necessary infrastructure. Since Sack defined the odiousness of debt and its non-binding character already at the beginning, this additional requirement is contradictory, just as the factors "knowledge" and "hostile act" which can only be considered an additional indicator for odiousness. Knowledge and hostility seem to aim at the criminal category of "intent" and "offence" and do not facilitate the desired debt repudiation, since the decisive question for debt repudiation is whether the sovereign debt is the result of loans that have been used in the interest of the public or not. It is the same with *ius cogens* violations in the context of odiousness: they can be useful in demonstrating that the public would more likely than not have disapproved of the loan, the debt connected to it and the use of its funds – but for proving of the use in itself and for the question of civil claims arising from this, this question is redundant.

183 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 27 "Lors de la conclusion de l'emprunt, les créanciers ne peuvent que rarement prévoir la destination ou l'emploi des sommes de l'emprunt. Puisque l'argent de l'emprunt est à la libre disposition du gouvernement, ce dernier peut lui donner la destination qui lui plaira."

184 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 157 "Les dettes «odieuses», contractées et utilisées à des fins lesquelles, au su des créanciers, sont contraires aux intérêts de la nation, n'engagent pas cette dernière - au cas où elle arrive à se débarrasser du gouvernement qui les avait contractées - sauf dans la limite des avantages réels qu'elle a pu obtenir de ces dettes (v. supra, § 6)."

Sack claims twice,[185] once the debt had turned odious, it would become the personal debt of the officials that incurred the debt and therefore the debt would fall with the demise of the regime, but he does not give any reason how this happens. His proposal does not explain how the debt would legally migrate from the state to the person who has represented the state upon entering the contract. It does not explain either, if the migration of the debt takes place while that person is still a government official or only once the official was turned into a private person. Additionally, it remains unclear, if only the signatory would become personally liable. This could mean that people will become personally liable who have not much to decide in the government, while the heads would not bear any responsibility at all. Equally important would be a clarification as to how personal liability would look like in the cases of spouses, children and cronies who routinely benefit from the embezzled funds and have supportive functions, while they are only occasionally actively involved in politics and who are unlikely to sign the loan agreement.

4. Summary: Why Sack's Odious Debt Doctrine Cannot be Applied

Sack presents the Odious Debt Doctrine as if it were located where criminal law and contract law intersect and – even worse – pretends to offer a quick fix: debts of despots don't have to be paid. His doctrine is pieced together of well-known principles of law and philosophy while it lacks definitions for terms such as "despotic", "knowledge" and "hostile act". Since these elements are only explanations of additional variations, they do not define the doctrine but rather overburden and distract the reader. If debt repudiation is the goal, criminal law does not offer a solution. Instead, it makes sense to look for options in contract law that could help repudiate contractual claims, should contract law be applicable to sovereign debt.

In the realm of sovereign debt, the state acts within the boundaries of contract law because the state addresses lenders, such as investors, banks or citizens with the wish to incur debt beyond what can be raised through taxation, which means that the state would like to enter into a loan agreement, or business relationship with other parties. This undertaking is voluntary by nature and therefore is created between equal parties. The only legal option for the state to engage in voluntary loan or business agreements with private parties abroad and at home is a contract based on civil or common law because there is no other law

185 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 157 "Cette dette n'est pas obligatoire pour la nation; c'est une dette de régime, dette personnelle du pouvoir qui l'a contractée, (…)" and "(…) ils ne peuvent donc pas compter que la nation affranchie d'un pouvoir despotique assume les dettes "odieuses" qui sont des dettes personnelles de ce pouvoir."

available for this purpose. States traditionally act privately when entering into contracts with lenders, as Sack points out.[186] The opposite of this relationship is the fiscal subordination of the subject for taxation purposes, where the state imposes compulsory levies on citizens and corporations residing in the state's jurisdiction to fund government expenses. Tax law as a part of public law regulates for example the evaluation of taxable income and assets as well as the collection of taxes. Taxation is a sovereign relationship between state and individual, therefore tax law is not suitable to regulate voluntary loan contracts or bonds. Despite the two entirely different concepts of state-funding, they are connected: regularly the government will have to use taxes to guarantee the payment of the loans.[187] Consequently, it can be ascertained that the relationship between lender and borrowing state is private in nature, hence civil or common law principles apply.

If the relationship is a contractual one, one could seek debt repudiation two ways: In the case of violent dictatorships that do not consider public interest, the unconscionability of contracts could be an option, while corrupted governments that hold elections but embezzle funds under the pretext of funding various projects, a solution via agency law could be viable.

Third Chapter: Cases Related to Odiousness, Contractual Basis for Repudiation

Although the Odious Debt Doctrine is dysfunctional, some cases show that the repudiation of sovereign debt that is considered illegitimate can be achieved. The third chapter will therefore evaluate some of them in order to determine under which conditions debt repudiations are feasible.

1. The Tinoco Arbitration by Taft

The question of the validity of sovereign debt can come up in the context of state succession but successions are not a precondition for debt repudiation. State succession has been made part of the discussion about odious debt because Aristotle has been

186 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 31 quoting Paul Ruff, 32 quoting P. Guggenheim, 34 quoting G.S. Freund

187 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 44 quoting A. Moser, 61 quoting § 43 of the constitution of Sachsen-Meiningen-Hildburghausen.

misinterpreted and misquoted while Grotius' work on sovereign debt obligations has remained largely ignored. Analysing the work of Sack, Aristotle and Grotius, this thesis clarified that the successions of states and governments are not helpful in the quest for equitable debt repudiation but rather a distraction. This claim is confirmed by the Tinoco arbitration award, one of the cases regularly cited in the context of odious debt because at first sight it looks very much like the blueprint for the Odious Debt Doctrine. Nevertheless, Sack used it merely for his analysis of state and government succession[188] without making any reference to it in his chapter on odious debt. The second chapter demonstrated what factors rendered Sack's doctrine dysfunctional, but why did Taft's arbitration award reach an equitable repudiation of sovereign debt, if the doctrine and the award are similar?

In 1923 the Chief Justice of the United States of America, William H. Taft, was asked to decide the Tinoco Claims Arbitration of Great Britain v. Costa Rica.[189] The Tinoco arbitration award resolves the dispute over a payment claim and an exploration concession without resorting to any theory about state succession. This is worth mentioning because this case is based on claims that are connected to three successive Costa Rican governments that changed by way of revolutions.

The first part of the arbitration award concerned a loan Costa Rica refused to pay. These loans had been taken by former dictator Federico Tinoco on behalf of Costa Rica and were then used for private purposes. Taft confirmed the British view that Tinoco had formed a "sovereign" and "*de facto* government" initially with public support and recognized by many Latin American and European governments.[190] Thus, the Tinoco government could legally bind Costa Rica but the debt in question was not public debt as it was not in the public interest and for private purpose only. According to Taft, the bank had been aware of the personal enrichment as well as the popular movement to overthrow the government. Based on the submissions of the parties during the arbitration, Taft found the bank had extended the loan despite its knowledge about this situation and therefore ruled in favour of Costa Rica's repudiation of the British payment.

The Tinoco arbitration award not only offers support for a default on sovereign debt that is incurred for private purposes, it also offers support for a solution using the agency of government instead of discussing the question of state succession:

> It is ably and earnestly argued on behalf of Costa Rica that the Tinoco government cannot be considered a de facto government, because it was not established and maintained in accord with the constitution of Costa Rica of 1871. To hold that a

188 A.-N. Sack, *Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières* (Librairie Recueil Sirey, Paris 1927) 2-3, 11
189 *Tinoco Arbitration* (GB v Costa Rica) (1923) 1 RIAA 369
190 ibid 380

> government which establishes itself and maintains a peaceful administration, with the acquiescence of the people for a substantial period of time, does not become a de facto government unless it conforms to a previous constitution would be to hold that within the rules of international law a revolution contrary to the fundamental law of the existing government cannot establish a new government. This cannot be, and is not, true. The change by revolution upsets the rule of the authorities in power under the then existing fundamental law, and sets aside the fundamental law in so far as the change of rule makes it necessary. To speak of a revolution creating a de facto government, which conforms to the limitations of the old constitution is to use a contradiction in terms. (…) The issue is not whether the new government assumes power or conducts its administration under constitutional limitations established by the people during the incumbency of the government it has overthrown. The question is, has it really established itself in such a way that all within its influence recognize its control, and that there is no opposing force assuming to be a government in its place? Is it discharging its functions as a government usually does, respected within its own jurisdiction?[191]

In other words: an internationally recognized government based on a previous constitution is not necessary to bind the state contractually. This would render political movements obsolete and revolutions as well as international co-operation impossible. The deciding question is: does the de facto government work like any other government peacefully representing and taking care of its citizens? Then it is legitimate, it has agency to represent the state. If not, the debt incurred is called by Taft "unlawful".[192] He compares the Tinoco case to the Jarvis case where a government in demise could not legally bind the state of Venezuela, either. In this case, Paez, a Venezuelan citizen, was an insurgent against the government of Venezuela in 1849, and won Jarvis's support for the conspiracy, who supplied arms and a vessel. "This was a crime against the United States on Jarvis's part, because the United States was on terms of amity with Venezuela." The revolution failed but in 1861, however, when Paez was in Venezuela, a spontaneous revolution permitted him to grab power. In 1863 Paez issued bonds to Jarvis to compensate him for his expenses of 1849, right before the Paez government collapsed. Taft: "The commissioner held that there was no lawful consideration for the bonds. (...) It was a personal obligation of Paez, if it was an obligation at all. It was not a debt of Venezuela. It was invalid and unlawful because of its vicious origin, both by the laws of the United States and the laws of Venezuela."[193] Relevant for the repudiation in the Paez case was the crime Jarvis committed against the United States' law, that means entering the contract was connected to committing a crime, based on which there was no lawful consideration for the bonds, rendering the payment through bonds invalid.

Similar to Sack and the commissioner of the Jarvis case, Taft hints here at a possible shift in the obligations from the state to the previous head of government, Paez, but does not

191 ibid 381
192 ibid 394
193 ibid 383

elaborate on it any further. Instead, he focuses on the illegality of the underlying contract which made it impossible for the government in demise to legally oblige Venezuela to pay the expenses.

It was also argued that the Tinoco government had not been recognized by some other powers, such as France, Great Britain, Italy and the United States and therefore no succession of government had taken place, despite its recognition by several other states such as Argentina, Austria, Brazil, Denmark, Ecuador, Germany, Holland and Switzerland.[194] Recognition of a government is but one means to determine if a succession of government or state took place and if a sovereign government was formed that could legally bind the state:

> But when recognition *vel non* of a government is by such nations determined by inquiry, not into its *de facto* sovereignty and complete governmental control, but into its illegitimacy or irregularity of origin, their non-recognition loses something of evidential weight on the issue with which those applying the rules of international law are alone concerned. (…) Such non-recognition for any reason, however, cannot outweigh the evidence disclosed by this record before me as to the de facto character of Tinoco's government, according to the standard set by international law.[195]

Taft clarifies here that the recognition of government is not important, since the recognition depends on outside governments and their policies only. Instead, the de facto ability of the new government to govern the state is decisive, as recognition by foreign powers is merely the admission to the society of nations.[196]

In contrast to this outside relationship, the protection by way of diplomatic intervention a government can give a subject is only an internal matter with no legal effect to the outside: “It is urged that the subjects of Great Britain knew of the policy of their home government in refusing to recognize the Tinoco régime and cannot now rely on protection by Great Britain. This is a question solely between the home government and its subjects.”[197] In the same section Chief Justice Taft points out that a state could also issue a warning that its citizens would not be able to rely on their government’s support, as the United States of America had done in this case, unlike Great Britain. Alternatively, export and investment guarantees that are backed by state owned export credit agencies protect domestic business from risks abroad, such as expropriation, since 1917.[198] Be that as it may, related to the

194 ibid 380
195 ibid 381
196 ibid 384
197 ibid 384
198 For example, the German Hermes Kreditversicherung AG insured export risks in 1917, see: Press Archives of the Hamburgisches Welt-Wirtschafts-Archiv, hosted by the Leibnitz Information Centre for Economics, Hamburg, < https://pm20.zbw.eu/folder/co/0111xx/011102/about.en.html > accessed March 09, 2023. For information of modern-day regulations for OECD members, see Working Party on Export Credits and Credit Guarantees, ‘Recommendation Of The Council On Common Approaches For Officially Supported Export Credits And Environmental And Social Due Diligence (The “Common Approaches”)‘, TAD/ECG(2016)3, OECD, Paris

issue of debt repudiation, diplomatic interventions are a form of support that a government could give a lender registered in its jurisdiction, but they do not result in a legal claim to repudiate debt.

From the Tinoco arbitration it can be deduced that a de-facto government is able to legally bind the state it represents as long as it enjoys popular support. Therefore, claims directed against this state can be refuted only under limited circumstances. In his arbitration award, Taft describes the decline of support the Tinoco government faced turning it into a suppressive regime:

> It is evident from the exhibits that in the spring of 1919 the popularity of the Tinoco régime had disappeared, and that the political and military movement to end that régime was gaining strength. Supporters of the former government invaded the northern part of Costa Rica and the Tinoco government found it necessary to suspend the guarantees of personal liberty and establish martial law, beginning early in 1919, for periods of thirty days continuously renewed until its fall in September. The sinking credit of the Tinoco government and the expenses of the maintenance of the army raised in its defence, had produced a stress in its finances which led to the legislation authorizing the issue of the fifteen millions of colones. The emergency was illustrated in the use of the very irregular form of the notes of issue by the Banco Internacional de Costa Rica authorized by the legislation of June and July of 1919, and by a sale of the deposit of silver coin held in reserve by the Bank of Costa Rica, which acted as the national treasury. It became perfectly clear from the mob violence and disturbances in June and the evidences of the unpopularity of the Tinoco régime, that it was in a critical condition, and an agent of the Royal Bank testifies that the retirement of the Tinocos "was known as a positive thing about to take place (...)".[199]

Analogous to Aristotle, this section describes the characteristics of a régime that lost its authority to represent its people and thus lacks now the agency to legally bind the state: the government restricts the civil liberties of its citizenry and the army raised in the defence of the government increases the expenses. It is important to note that the army serves the interests of the Tinoco government, not Costa Rica as a whole. Therefore, it could be argued that also this constitutes a use of public funds for personal benefit. “Taft does not regard the political disorder and lack of control as dispositive on the Royal Bank claim, instead presenting them as part of the evidence that the loan was unlikely to serve valid state interests. (…) The existence of a legitimate government purpose appears to be the deciding point, with the extreme circumstances acting as supporting evidence.”[200] Just as the beginning and the end of agency has to be publicly declared by the principal, violence and uprisals are the public declaration that the right to represent people has ended. In its

199 *Tinoco Arbitration* (GB v Costa Rica) (1923) 1 RIAA 393
200 Lienau O., ‘Who is the "Sovereign" in Sovereign Debt? Reinterpreting a Rule-of-Law Framework from the Early Twentieth Century’ (2008) Yale Journal of International Law, Volume 33 Issue 1, 83

last phase, the Tinoco regime skirts laws that it used to comply with as a government and manipulates funds and accounts, in order to maintain access to credit which it uses to remain in power through financial favours or suppression and finally secures funds for its retirement abroad.[201]

The Tinoco case highlights not only the funding of potentates, but also of politically exposed people.[202] Not only Tinoco himself, also Tinoco's brother had received funds from the credit lines, too, and Taft points out how easy it would have been for the bank to detect that the funds were designated for unofficial use only:

> (…) the amounts, the dates, and the result leave no doubt (…) that (…) the credit to the government of $200,000 (…) and the withdrawal of $200,000 on August 2nd, were all part of the same transaction intended to secure to the two Tinocos the drafts for $100,000 each (…). It thus appears that the present claim of the bank rests on its payment of $200,000 to the Tinocos, $100,000 to Frederico Tinoco, "for expenses of representation of the Chief of State in his approaching trip abroad", and $100,000 to Jose Joaquin Tinoco, as Minister of Costa Rica to Italy for four years' salary and expenses of the Legation of Costa Rica in Italy, to which post the latter had been appointed by his brother. The Royal Bank cannot here claim the benefit of the presumptions which might obtain in favour of a bank receiving a deposit in regular course of business and paying it out in the usual way upon checks bearing no indication on their face of their purpose. The whole transaction here was full of irregularities. There was no authority of law, in the first place for making the Royal Bank the depositary of a revolving credit fund. The law of June 28th authorized only the Banco Internacional to be made such a depositary. The thousand dollar colones bills were most informal and did not comply with the requirements of law as to their form, their signature or their registration. The case of the Royal Bank depends not on the mere form of the transaction but upon the good faith of the bank in the payment of money for the real use of the Costa Rican Government under the Tinoco régime. It must make out its case of actual furnishing of money to the government for its legitimate use. It has not done so. The bank knew that this money was to be used by the retiring president, F. Tinoco, for his personal support after he had taken refuge in a foreign country. (…) The case of the money paid to the brother, (...) the appointed Minister to Italy, is much the same. (...) It includes the salaries and expenses for four years. To pay salaries for four years in advance is a most unusual and absurd course of business. All the circumstances should have advised the Royal Bank that this second draft, too, was for personal and not for legitimate government purposes. It must have known that Jose Joaquin Tinoco in the fall of his brother's government, which was pending, could not expect to represent the Costa Rican Government as its Minister to Italy for four years, that the reasons given for the payment of the money were a mere pretense and that it was only (...) an abstraction of the money from the public treasury to support a refugee abroad. (…) Whatever it was, it is so closely connected with this payment for obviously personal and unlawful uses of the Tinoco brothers that in the absence of any explanation on behalf of the Royal Bank, it cannot now be made the basis of

201 *Tinoco Arbitration* (GB v Costa Rica) (1923) 1 RIAA 393
202 ibid 389-392

> a claim that it was for any legitimate governmental use of the Tinoco government.[203]

It is noteworthy that Taft stresses the irregularity underlying the transaction, meaning the debt was not incurred according to the laws in force at that time. This means that not only the misappropriated funds can matter, but also the legality of the administrative procedures that make sovereign loans possible, which becomes even more relevant in the second part of the Tinoco arbitration.

This second part deals with the Amory concession for oil exploration which was controlled by the British Oil Fields Ltd. Based on the concession, exploration, investment and exploitation were supposed to take place in half of Costa Rica's territory over a certain period of time and up to a certain value. Costa Rica was supposed to receive 25 US Cents per ton of crude oil over fifty years, as well as fuel and lubricant for its railroad system. For most other taxes the investor was granted an exemption over the same period.[204] The accounts show that the concessionaires did everything necessary to fulfil their obligations of the contract by shipping equipment to Costa Rica and beginning the exploration in good faith. The contract, however, was invalid: "The most serious objection to the concession is that it was granted by a body without power to grant it."[205] The concession had been granted by the Chamber of Deputies, with the approval of President Tinoco. But the Tinoco constitution of June 8, 1917, distributed governmental power among the legislative, the executive and the judicial powers. The legislative power was held by congress which was composed of two chambers, the Senate and the chamber of Deputies. Article 76 stated the Congress was to meet as a single body under certain circumstances, in order to approve or alter laws and to impose direct or indirect taxes and to privatize national property. Also, Congress was to approve important contracts the government planned to enter, if one third of the present members of the chamber of Deputies required an approval by the Senate.[206] The concessionaire was to be exempted by certain taxes but obliged to supply fuel and lubricants for the Costa Rican railroad as well as a revenue tax of 25 US cents for each ton of crude oil for fifty years. Taft comes to the conclusion that the concession was unconstitutional and therefore invalid in its entirety as the necessary requirements of the legislation were not met:

> The protection which these clauses afforded against the heavy reduction of dividends by increased future taxes, was one of the great factors of value in the contract. It seems to be impossible to escape the conclusion that the power to grant

203 ibid 393 - 394
204 ibid 396
205 ibid 397
206 ibid 397-398

> such exemptions and to limit future taxation could only be exercised under the constitution of 1917 by Congress in a single body. The granting of this concession certainly involved the power to approve laws fixing, enforcing or changing direct or indirect taxes. As the Chamber of Deputies was expressly excluded from exercising this power alone, Article X was invalid. (…) My conclusion is supported by the action of President Tinoco himself in vetoing a law granting future exemptions from taxation to an insurance company enacted by the Senate, on the ground that only the Congress as a single body could grant them under its exclusive power to fix, enforce, or change direct or indirect taxes. It is impossible to reject the Article X and hold the remainder of the concession valid. That article is too vital an element in its value. The contract cannot be made over by this tribunal for the parties.[207]

The second part of the Tinoco arbitration award about the Amory concession is important due to its contrast with the claims of the Royal Bank of Canada. The payments to the Tinoco brothers and the preparations for these payments under the intentional circumvention of the law took place in June and July of 1919, the last months of the Tinoco régime, which showed clear signs of demise since martial law had been introduced in spring the same year to defend the régime. Unlike this, the Amory concession was approved by the wrong body and contrary to the constitution on June 26, 1918. This was one year after Tinoco had won the elections with 61.000 votes to 259 on May 1, 1917, [208] and one year before his resignation in August 1919. Since Taft focused on the popular support to determine whether a de facto government had been established that was in the position to bind Costa Rica contractually, it is important to see that in the chronology of the Tinoco government, this concession was granted during a period of political stability since civil unrest started only in early 1919. During this period the president himself vetoed a different law by the Senate granting tax exemptions to an insurance corporation, on the ground that only the Congress as a single body of both houses could grant these exemptions, in accordance with the constitution of 1917. Taft observes that Tinoco could have likewise vetoed the Amory concession. In other words, he could have also demanded a constitutional concession instead. Therefore, the Amory concession would have been invalid in any state whose constitution vests a particular body with the power to decide on tax laws and exemptions, but a non-authorized body makes the decision. Taft therefore held that the concession could be nullified also by the subsequent government as the concession was invalid under the Constitution of 1917.[209] It is unclear why the parties involved granted Amory the desired concession in a process that led to its illegality. Based on the arbitration material, it seems the Amory concession was not used by Tinoco for

207 ibid 398
208 ibid 379
209 ibid 399

personal enrichment, either. But as a result, the concession was unconstitutional during any period of the Tinoco administration.

Based on the concession, Costa Rica would have granted the British Controlled Oil Fields Ltd. the right to exploit the local oil fields over fifty years and to use all natural resources and infrastructure as far as their use was necessary for the exploitation, while granting tax exemptions to facilitate the exploration and exploitation.[210] "It is evident that it was the hope and expectation of both parties that oil would be discovered and that upon its discovery the company would develop a large production, refining and transmission of oil, involving the expenditure of large capital and the investing of it in plants of millions of value. The protection which these clauses afforded against the heavy reduction of dividends by increased future taxes, was one of the great factors of value in the contract."[211] Costa Rica's refusal to uphold the concession is not exactly the same as the repudiation of odious debt that is based on a loan or on bonds. This is maybe the reason why the second part tends to be ignored by researchers of odious debt.[212] Yet, it is a contractual obligation that can be refused just the same as a payment obligation, only this time the repudiation works because of the unconstitutional procedure. Awarding the concession was illegal because the wrong body made the decision, which is a formal problem. According to Taft, formal as well as material mistakes can make a claim illegal and therefore justify a repudiation.

In comparison, the Royal Bank of Canada transaction, was full of clear irregularities which made it obvious that the Tinoco brothers had come up with this scheme in the last months of their government in order to retire abroad on public expense. The gravely irregular process and the preparations to go to Italy offered sufficient conclusive evidence that the funds incurred were going to be misappropriated for private purposes which made an explicit statement of the Tinocos or any other person involved redundant. It is the contrast between the straightforward unconstitutionality of a decision-making process of an administration on the one side and the breaking of laws in order to facilitate personal enrichment on the other, which makes this case so valuable a tool in paving the way for legal grounds of the repudiation of debt and other obligations.

The arbitration for the Tinoco case took place in 1923, four years before Sack's publication of the odious debt doctrine in 1927. As mentioned above, Sack refers to the Tinoco

210 ibid 395

211 ibid 398

212 Jeff King, *The Doctrine of Odious Debt in International Law – a Restatement* (Cambridge University Press 2016) contains no analysis or reference to the Amory concession, for example.

arbitration briefly in the context of succession[213] but it remains unclear why he seems to ignore Taft's detailed arguments. Taft developed the criteria that make the idea viable, albeit in a narrow legal space: Taft refrains from using state succession and the recognition of a government by other governments because these two factors are not important to bind a state legally. Decisive for this is a de facto government that maintains a peaceful and law-based administration of the whole country under its control, uncontested by other parties, with the acquiescence of the people for a substantial period of time.[214] To clarify if a de facto government is formed, Taft asks further: "(…) has it really established itself in such a way that all within its influence recognize its control, and that there is no opposing force assuming to be a government in its place? Is it discharging its functions as a government usually does, respected within its own jurisdiction?"[215] Likewise, the discussion on state succession is irrelevant for the validity of sovereign debt in most cases. But the new government can lose its popular support the same way as the previous one and cannot legally bind the state any longer once it has ceased to be the de facto government. As soon as the de facto government does not adhere any more to its own laws and constitution, it loses its status as de facto government and contracts based on such a circumvention can be rightfully repudiated by the following government.

Unlike Sack, Taft accepts political evolution by revolution, since "[t]o speak of a revolution creating a de facto government, which conforms to the limitations of the old constitution is to use a contradiction in terms."[216] Taft explains that a change of government and internal policy, such as the transformation of a monarchy into a republic and vice versa does not affect the state's position in international law. International law is clearly geared towards a continuity of international relation and free of any value judgement as to the form of government and its ideology.[217] Only once the Tinoco government ignored its own rule of law and lost its status as a de facto government, it could not legally bind Costa Rica any longer. While Sack gets distracted by the problem of state succession, Taft's decision on the Royal Bank of Canada claim works because it does not deal with state succession at all but with the question of the validity of governmental activity. According to Odette Lienau, Taft was looking for "governmental purpose as a requirement for valid sovereign action".[218]

213 Sack A. N., 'Les Effets Des Transformations Des États Sur Leur Dettes Publiques Et Autres Obligations Financières' (1927) Librairie du Recueil Sirey, Paris 11
214 *Tinoco Arbitration* (GB v Costa Rica) (1923) 1 RIAA 377, 381
215 ibid 382
216 ibid 381
217 ibid 377-378 Taft quoting Dr. John Basset Moore's *Digest of International Law* Vol. I, 249, Prof. Borchard's *The Diplomatic Protection of Citizens Abroad* and several others.
218 Lienau O., 'Who is the "Sovereign" in Sovereign Debt? Reinterpreting a Rule-of-Law Framework from the Early Twentieth Century' (2008) Yale Journal of International Law, Volume 33 Issue 1, 81-85

The Amory concession and the Royal Bank of Canada claim are two typical disputes that can arise in the context of the enforceability of sovereign obligations. The question is, if Taft would have decided both claims in an identical fashion without an uprisal? The violation of formal law in respect of the concession would lead to a refutable claim in any government. But how about the payment claim? What if the Costa Ricans would have been in apathy, not interested, misled by media and government and lured into re-election? Is the force applied by the Tinoco brothers the *conditio sine qua non* for the odiousness of the claim raised by the Royal Bank of Canada? To insist violence is the only precondition for odiousness does not seem logical, since it is rather the catalyst for the regime's demise and an indicator for the deconstruction of the rule of law. In the 19th century Frédéric Bastiat remarked that "[w]hen plunder has become a way of life for a group of men living together in society, they create for themselves in the course of time a legal system that authorizes it and a moral code that glorifies it."[219] This observation does not refer to violence, but the result is the same, plunder. Should the legal system be rigged over time in favour of the incumbent and the supporting parties, or other vested interests, it is arguable that such a system furthers misappropriation of funds for favours and personal purposes while it does not function to the benefit of the majority of citizens. If the rule of law has been undermined and the system is a democracy by name only, such a situation bears characteristics of a regime that does not enjoy the support of the citizens. According to Radbruch, such a legal system is not law since it is not just and does not treat citizens and other stakeholders alike.[220] It is the positive support of the population that Taft looks for in a state ruled by a de-facto government; he even approves of revolutionary regime change against the constitution as the ultimate vote of no confidence, and what is true for a de-facto government, is true for any government.

Like Michalowski,[221] one could claim that loans given to a state that violates *ius cogens* norms will automatically become invalid. According to King, this is connected to the so-called "fungibility problem".[222] Some argue any such loan is odious because even if it was earmarked by the lender for a benign purpose, such as the construction of a hospital, it would release other funds in the state budget that could be used by the dictator for *ius cogens* violations. This option with an ex-ante view could lead to the prevention of illegitimate debt which is in line with the due diligence approach recommended by the United Nations:

219 Frédéric Bastiat, *Economic Sophisms*, Goddard A (tr, ed), (The Foundation For Economic Education Inc. 1964) 130
220 Gustav Radbruch, 'Gesetzliches Unrecht und übergesetzliches Recht' Süddeutsche Juristen-Zeitung (1946)
221 Sabine Michalowski, *Unconstitutional Regimes and the Validity of Sovereign Debt – A Legal Perspective* (Ashgate 2007) 71-88,
222 Jeff King, *The Doctrine of Odious Debt in International Law – a Restatement* (Cambridge University Press 2016) 188-191

> "Creditors and debtors share responsibility for preventing and resolving unsustainable debt situations. For creditors, this includes the obligation to perform due diligence on the creditworthiness and ability to repay of the borrower as well as the duty to refrain from providing a loan in circumstances where the lender is aware that the funds will be used for non-public purposes or for a non-viable project. For debtor States, this entails an obligation to contract loans and use the loan funds in ways that serve the public interest and repay the debt in a timely fashion."[223]

This idea is certainly worth discussing if the aim is preventing human rights violations. Yet, the odious debt doctrine wants to empower states that overthrew their "despotic regimes" with a tool that helps these states repudiate debt of the previous regime, something that could take place only ex-post. The purpose of these two options differs: the first option is supposed to prevent money from going into the pockets of the dictator, while the second option is concerned with the prevention of the state's money going out of the budget to enrich the lender.

Taft touches upon fungibility when he writes about the money taken for Tinoco's brother:

> To pay salaries for four years in advance is a most unusual and absurd course of business. All the circumstances should have advised the Royal Bank that this second draft, too, was for personal and not for legitimate government purposes. It must have known that Jose Joaquin Tinoco in the fall of his brother's government, which was pending, could not expect to represent the Costa Rican Government as its Minister to Italy for four years, that the reasons given for the payment of the money were a mere pretense and that it was only (...) an abstraction of the money from the public treasury to support a refugee abroad. (…) Whatever it was, it is so closely connected with this payment for obviously personal and unlawful uses of the Tinoco brothers that in the absence of any explanation on behalf of the Royal Bank, it cannot now be made the basis of a claim that it was for any legitimate governmental use of the Tinoco government.[224]

As reported by Taft, the payment was "an abstraction of the money from the public treasury (…) Whatever it was it is so closely connected with this payment for obviously personal and unlawful uses (…)". So money is fungible, but for Taft this is not a problem. After all, it is not relevant for the arbitration that the money that is paid into the bank is not necessarily identical with the money withdrawn from the bank. When it comes to the ex-post option, it is sufficient evidence for the misuse of funds if some of the state's money went missing, and it doesn't matter which money exactly because the overall balance of the state's budget shows a reduction. The subtraction of funds is what matters for the state because it is dependent on these funds to fulfil its tasks as a state and any missing amount will affect the population negatively. This approach is only logical: in general, the claim of

223 United Nations, Guiding principles on foreign debt and human rights, A/HRC/20/23 Article 23
224 *Tinoco Arbitration* (GB v Costa Rica) (1923) 1 RIAA 393-394

a depositor against the bank is a payment claim for the same sum, not for the identical coins and bills of the depositor.[225] For a bank it is impossible to return exactly the same bills that the depositor paid in since in today's banking system the bank will have to work with that money. This means, the money paid into an account will become the property of the bank and the client receives a payment claim for the same sum. This arrangement is not only necessary because it is impossible to find the same bills when the client demands his money back, but it is also necessary since the bank will use the money that the client deposits for its own business, for its own benefit. If the bank could not become the owner of her clients' money, the institute and her staff would embezzle their clients' funds and commit an offence as soon as the money is used for the bank's purpose. That the payment claim against the bank is not as valuable as money becomes apparent when the client of a bank in distress has the choice to keep the payment claim or to take cash. But since this is not obvious, this solution did not draw a lot of criticism so far. Hence, a bank is only obliged to pay the same sum upon demand, not the identical bills.

It makes certainly sense to discuss fungibility if researchers are interested in the prevention of human rights violations by interrupting the funding of questionable governments. Claims that fungibility is a problem for the repudiation, however, collides with the everyday practice in banking.

In Great Britain v. Costa Rica, Taft formulated a coherent solution for the repudiation of claims against a state. In the case of the payment claim, it was clear that the Tinoco brothers had no legal claim to the money they had arranged for in order to enjoy their retirement abroad, which is a violation of material law. The concession, on the other hand, had been approved by the wrong body and therefore it had been created under the violation of the formal requirements of the constitution. So, the claims were invalid in both cases, without referring to the succession of state and government and as it seems also without the need for violence from the side of the government. Decisive, however, is the support of the population vis-a-vis their government, which is missing in case of uprisals and revolutions, since this are activities of the citizens against the government, contesting its authority. In 1923 Taft paved the way for an organized repudiation of sovereign debt with his Tinoco arbitration award and coincidentally proved that most elements of the odious debt doctrine are redundant, before Sack formulated it in 1927.

225 Peter Derleder, Kai-Oliver Knops & Heinz Georg Bamberger eds,, 'Deutsches und Europäisches Bank- und Kapitalmarktrecht', *Springer* (Berlin 2017) §41 nr. 4: "(…) das Kreditinstitut ist verpflichtet, Geld in gleicher Menge nach Maßgabe der hierbei getroffenen Vereinbarungen dem Berechtigten zurückzuerstatten." - translation: "(…) the bank is obliged to return money in the same amount to the beneficiary in accordance with the agreements made in this regard."

2. Leukerbad Decision, Switzerland

Leukerbad is a Swiss municipality known for its hot springs but also for its bankruptcy due to massive infrastructure investments, for which the mayor Otto G. Loretan raised the funds on the capital market. On 20 July 1999, this had resulted in a total debt burden of CFH 223 million which is some CFH 150,000 per inhabitant. With CFH 6 million in financial assets, CFH 217 million remained as residual debt and the available funds were not even enough to pay the interest.[226] Loretan's mishandling of funds resulted in a sentence of five years imprisonment for multiple counts of fraud and embezzlement in 2004.[227] In a restructuring plan, three expert commissioners had calculated that the municipality could bear a maximum debt of 44 million, so the creditors were asked to write off 80%. Many lenders rejected the restructuring plan including the requested debt cut since they had speculated that the canton would take over the debt. But the canton refused and instead the municipality was put into state administered receivership on 20 July 1999 after which the lenders had to write off 78% of their investments.[228] The competences of this kind of receivership does not go beyond the authority of the general administration, e.g. it cannot reduce debt by intervening with the claims of the lenders. The Bundesgericht (the Swiss Federal Tribunal) argued that the motivation for the Swiss law governing forced administration was mainly concerned with the economic reputation of the municipality which had already suffered during the world economic crisis of the 1930ies. Hence, the cantons and the confederation refused to vest the state administered receivership with rights that could invoke a single-sided debt reduction and they also refused to introduce the bankruptcy of municipalities. The cantons, in turn, can introduce rules for payment moratoriums, interest rate reductions by half and similar measures conducted by advisory councils vis-a-vis the lenders, in the case of distressed municipalities.[229] The advisory council shall also collect tax arrears and legal claims vis-a-vis debtors. Insofar as it appears necessary, expedient and sustainable, the advisory council shall increase taxes and other charges, fees or remunerations (or introduce new ones), subject to the consent of the cantonal government and the limits of cantonal and federal law.[230] Article 9 section 1 of the "Federal Act on debt collection against municipalities and other corporations under

226 BGE 127 III 55 (1st December 2000); 58 nr. 3. b); Thomas Fuster, 'Zu viel Eile in Leukerbad', *Neue Zürcher Zeitung* (Zürich 1lth January 2001) <https://www.nzz.ch/article73PZQ-ld.162057?reduced=true> accessed 4th June 2021

227 Schweizer Nachrichtenagentur, 'Fünf Jahre Zuchthaus für Otto G. Loretan', *Neue Zürcher Zeitung* (Zürich 1st September 2004) <https://www.nzz.ch/article9TTQZ-ld.314477?reduced=true> accessed 1st June 2021

228 BGE 127 III 55 (1st December 2000); 56 nr. A; Christian Teevs, 'Das Schuldendorf der Schweiz', *Der Spiegel* (Hamburg 09 December 2013) <https://www.spiegel.de/wirtschaft/soziales/schweizer-dorf-leukerbad-kaempft-gegen-seine-geschichte-a-937206.html> accessed 23 March 2023

229 BGE 127 III 55 (1st December 2000); 60-61 nr. 4. & 5.

230 ibid 61 nr. 4. b)

cantonal public law" (SchGG) sticks out here because it determines that only financial assets can be used for debt collection. Municipal assets that are used for public services cannot be used to satisfy claims of lenders.[231] This shows that while the law seeks to satisfy the claims of creditors, it also aims to support municipalities in the performance of their duties towards citizens by not touching the resources necessary for services of general interest.

The financial inspectorate of the canton issued several warnings about the unsustainable debt burden in 1993 and 1996, but to no avail. In its annual report for the year 1996 to the Parliament and the Staatsrat (translates to "State Council", which is the cantonal government, also called in Switzerland Conseil d'État or Consiglio di Stato, respectively) in March 1997, the financial inspectorate stated that the legal requirements for granting and taking out loans were not being complied with in Leukerbad.[232] The Basler Kantonalbank (the cantonal bank of Basel), sued the canton for damages at the Bundesgericht, claiming the canton had failed to adequately supervise the municipality of Leukerbad and this had caused the bank losses that the canton was liable for.[233] Several municipalities and other public bodies filed similar law suits.[234] The canton of Valais essentially argued that the applicant's claim was inadmissible. Secondly, the alleged damage was based on invalid or even void claims. Furthermore, the canton had not committed any breach of official duty and was therefore not responsible for any unlawful occurrence of damage. Moreover, it would have been the responsibility of the Basler Kantonalbank to check the solvency of the municipality of Leukerbad; the fact that it had not done so excluded any liability on the part of the canton. Moreover, it was not proven to what extent the damage could have been avoided if the canton had intervened.[235]

Among other things, the Bundesgericht is responsible for contractual claims between private parties and the canton which are based on civil law, if the disputed value exceeds CFH 8,000.[236] According to article 19 VG[237], the Bundesgericht decides also on third party claims against the state that are based on the conduct of the State Council and the cantonal

231 Art. 9 section 1 of the Swiss Bundesgesetz über die Schuldbetreibung gegen Gemeinden und andere Körperschaften des kantonalen öffentlichen Rechts (SchGG), 4 December 1947, reads: "Die Vermögenswerte eines Gemeinwesens, die unmittelbar der Erfüllung seiner öffentlichen Aufgaben dienen, stellen sein Verwaltungsvermögen im Sinne dieses Gesetzes dar und können auch mit seiner Zustimmung weder gepfändet noch verwertet werden, solange sie öffentlichen Zwecken dienen." - translation: "The assets of a municipality that directly serve the fulfilment of its public duties constitute its administrative assets within the meaning of this Act and may not be attached or realised even with its consent as long as they serve public purposes." <https://www.fedlex.admin.ch/eli/cc/1948/873_853_825/de> accessed 3 June 2023

232 BGE 2C.1/2001 II (3rd July 2003); nr. C.

233 ibid nr. I

234 BGE 2C.4/1999, 2C.5/1999 and 2C.4/2000

235 BGE 2C.1/2001 II (3rd July 2003); nr. K

236 ibid "Erwägung – Verfahren 1.2." discussing the applicable Art. 42 aOG

237 Bundesgesetz über die Verantwortlichkeit des Bundes sowie seiner Behördenmitglieder und Beamten (Verantwortlichkeitsgesetz, VG) – translated: "Federal Act on the Liability of the Confederation, the Officials of her Authorities and the Public Officials"

court or their members. Hence, as the highest court in Switzerland, the Bundesgericht is the correct court for claims raised by the Basler Kantonalbank, a public body that handed out loans based on civil law to the municipality Leukerbad.

The claimant alleges that it has suffered material damage as a result of the conduct or inaction of the State Council or its subordinate authorities, which are public officials within the meaning of article 3 VG.[238] The bank claimed that Leukerbad's default on her loan constituted a damage. Along with the defendant canton the court agreed that theoretically there is no loss under federal law as a municipality cannot become bankrupted and the payment schedule has been extended; but in this case it has to be assumed that the debt cannot be collected since there is no legal provision based on which a financial reorganisation within a reasonable time frame is next to impossible due to the extreme over-indebtedness. The court, however, decides to leave the discussion undecided. Instead, the Bundesgericht highlighted that borrowing money on the market through bonds and loans is regulated by law. For instance, if the upper limits of 1%, 5% and 10% of the gross revenues of the last administrative year are exceeded, the municipal assembly must approve the borrowing, and in some cases the State Council. According to the Bundesgericht, the law does not comment on the legal sanctions in the case of possible borrowing despite the absence of the required approvals. The commitment in question in the present case was entered into without a resolution by the municipal assembly and without approval by the State Council; since the beginning of the 1980s, apparently only one loan by the municipality - in 1986 to the Raiffeisenkasse Leukerbad for ten million Swiss francs for the construction of a school - has been approved by the Council of State. However, the Bundesgericht decided not to discuss the consequences of the lack of approval any further, since a damage had not occurred yet as a settlement of the debt was not probable but still conceivable.[239]

Next, the Bundesgericht established that the Swiss Confederation and the municipalities are liable for any damages that their employees or officials cause illegally to a third party through action or omission during the execution of official duties.[240] Injured parties cannot claim damages directly from officials, but the state can take recourse against the official for the damage, article 7 VG. Based on this federal act on liability, negligence is not a precondition, but a wrongful act or an omission are. The infliction of the damage is unlawful if the official's activity violates the requirements or prohibitions that serve to

238 BGE 2C.1/2001 II (3rd July 2003); nr. 2.5
239 BGE 2C.1/2001 II (3rd July 2003); nr. 3.
240 Article 4 VG (Verantwortlichkeitsgesetz - Federal Act on the Liability of the Confederation, the Officials of her Authorities and the Public Official)

protect the legal rights of citizens. The wrongful act can be illegal due to the violation of a protected legal right or the sanctioned behaviour.[241]

Then the Bundesgericht explains that there is no general legal duty to act in the interest of others. Rather, the duty to act is only relevant under the law on liability if it pursues the interest of the injured party and results from a protective provision in his or her favour. Consequently, wrongful omission presupposes a guarantor position for the injured party. Hence, anyone who fails to perform an act to which he is not legally obliged due to the lack of a guarantor position does not violate it and does not act unlawfully. Since property as such is not protected like an absolute right, damage to property through state action or omission can only trigger state liability if this action constitutes wrongful conduct.[242] In this context, neglected supervisory duties can constitute a significant breach of official duty. Such organisational liability is not exclusively linked to individual misconduct of state bodies but attributes the non-fulfilment or poor fulfilment of the official duty to the responsible state body as a whole. It has to be noted that as soon as there is a failure at a lower level, it is irrelevant whether the higher level is aware of it or not, due to the organisational liability. However, it remains indispensable that there is a duty to intervene, either directly vis-à-vis the organisational unit to be supervised by the authority responsible for it, or by another body informing the responsible authority of the facts that require intervention.[243] On top of that, the court points out that a liability-generating misconduct does not already exist with every breach of official duty, but only as soon as an official duty essential for the exercise of the sovereign (official) function has been breached.[244] Furthermore, according to the principles of legal liability, an adequate causal connection between the inactivity of the state organs in breach of duty and the damage claimed is necessary. Such a connection is legally relevant if the conduct of the damaging official was in itself capable, according to the ordinary course of events and the experience of life, of bringing about a damage of the kind that occurred. In the case of omission, there must be a so-called hypothetical causality, i.e. it must be examined whether dutiful action would have prevented the damage. The causal connection can be interrupted by another predominant causal event. This also includes a predominant fault on the part of the injured party or a corresponding third-party fault. A fault on the part of the injured party that does not predominate, and thus does not interrupt the causal connection, can lead to a reduction of damage claims.[245]

241 BGE 2C.1/2001 II (3rd July 2003); nr. 6. - 6.1.1.
242 BGE 2C.1/2001 II (3rd July 2003); nr. 6.1.2.
243 ibid nr. 6.1.3.
244 ibid nr. 6.1.4.
245 ibid nr. 6.2.

After these considerations the court discusses the potential guarantor status of the defendant and the question if his omissions were illegal. The plaintiff claims that the Canton of Valais violated its duty of supervision towards the municipality of Leukerbad; it should have intervened in time to prevent the municipality from becoming insolvent. The claim is based on liability for failure to act in breach of official duties. According to the above, such liability requires that the cantonal bodies - at whatever level - had an official duty to take action vis-à-vis the municipality in question or to persuade the authority responsible for such action to intervene in good time. However, it is also necessary that the corresponding official duty has the purpose of pursuing the interest of the plaintiff and that the duty results from a protective provision in her favour. This presupposes that the defendant canton is in a guarantor position for the bank.[246] The Swiss Federal Constitution expressly stipulates that municipal autonomy is guaranteed in accordance with cantonal law, article 50 section 1 BV (Bundesverfassung, Swiss Federal Constitution). Accordingly, the cantons regulate the municipalities, their organization and responsibilities in their legislation. However, to the extent that the communes are granted autonomy, the canton cannot be held responsible for the unlawful acts of the communal administration. Such a responsibility only comes into question if the cantonal bodies have violated their statutory supervisory duties. However, how far this goes is a matter for cantonal law. This determines, for example, whether the canton has to intervene ex officio in every case, or only if the infringement has reached a certain level of severity, or only if it is called upon in a procedure provided for this purpose.[247] The constitution of the canton of Valais (KV) determines in article 69 that municipalities organize their affairs independently within the limits of the constitution and the law. In accordance with article 70 KV, municipalities carry out their activities in such a way that it is compatible with the public interest, whereby the municipal assets must be used appropriately and managed carefully (article 70 section 3 KV). According to article 75 section 1 KV, the municipalities are subject to the supervision of the State Council within the limits of article 69 KV and based on article 75 section 2-4 KV transactions such as loans must be approved by the State Council. The constitutional principle that can be applied on cantonal level is that the canton is entitled to monitor legality but can exercise discretionary control only where this is expressly provided for in the laws of the canton.[248] As discussed above, a Swiss municipality cannot cease to exist and therefore cannot declare bankruptcy and be wound up to satisfy lenders. Instead, a state administered receivership can be ordered by the canton upon demand of an affected party, if there are concerns that the municipality might not be able to fulfil her

246 ibid nr. 7
247 ibid nr. 7.1.1.
248 ibid nr. 7.1.2.

obligations. The federal act regulating debt collection against municipalities determines that only financial assets can be used, whereas municipal assets that are used for public services cannot be used to satisfy claims of lenders.[249] Article 39 SchGG transfers the financial competence of the municipal government to the state administered receivership, which can also increase local taxes and fees.[250] Following article 2 GOG (Gesetz über die Gemeindeordnung, or Act on Municipal Regulations), the public bodies are independent in all their tasks that they undertake in the public interest, as well as for all assigned tasks within the legal limits. Based on article 121 section 1 GOG, public bodies are subject to the supervision of the state, which ensures that they administer themselves in accordance with the constitution and the law. According to article 122 GOG, supervision is exercised by the State Council itself, by cantonal departments or a governor appointed by the government.[251] As stated in article 128 GOG, the State Council, after a preliminary investigation and warning, places the public bodies that persistently do not fulfil their obligations and defy the orders of the government or significantly endanger their financial balance or assets under state administered receivership in whole or in part; for this purpose he designates the commissioner(s) or an agency of the state and determines their powers by way of resolution.[252] Another precautionary measure is the Financial Budget Act which primarily regulates the cantonal financial administration, but it also regulates the municipalities to which the state has assigned a public task and in which it is financially involved, whereby of course the municipal autonomy is expressly reserved.[253] As reported by the Bundesgericht, the legal regulations and the corresponding options for municipal supervision in the canton of Valais are rather limited. Possibilities of intervention exist only if a task or action prescribed by law is neglected or if a municipality persistently fails to fulfil its obligations or seriously jeopardizes its financial balance or assets. As the defendant Canton of Valais demonstrates when submitting the relevant Council minutes, great importance was attached to municipal autonomy when the statutory regulation was enacted, which was also expressly confirmed by a witness statement. The Valais municipalities should therefore have wide room for action, especially in financial terms, which means that the canton should hold back as much as possible when it comes to regulatory interventions.[254]

As the court points out, the regulations on municipal supervision primarily serve the public interest. First of all, because these regulations enable the canton to fulfil its task of

249 Fn 197, 198
250 Article 37 SchGG
251 BGE 2C.1/2001 II (3rd July 2003); nr. 7.2.-7.2.2.1.
252 ibid nr. 7.2.2.1.
253 ibid nr. 7.2.2.2.
254 ibid nr. 7.2.2.5.

supervision, which benefits all municipalities in the canton of Valais. It is intended to ensure that the municipalities fulfill their tasks, that the equalisation of burdens (especially the national fiscal equalisation, called “Finanzausgleich”[255], which is supposed to reduce the cantonal differences in financial capacity and to perform government tasks more efficiently) takes place and is carried out correctly. Last but not least, communal supervision serves to protect the commune itself and its inhabitants.
The provisions on communal supervision are thus fundamentally suitable, insofar as they oblige the canton to act or entitle it to take measures, to establish a guarantor position of the canton vis-à-vis the municipalities.[256]

For the present case, as the court explains further, it is decisive whether the legal regulation of the duty of supervision also serves to protect the creditors of the communes, i.e. if it establishes a corresponding guarantor position of the canton vis-à-vis the creditors.
In this context, the purpose of the norm in question is crucial, which must be distinguished from its effect. For the assumption of a guarantor position, it is insufficient that a provision accidentally has a protective effect. Rather, this effect must be based on a corresponding purpose and be consistent with it. Particularly in the area of indirect damage, it cannot be enough that an indirect protective effect, which emanates from a norm, establishes a guarantor status if this effect does not correspond to the purpose of the norm but merely arises incidentally. Otherwise, such a double reflex liability - liability for indirect damage due to an indirect protective effect - would go too far and entail sprawling responsibilities, often unforeseeable in their scope. The establishment of a guarantor's position relevant for liability must therefore be limited to norms that have the corresponding protection as their actual purpose and not merely as a side effect. In research and teaching the opinion prevails that the injured party must have a legally privileged position in order for liability to be possible, that the legal norm must be established directly for the protection of the injured party or should prevent damage of the kind that has occurred. The Bundesgericht agrees. In this context, the protective purpose of a provision or regulation - here: the relevant supervisory regulation - is to be determined on the basis of its specific design.[257]

According to the municipal code of the canton of Valais, the municipalities have extensive autonomy in financial terms. It is true that the canton expressly has to monitor the financial balance; However, neither the annual accounts nor the balance sheets or, more generally, the financial situation of a municipality are to be approved by the canton. The canton will

255 Eidgenössische Finanzverwaltung, ‘Der Nationale Finanzausgleich”, Schweizerische Eidgenossenschaft (Bern 2020) <https://www.efv.admin.ch/dam/efv/de/dokumente/finanzausgleich/dokumentation/finanzausgleich-2020.pdf.download.pdf/Finanzausgleich-2020-d.pdf> accessed 09 September 2022
256 BGE 2C.1/2001 II (3rd July 2003); nr. 7.3.-7.3.1.
257 ibid nr. 7.3.2.

only intervene the second time the estimate and the invoice are rejected by the responsible municipal body. As stated by Valais law, there is also no upper limit for the debt of a municipality. Insofar as the canton has to monitor their financial balance and, in extreme cases, order compulsory administration, it is only a matter of protecting the (public) community assets. The authorization requirements for certain financial transactions under article 16 and article 123 GOG also aim to force the executive authorities to be diligent when entering into obligations.

From the Act on Municipal Regulations it is difficult to deduct that the purpose of municipal supervision is also the protection of creditors, who and whose assets are not mentioned in the act. It is not obvious that the state with its municipal supervision should protect the interests of those who want to grant loans to a municipality. In principle, lenders are free to inform themselves about the solvency and financial situation of a municipality before concluding a contract with it, whereby they additionally benefit from the fact that the relevant information is relatively easy to obtain in the case of a public body - at least easier than in the case of private borrowers. The only public interest that could justify creditor protection would be the facilitation of municipal credit; however, such a purpose would have to be clearly evident from the law, which is not the case with the Valais law on municipal regulations.[258]

Indeed, the rules of municipal supervision can also develop a protective effect in favour of creditors in that the canton has to monitor the financial situation in the interest of the municipalities and their residents and citizens. However, this is merely a reflex effect and not the actual protective purpose of the municipal supervision that could justify a guarantor position of the canton vis-à-vis the creditors. Moreover, the Bundesgericht has made similar considerations - in the opposite sense - in the case of banking supervision: The purpose of banking supervision is to protect the interests of customers, investors and creditors, but not to protect the banks from acts by their own bodies that harm them, although in principle a protective reflex effect by banking supervision could also arise in favour of the banks. Nevertheless, it can be inferred from the case law of the Bundesgericht that, in connection with state supervisory and control duties, a guarantor's position in favour of third parties who are not themselves to be supervised or controlled, but who claim a reflex damage that is said to have arisen from a lack of supervision and control vis-à-vis another person or organisational unit, is only recognised with great reluctance.[259]

258 ibid nr. 7.3.3.
259 ibid nr. 7.3.3.1.

The opposing position is ultimately based on the view that the canton, due to its supervisory duty, must also guarantee legal certainty for the legal transactions of third parties with the municipalities. This is the basic position taken by the expert opinions submitted in the four federal court liability proceedings in connection with Leukerbad, all of which confirm a guarantor position of the canton vis-à-vis the creditors. However, none of the expert opinions addresses the relationship between the protective purpose of the law and its protective effect or the problem of the double reflex, which is why the conclusions of the expert opinions are not compelling for the question of the canton's guarantor status vis-à-vis the creditors.[260]

The financial budget law of the canton of Valais primarily applies to the canton and its administration; with regard to other organizational units, it essentially only aims at protecting state assets and safeguarding the economic use of state funds that are made available to other organizational units such as the municipalities. This becomes evident from the fact that the canton's financial supervision extends primarily to control tasks involving the use of cantonal funds, in particular subsidies and financial equalization contributions. At best, a protective effect in favour of other municipalities that are subject to the national financial equalisation can also be derived from this. Again, it is not evident that the law aims to protect creditors, even if a corresponding actual reflex effect can result. The same applies to the tax law of the canton of Valais, which aims to regulate the national financial equalisation, control the tax collection and guarantee the proper determination of the taxation factors. Thus, neither the financial budget law, nor the tax law aim to protect creditors.[261]

The only thing left for the Bundesgericht to examine is the significance of the federal debt collection regulations in the present context. The federal debt collection regulations for municipalities are primarily intended to preserve the creditworthiness of the municipalities. However, there is no provision for the canton's liability for the municipalities' debts, which the Federal Council even expressly pointed out in its dispatch on the law. Therefore, creditors of municipalities have to consider this when granting loans to them.

After all, federal law also provides for measures which – following the general orientation of debt collection and bankruptcy law – serve to protect creditors. The advisory council in particular pursues the interests of creditors (article 28 section 2 SchGG). However, special debt collection organs are responsible for this. In this context, the cantonal governments have certain powers and rights of petition which only apply once a debt enforcement

260 ibid nr. 7.3.3.2.
261 ibid.nr. 7.3.3.3.

procedure is underway. Therefore, it cannot be concluded that the canton is obliged to check the financial situation of its municipalities in advance and at any time before debt enforcement measures are taken in a municipality, even if federal law does not prohibit the canton from doing so; But if the canton waives this option, he is only obliged to protect creditors once debt enforcement proceedings have been initiated and the relevant provisions begin to take effect.[262]

On 16 September 1998, the State Council of the Canton of Valais decreed initial measures against the municipality of Leukerbad. From 20 November 1998, the partial forced administration took effect. On 8 February 1999, Leukerbad was pursued for the first time by a creditor - the residents' municipality of Rheinfelden - for failure to meet financial obligations due to existing over-indebtedness. After the creditors of the municipality of Leukerbad rejected a reorganisation plan drawn up by the commissioners appointed by the canton, the State Council of the Canton of Valais requested the Cantonal Court of Valais, as the upper cantonal debt collection supervisory authority, to order an advisory board pursuant to Art. 28 et seq. of the Debt Collection Act, which led to the establishment of the advisory board over the municipality on 20 July 1999. Thus, the Canton of Valais took action before serious debt enforcement proceedings related to the present factual situation were initiated against Leukerbad for the first time. It is not even alleged that the canton failed to fulfil its obligations arising from the federal debt collection regulations. The complaint is in fact based on the premise that it should have intervened even earlier, i.e. before 16 September 1998. Yet, such an obligation to protect creditors does not arise from the law on debt collection.[263]

From this the Court concludes that the supervisory duties of Valais towards its municipalities do not justify a guarantor position of the canton towards the creditors of the municipalities. As a result, the canton is not liable to the creditors for a breach of its supervisory duties towards the municipality of Leukerbad. Therefore, the Bundesgericht decided that the lawsuit is to be dismissed as unfounded.[264]

The odious debt doctrine might be dysfunctional, but the aim of the doctrine, the repudiation of debt, can be achieved in a variety of ways. The Leukerbad decision of the Swiss Bundesgericht is a key decision in this context: the court decided that lenders have no claim against the Swiss state for the compensation of losses suffered from the default of a Swiss municipality because there is no legal obligation for the state's supervision to protect the interest of investors. Instead, the state supervision is supposed to help

262 ibid nr. 7.3.4.-7.3.4.1.
263 ibid nr. 7.3.4.2.
264 ibid nr. 7.4.-8.1.

municipalities and the state's citizens. Since constitutions and international treaties are mostly concerned with the States' obligation to respect, protect and fulfil human rights and fundamental freedoms and not with the business interests of investors, this decision corresponds with the international legal framework. If payment claims are raised that could be problematic from a legal perspective, any state, also a democratic one, should analyse if a payment obligation actually exists. The Leukerbad case is a good example, as the claim of the Basler Kantonalbank looks justified at first sight. Only because the Bundesgericht addresses the relationship between the protective purpose and the protective effect as well as the problem of the double reflex, it allocates the risk correctly. According to the Swiss law risk is not allocated to the state that has no obligation to protect the lender's interest but to the lender who has to evaluate the risk of such a loan ex ante, since that is the business model of lending. Had the court decided in favour of the claimant, it would have eliminated risk and encouraged moral hazard. This would have resulted in reduced prudence of market participants who would have taken even more risk in the future because they could have relied on legislation that would protect them from market discipline. The Leukerbad decision rejects the bank's claim since debt repudiation based on the state's obligations vis-à-vis its own citizens is the only solution that conforms with the state's legal obligations. It is this decision of the Swiss Bundesgericht which corresponds with the original idea of the odious debt doctrine that unconscionable debt does not develop a binding effect on the population.

3. Lessons from Iceland and an Outlook on Greece

While the EU Commission, the European Central Bank and the IMF approached the financial crisis in destitute EU member states through the uniform imposition of austerity policies and the privatization of state assets, the small nation in the North Atlantic, Iceland, chose a different path with positive results for both, the population and the creditors. In consequence, just like the Swiss Bundesgericht, Island's government policies and the decision of the EFTA Court can serve as a blueprint for future discussions on the renegotiation and repudiation of sovereign debt.

The Icelandic response to the financial crisis, which affected its whole economy and social institutions, was unique. Iceland decided against drastic austerity, and it refused to accept payment claims raised by the IMF, the European Commission, the United Kingdom as well as by the Kingdom of the Netherlands in the context of the bankruptcy of the three major Icelandic banks Landsbanki, Kaupthing and Glitnir. From the viewpoint of constitutionalism and human rights law, it can be argued that Iceland's government reacted correctly, if it managed to protect the human rights of its citizens also during crisis by refusing to satisfy those private payment claims with taxpayer money. That human rights should be the primary concern of governments can be deducted from the hierarchy of laws that regulate the obligations and rights of states: most important are their constitutions and their commitments as they are spelled out in international treaties, then follow their laws and only then they are bound by contracts, such as loan contracts.

Economic and social policies, public health data and legal considerations overlap in this case, resulting in a good Icelandic social security system, instead of bailout programmes for banks and investors. To understand how Iceland managed to put human rights first and investors second, the crisis and Iceland's response have to be described in all their complexity.

3.1. The Financial Crisis in Iceland

In the 1990s, Iceland's government decided that Iceland's economy should grow by turning it into an offshore banking centre. The country incurred massive trade deficits from imports and borrowing in foreign currency, while the banks invested into risky but high-yield overseas investments, for example mortgage-backed securities from the United States. Simultaneously, these banks had to meet high payouts to investors, which lead to several warnings in 2006 and 2007 regarding the stability of the Icelandic financial system.[265] To generate more income that could be used to pay the investors and creditors, Iceland's major banks decided to offer lucrative online accounts for depositors abroad. The BBC called one of these risky new investment vehicles a "best buy": IceSave, from Iceland's privately held Landsbanki paid 5.2% to savers with at least GBP 250 in an online account.[266] According to Sigurgeirsdóttir and Wade this was but one way for the already shaky Icelandic banks to tap into new financial resources in order to pay the obligations for older depositors: 300,000 British citizens deposited their savings in IceSave and "[t]ens of millions of pounds arrived from Cambridge University, the London Metropolitan Police Authority, even the UK Audit Commission, responsible for overseeing local government

265 David Stuckler and Sanjay Basu, *The Body Economic – Eight experiments in economic recovery, from Iceland to Greece* (Penguin Books 2013) 60-61

266 Paul Lewis, 'Foreign banks offer best buys', BBC Radio 4's Money Box, 14 October 2006 <http://news.bbc.co.uk/2/hi/programmes/moneybox/6051276.stm> accessed 16 August 2017

funds."[267] From the early 1990s the Icelandic government was composed of people that claimed financial markets were efficient and self-regulating, so they relied on the banks themselves for information about the financial economy.[268] Thus, Iceland had a massive problem of moral hazard and regulatory capture because the modern-looking tiny state lacked regulators with know-how in international finance. Unfortunately, for the British, Dutch and other foreign depositors, IceSave and other entities abroad were established as 'branches' rather than 'subsidiaries' which meant that legally they were supervised by the Icelandic authorities without know-how, instead of their hosts'. Moreover, nobody seemed to bother that 320,000 Icelandic citizens were supposed to compensate more than 300,000 depositors abroad in the event of failure, despite warnings.[269] Consequently, when all three major Icelandic banks collapsed within one week, the deposit insurance called Depositors' and Investors' Guarantee Fund, which had been set up as a private entity in accordance with the EU directives 94/19/EC and 97/9/EC, did not have sufficient funds despite meeting the requirements of the EU directives.

Another creative way to obtain new funds were the "'love letters'—a novel way to get access to liquidity without pledging real assets as collateral."[270] The biggest three Icelandic banks Landsbanki, Kaupthing and Glitnir had exhausted their borrowing limit from Iceland's Central Bank, so they sold their own bonds to the smaller Icelandic banks who would use these as collateral to obtain loans from Iceland's Central Bank which would then be lent back to the big three banks. Then the three set up branches[271] in Luxembourg to whom they sold 'love letters', too. These 'love letters' were then used as collateral for loans from the Central Bank of Luxembourg as well as from the European Central Bank. The money the branches received was then funnelled back to the mother bank in Iceland. This worked so well that Landsbanki, Kaupthing and Glitnir obtained EUR 4.5 bn from the Central Bank of Luxembourg in the first six months of 2008. This means the participating central banks knowingly accepted bonds as collateral that were designed to circumvent the collateral requirements instead of demanding real collateral that was not in use already. Inexplicably, the Glitnir-bonds received an aaa rating from a U.S. credit-rating agency during this period, higher than that of Iceland itself.[272] When the subprime mortgage crisis of the United States lead to countless home foreclosures and a stock market crash there,

267 Silla Sigurgeirsdóttir & Robert H Wade, 'Lessons from Iceland' *New Left Review* (Issue 65 September/October 2010) <https://newleftreview.org/issues/ii65/articles/robert-wade-silla-sigurgeirsdottir-lessons-from-iceland> accessed 04 April 2019

268 ibid, see also Juan Pablo Bohoslavsky and Kunibert Raffer (eds), *Sovereign Debt Crisis – What Have We Learned?* (Cambridge University Press 2017) 115

269 ibid

270 ibid

271 ibid, economists Sigurgeirsdóttir and Wade write about "subsidiaries" here, although legally they seem to have been "branches" with the negative consequences for supervision, therefore this term is used.

272 ibid

Icelandic banks, who held a lot of U.S. mortgage default swaps, lost their investments to a large degree and could not pay their lenders.

In October 2008, IceSave collapsed, and the stock market fell by 90 percent.[273] In the same month the government turned to the IMF for a rescue package which offered USD 2.1 billion in loans in exchange for cutting public spending by 15 percent of GDP. The IMF demanded that 50 percent of Iceland's gross income was to be paid to these lenders over seven years, from 2016 to 2023. These austerity measures were meant to generate savings among the citizens and the state to pay back IceSave's private lenders, even though its owner, Landsbanki, was a privately owned bank. Like in other countries, the public was requested to pay for the poor business decisions of a bank and her lenders. As Stuckler and Basu point out in their research on public health, there are 182,000 families on this island, out of which some 100,000 had little or no debt at all. Unlike them, there were 244 wealthy families who had accrued investment debts exceeding USD 1 million.[274] These wealthy families and lenders abroad had benefited from the boom and the IMF policies were designed to make the public pay for their losses. For example, one of the austerity measures of the IMF demanded a 30 percent cut in the public health system which should also encourage privatization.[275]

The Economist stated in December 2008 that Iceland's banking collapse was the biggest ever, relative to the size of an economy, as all its large banks failed and the stock market crashed by 90 percent.[276] Suddenly, Iceland was faced with the bankruptcy of its healthcare system, as the state funding for state hospitals and state-run insurances had stopped. On top of that, with a plummeting króna, purchasing medication abroad with Iceland's currency had become expensive.

In this environment, public health researchers David Stuckler and Sanjay Basu intended to find out if democratic participation, social support, and inclusive social protection would make the island more resilient to a recession and would protect a public health disaster.[277] Iceland was the ideal place to study how a recession would affect public health, since nearly everybody had the same culture, diet, insurance coverage and the country enjoyed a strong, Nordic-style system of social welfare.[278] The debate that ensued in Iceland was about the question whether austerity or stimulus would improve public health and support

273 David Stuckler and Sanjay Basu, *The Body Economic – Eight experiments in economic recovery, from Iceland to Greece* (Penguin Books 2013) 60-61
274 ibid 62-63
275 ibid 63
276 Briefing, 'Iceland: Cracks in the Crust', The Economist (11 December 2008) <https://www.economist.com/briefing/2008/12/11/cracks-in-the-crust> accessed 11 June 2022
277 David Stuckler and Sanjay Basu, *The Body Economic – Eight experiments in economic recovery, from Iceland to Greece* (Penguin Books 2013) 59
278 ibid 58

the economy. With data from prior recessions, Stuckler and Basu showed that austerity would not restore investor confidence, would not lead to more investment and would not prevent a recession and a public health crisis but trigger the opposite results: austerity would lead to unemployment, reduce consumption and hamper economic development. IMF economists on the other hand, had simply assumed that government spending would reduce the economy, as their fiscal multiplier for Iceland and all other countries had a value of 0.5, meaning USD 1 spend by the government would generate only USD 0.5 in the economy. The IMF staff had no hard data to support their claim but insisted that state stimulus was detrimental and therefore reducing the budget would have an accelerating effect on the economy.[279] As it turned out, data from 25 European countries, the United States and Japan showed that the real fiscal multiplier value was about 1.7 on average, hence, the relationship was the opposite: austerity would lead to recessions and stimulus to recovery.[280] A poor understanding of the fiscal multiplier value and of the fact that austerity would harm the economy was not the only mistake, the IMF also grossly underestimated the damage the cuts in the public healthcare sector would cause. Stuckler and Basu's research proves that the fiscal multiplier for education as well as for public health is commonly above 3 while bailouts of banks and defence projects are usually significantly below 1. In the cases of defence projects and bank bailouts the funds are frequently not re-invested to generate technological development, jobs and profit. Instead, military spending is predominantly used up by consumption, such as paying military contractors or jet fuel, while the bank bailout money ends up in offshore accounts directly. State stimuli in education and public health, on the other hand, would trigger an immediate effect by increased employment for teachers and nurses, while also improving investment in domestic medical research and production. On the long run, better education and medical services would result in a smarter and healthier workforce.[281]

Within the half year between the end of 2008 and summer 2009, an agreement had been reached on governmental level that Iceland would guarantee the Depositors' and Investors' Guarantee Fund so that the insurance coverage to the lenders could be paid. For that purpose, Iceland was to take a loan of EUR 3.88 billion from the United Kingdom and the Netherlands which was supposed to be paid back over a period of 15 years.[282] The first IceSave bill was approved by parliament after amendments were added setting a cap on the

279 ibid 64
280 ibid 65; repeated concern for the IMF's inadequate policies is widespread. Joseph Stiglitz is quoted here to have said on Icelandic TV "If the IMF tells you to do austerity, kick them out."
281 ibid 65
282 Editors – Daily News, 'Iceland, the UK and Netherlands Agree on Icesave' *Iceland Review Online* (8 June 2009) <https://web.archive.org/web/20100117175556/http://www.icelandreview.com/icelandreview/daily_news/?cat_id=16567&ew_0_a_id=325387> accessed 27 January 2023

repayment based on the country's gross domestic product.[283] At the same time, the IMF review for the payout of the second tranche of the loan was delayed until a binding agreement was penned between Iceland, Great Britain and the Netherlands.[284] Since the parties did not reach an agreement, Iceland passed an amended second IceSave bill in December 2009 which was vetoed by the Icelandic president, Grímsson, who passed it to a national referendum, instead, stating the nation had a right to choose.[285] Not only had the president received a petition of one quarter of Iceland's population to veto the law,[286] Iceland had already faced massive protest over the course of 2009 which had called into question the plan to let the public pay for the IceSave losses and the IMF-imposed austerity.[287]

The referendum was held in March 2010 with 98 percent of the electorate voting against bailing out the bankers[288] and for investing into the Icelandic economy and rebuilding their democracy instead. Both options to choose from were connected to hardship. But the bailout, which was supported by only 2 percent in the referendum,[289] would have benefited the bankers and lenders and left the citizens only with the hope that eventually investors would return. Alternatively, they could reject the bailout and invest in rebuilding their democracy as well as their economy instead – equally with the hope that at a later stage Iceland would become attractive for international investors again. The hope was that rejecting the IMF proposal would at least yield immediate results in their society, as it would keep people employed and retirees could keep their pensions, which means both would have money left for consumption and would not leave the island. Moreover, the collapse of the banks was not their responsibility, as long as Icelandic law did not provide for any obligation of the government to take care of investors, just as in the Leukerbad case. From that point of view, the refusal to bail out the banks seems to have been the logical choice for Iceland's citizens.

After the 2010 referendum, Iceland, the UK and the Netherlands negotiated the IceSave bill 3 with better conditions such as lower interest rates and a longer time frame for

283 Omar Valdimarsson, 'Iceland parliament approves debt bill' *Reuters* (28 August 2009) <https://www.reuters.com/article/ousiv/idUSTRE57R3B920090828> accessed 10 March 2019
284 Editors, 'PM: Iceland cannot wait much longer for IMF payout' *IceNews* (29 September 2009) <https://web.archive.org/web/20120324111432/http://www.icenews.is/index.php/2009/09/29/pm-iceland-cannot-wait-much-longer-for-imf-payout/> accessed 10 March 2019
285 Editors - BBC News, 'Iceland leader vetoes bank repayments bill' *BBC* (5 January 2010) <http://news.bbc.co.uk/2/hi/business/8441312.stm> accessed 12 February 2019
286 ibid
287 Editors – Daily News, 'President of Iceland Vetoes Icesave Legislation' *Iceland Review Online* (5 January 2010) <https://web.archive.org/web/20100114080456/https://www.icelandreview.com/icelandreview/daily_news/?cat_id=16567&ew_0_a_id=356059> accessed 11 March 2019
288 https://www.statice.is/statistics/population/elections/referenda/ see also David Stuckler and Sanjay Basu, *The Body Economic – Eight experiments in economic recovery, from Iceland to Greece* (Penguin Books 2013) 66
289 Silla Sigurgeirsdóttir & Robert H Wade, 'Lessons from Iceland' *New Left Review* (Issue 65 September/October 2010) <https://newleftreview.org/issues/ii65/articles/robert-wade-silla-sigurgeirsdottir-lessons-from-iceland> accessed 04 April 2019

payments which was again passed on to a referendum by the president, scheduled for 9th April 2011. Yet, also this time 60 percent of voters rejected the proposal.[290]

Data from 2007-2009 shows no or only temporary statistically significant increase of suicides or heart attacks in Iceland, incidents that would commonly be attributed to the stress during recessions. Likewise, mental health problems did not increase to levels that were statistically relevant. Instead, people reported about positive effects across the board, probably because of working less and having more leisure time. In fact, Iceland had remained the happiest place in the world, according to the UN World Happiness Report of 2012.[291] Despite the economic crisis, Iceland had remained healthy as well as happy since they ate healthier at home, smoked and drank less and also got more sleep. It is unclear if the recession caused the healthier behaviour, but there are other indicators that also point into this direction. For example, McDonald's left the country in October 2009, so the islanders returned to eating local fish as a substitute. Fish was not only important for public health: as reported by the Wall Street Journal, only three years after the crisis Iceland was "coming back" due to increased exports facilitated by a cheap króna leading to a revival of Iceland's fisheries and the economy.[292] Also alcohol played an important role for public health. Iceland rejected the IMF's demand for privatizing alcohol shops to improve the economy. Instead of increasing consumption during the crisis, tight regulation and expensive imports due to the cheap currency made alcohol consumption expensive and the demand plummeted.[293]

Iceland accepted only a modified IMF rescue package with "expenditure compression" beginning in 2010,[294] but it left the programme already in 2012.[295] The new government had bought time until 2011[296] to increase its investment into its healthcare system, which offset unaffordable pharmaceutical imports and set up additional safeguards. For example, Iceland secured food, housing and employment. Overall, the social and health related spending rose from 21 to 25 percent of GDP from 2007 to 2009. This increase also included debt relief programmes, so distressed citizens could keep their homes. As a result,

290 https://www.statice.is/statistics/population/elections/referenda/
291 David Stuckler and Sanjay Basu, *The Body Economic – Eight experiments in economic recovery, from Iceland to Greece* (Penguin Books 2013) 68-70
292 ibid 70, Charles Forelle, 'Fishing Industry Aids Iceland's Recovery' *Wall Street Journal* (18 May 2012) <https://www.wsj.com/video/fishing-industry-aids-iceland-recovery/E1ED2AC5-D98B-4760-844E-67F8BA64A136.html> accessed 19 November 2015
293 David Stuckler and Sanjay Basu, *The Body Economic – Eight experiments in economic recovery, from Iceland to Greece* (Penguin Books 2013) 70-71
294 Ajai Chopra and James Roaf, "Iceland 2012 Article IV Consultation And First Postprogram Monitoring Discussion" *IMF Country Report No. 12/89* (April 2012) 6 <https://www.imf.org/external/pubs/ft/scr/2012/cr1289.pdf> accessed 14 June 2023
295 BBC Editors, 'Iceland debt 'safe to invest' after ratings upgrade' BBC News 17 February 2012 <https://www.bbc.com/news/business-17075011> accessed 17 March 2015
296 Silla Sigurgeirsdóttir & Robert H Wade, 'Lessons from Iceland' *New Left Review* (Issue 65 September/October 2010) <https://newleftreview.org/issues/ii65/articles/robert-wade-silla-sigurgeirsdottir-lessons-from-iceland>

Iceland had no significant increase of homelessness and households at risk of poverty, unlike Spain, where foreclosures and evictions were the standard, rendering many citizens homeless.[297] Despite these additional expenses, "Iceland has experienced smaller falls in gdp [sic] and employment than big public-spending slashers like Ireland, Estonia and Latvia", so Sigurgeirsdóttir & Wade.[298] "The Body Economic" is probably the most comprehensive work on public health and economic crisis, it studies the impact of policy decisions of several governments over many years. Its authors Stuckler and Basu describe Iceland during the crisis as a place characterized by solidarity and a democracy that enjoys full support of its citizens – with hardly any negative social or health impact.[299] So it does not come as a surprise that the citizens of Iceland turned down another proposal in the following referendum in April 2011, according to which the IceSave investors would have been immediately paid back.[300]

Apart from the fisheries, also other sectors of the economy recovered soon. In 2012 the economy grew by 3 percent while unemployment shrank below 5 percent. In June that year the island made some repayments of loans, earlier than expected, while Fitch restored Iceland's rating to "investment grade".[301] In its ex-post evaluation of the programme, the IMF stated that the key elements of the Icelandic welfare state had been maintained "by designing the fiscal consolidation in a way that sought to protect vulnerable groups by having expenditure cuts that did not compromise welfare benefits and raising revenue by placing greater tax burden on higher income groups."[302] The experience with the program was proof "that the social impact can be eased in the face of fiscal consolidation following a severe crisis by cutting expenditures without compromising welfare benefits, while introducing a more progressive tax system and improving efficiency" and that "bank restructuring approach allowing creditors to take upside gains but also bear part of the initial costs helped limit the absorption of private sector losses by public sector."[303] That means, the IMF documented that the protection of health and social standards does not hamper economic recovery[304] and that bank restructuring may entail the sharing of losses between state and creditors.[305] The IMF knew from 2012 onwards that their assumptions

297 David Stuckler and Sanjay Basu, *The Body Economic – Eight experiments in economic recovery, from Iceland to Greece* (Penguin Books 2013) 71-72

298 Silla Sigurgeirsdóttir & Robert H Wade, 'Lessons from Iceland' *New Left Review* (Issue 65 September/October 2010) <https://newleftreview.org/issues/ii65/articles/robert-wade-silla-sigurgeirsdottir-lessons-from-iceland>

299 David Stuckler and Sanjay Basu, *The Body Economic – Eight experiments in economic recovery, from Iceland to Greece* (Penguin Books 2013) 73

300 ibid 74

301 BBC Editors, 'Iceland debt 'safe to invest' after ratings upgrade' BBC News 17 February 2012 <https://www.bbc.com/news/business-17075011> accessed 17 March 2015

302 Emil Stavrev, Alessandro Giustiniani, Wojciech Maliszewski, Kyung-Seol Min, Michael Tharkur and Hui Tong "Iceland: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-by Arrangement" *IMF Country Report No. 12/91* (April 2012) 17-18 <https://www.imf.org/external/pubs/ft/scr/2012/cr1291.pdf> accessed 14 June 2023

303 ibid 2

304 ibid 2

305 ibid 22

were incorrect and that there was a better way to help a state but austerity. Overall, "[t]he program was successfully completed."[306]

When the United Nations Independent Expert on Foreign Debt and Human Rights, Juan Pablo Bohoslavsky conducted an official visit to Iceland in December 2014, he intended to clarify two points: to what extent had Iceland fulfilled its obligations to protect economic, social and cultural rights in the context of the financial crisis and what legal steps can be taken to prevent negative human rights impacts in the context of financial crises and economic adjustment programmes.[307] The emergency legislation approved by parliament in October 2008 and adjustment policies were based on the principle that socialization of the banks' losses should be avoided as far as possible. Private savings in Icelandic deposit accounts were protected and given preference over other claims, including those by international institutional investors.[308] The economic side of the adjustment programme can be described as increasing revenue generation through taxation, together with fewer expenditure cuts while the legal side helped with the protection of society. It was decided to introduce a temporary wealth tax, increase the flat tax on capital income and the VAT, and the reintroduction of a progressive income tax system. Still, the poorest 20 percent of the population lost 9 percent of their disposable income between 2008 and 2010, while the wealthiest 10 percent seem to have lost 38 percent of their income. This figure, however, is uncertain, as the UN's Independent Expert on Foreign Debt and Human Rights points out, since some of that Icelandic money might have ended up in tax havens instead, as the Panama Papers scandal suggests.[309] Another step favouring indebted households were the targeted debt relief programmes and a law based on which claims against bankrupt individuals expired already after two years after bankruptcy, instead of four.[310] Companies could also apply for debt relief, as long as the assessment showed the business could reach profitability. Weeding out unprofitable business prevented the state from misallocating funds, while protecting employment and rebuilding trust.[311] On top of this, the Supreme Court ruled in 2010 that loans that were indexed in foreign currencies were illegal, as they violated consumer protection laws, a step that reduced the debt burden even further.[312] Against the usual trend in financial crises, Iceland's social transfers and taxation policies

306 ibid 2
307 Juan Pablo Bohoslavsky and Kunibert Raffer (eds), *Sovereign Debt Crisis – What Have We Learned?* (Cambridge University Press 2017) 104
308 ibid 106
309 ibid 113 fn 19 referring to S. Erlanger, S. Castle and R. Gladstone, 'Iceland's Prime Minister Steps Down Amid Panama Papers Scandal' *New York Times* (5 April 2016) <www.nytimes.com/ 2016 / 04 / 06 /world/europe/panama-papers-iceland.html?_r= 0> accessed 23 February 2020; see also Jon Henley, 'Iceland PM steps aside after protests over Panama Papers revelations' *The Guardian* (05 April 2016) <https://www.theguardian.com/world/2016/apr/05/iceland-prime-minister-resigns-over-panama-papers-revelations> accessed 23 February 2020
310 ibid 113 IV.B.
311 ibid
312 ibid 114

reduced inequality significantly which can be attributed to the human rights – centred approach.[313] There is another peculiarity in Iceland's case: there were the traditional expenditure cuts, capital controls and the rebuilding of the banking sector as the standard measures of the IMF toolbox. But, as the United Nations Independent Expert notes, all this happened while Iceland's social protection remained largely untouched or was improved even. In the light of the standard IMF adjustment programmes, this was unorthodox, and it is unknown why the IMF did not demand the reduction of the social protection services and the privatisation of the health sector as usual.[314] As mentioned above, the IMF even expressed its satisfaction with the successful completion of the programme afterwards. From the point of debt repudiation, however, it has to be noted that there is no legal obligation for a state to accept the terms of the loan offered by the IMF. For this reason, this case is special, as the IMF would normally refuse handing out loans without signing an agreement on the reforms recommended by it.

3.2. EFTA Surveillance Authority and EU Commission v. Iceland

The citizens rejected the IceSave bills designed to pay damages to the British and Dutch lenders in two referenda. This lead to a legal dispute, in the course of which Iceland was sued by the EFTA Surveillance Authority, which submitted her application to the EFTA Court in 2011,[315] demanding the Court's declaration that by failing to ensure payment of the minimum amount of compensation to IceSave depositors in the Netherlands and in the United Kingdom Iceland had failed to comply with the obligations resulting from the Agreement on the European Economic Area and corresponding acts (Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes). The EFTA Surveillance Authority and the EU Commission claim that Iceland discriminated against British and Dutch lenders based on their nationality, which would have violated article 4 of the Agreement on the European Economic Area (EEA Agreement) which provides "[w]ithin the scope of application of this Agreement, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited."

Ever since 1 January 2000 Iceland's Depositors' and Investors' Guarantee Fund has operated in accordance with Directive 94/19/EC to compensate depositors and investors in cases of bankruptcies in the banking sector. Therefore, the deposits at the British and Netherlands branches of Landsbanki were under the responsibility of Iceland's Depositors'

313 ibid 113 IV.A., 122 VI.
314 ibid 106
315 *EFTA Surveillance Authority, applicant, supported by the European Commission, intervener, v Iceland, defendant* Case E-16/11 [2013] EFTA Court (28 January 2013)

and Investors' Guarantee Fund.[316] From May 2008, Landsbanki decided to take part in the British and Dutch deposit guarantee scheme to supplement its home scheme, as these protected deposits up to GBP 50.000 and EUR 40.000, later EUR 100.000, respectively.[317] On 3rd October 2008, the British Financial Supervisory Authority froze the Landsbanki assets in Britain; British and Dutch depositors lost access to their accounts shortly after. On 7 October 2008 Landsbanki collapsed. The Icelandic Financial Supervisory Authority immediately suspended the bank's board of directors and appointed a winding-up committee which assumed the full authority of the board.[318] The Icelandic Minister of Finance established new banks under the Icelandic Emergency Act between 6 and 9 October 2008 after which the domestic deposits were transferred to the new bank "New Landsbanki" which was established by the Icelandic Government to achieve a restructuring of the Icelandic banks.[319] The Icelandic Financial Supervisory Authority triggered the payment obligation of the Depositors' and Investors' Guarantee Fund, but it also extended the 3 months – time limit by almost one year in accordance with article 10 (2) of the Directive 94/19/EC.[320] On 19 November 2008, the IMF approved a two-year Stand-By Arrangement of USD 2.1 billion, out of which USD 827 million was made available immediately, with eight further instalments to follow. One element of the IMF Arrangement were stringent capital controls to prevent further devaluation of the Icelandic króna.[321] In late 2008, the Dutch guarantee scheme paid all account holders up to EUR 100.000 each and the UK government decided to pay all retail account holders full compensation for their deposits. Based on the IMF's request, now also capital account restrictions were introduced, which restricted all international foreign currency transfers except those for the purchase of goods and services, which were gradually removed only about one year later. By March 2009 about 93% of the banking sector in Iceland had collapsed.[322]

The EFTA Court starts its reasoning by stating that it needs to clarify whether the Directive envisages that the defendant Iceland should have ensured payment to depositors in the IceSave branches in the Netherlands and the United Kingdom in accordance with Directive articles 3, 4, 7 and 10 during a systemic crisis of the magnitude experienced in 2008. Additionally, it must also be evaluated whether the defendant has infringed the alleged obligation of result. Based on the applicant's submission, the Directive imposes this

316 *EFTA Surveillance Authority, applicant, supported by the European Commission, intervener, v Iceland, defendant* Case E-16/11 [2013] EFTA Court (28 January 2013) nr. 26, 29

317 ibid 30

318 ibid 31-34

319 ibid 36-38

320 ibid 40; the Directive and its articles mentioned in this decision refer to Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, No L 135/5 of 31 May 1994

321 ibid 41

322 ibid 42-43, 46

"obligation of result" on EEA States (member States of the European Economic Area) to ensure that a deposit-guarantee scheme is set up capable of guaranteeing that, in the event of deposits being unavailable, the aggregate deposits of each depositor are covered in all circumstances. Further, the obligation of result requires States to ensure that duly verified claims by depositors are paid within the three-month deadline laid down in article 10 of the Directive. The applicant contends that Iceland has not fulfilled all its obligations simply by transposing the Directive into national law and setting up and recognising a deposit-guarantee scheme without any regard to whether the compensation of depositors is ensured under the conditions prescribed in the Directive.[323] The court points out that a violation of the EU Directive can only be found if there is a situation contrary to EEA law which is objectively attributable to the EEA State concerned.[324] The aim of this Directive is, on the one hand, the freedom of establishment and freedom to provide services in the banking sector, and the stability of the banking system and protection for savers, on the other. Hence, the depositor schemes should not impede the ability for banks to do business. So, European regulatory policies in the relevant field are based on the principles of mutual recognition and a "single passport" mechanism that allows financial services operators lawfully established in one EEA State to establish and/or provide their services in other EEA States without further authorisation requirements.[325] The Directive is not one of absolute constraint since it leaves the EEA States free to introduce and recognise several deposit-guarantee schemes within their territory, thereby allowing the credit institutions to choose the model that will suit them best. The EFTA Court agrees with the ECJ that those provisions are supposed to guarantee depositors that the credit institution in which they make their deposits belongs to a deposit-guarantee scheme and fulfils its obligations. This shall ensure the protection of their right to compensation in the event that their deposits are unavailable. However, this refers only to the existence and functioning of the deposit-guarantee. The Directive does not exhaustively regulate the unavailability of deposits, it simply requires EEA States to provide for a minimum level of protection. "It is therefore clear that national authorities have considerable discretion in how they organise the schemes."[326] The Directive reflects the Member States' agreement to a minimum level[327] of protection and supervision: From article 3 of the Directive, it can be deducted that EEA States have to introduce and officially recognise a deposit-guarantee scheme. Additionally, they have to fulfil certain supervisory tasks in order to ensure the proper functioning of the

323 ibid 75-77
324 ibid 117-118
325 ibid 125-127
326 ibid 133-134
327 ibid 136-137

deposit-guarantee scheme. But it is not envisaged in that provision that EEA States have to ensure the payment of aggregate deposits in all circumstances.[328]

In 2009, the minimum threshold for the guarantee in article 7 of the Directive has been increased to EUR 50,000 and from 1 January 2011 the scheme had to reach EUR 100,000 which indicates that the legislator saw it was necessary to improve the situation.[329] That an increase was regarded necessary supports the view that the obligation on the EEA States under the original 1994 version of the provision applicable in the case at hand is limited to ensuring that national rules which require a coverage level of at least EUR 20,000 are maintained or adopted.[330] Furthermore, the EFTA Court points out that pursuant to article 7(6) of the Directive, States have to ensure that depositors might take action for compensation. This means, article 7 (6) of the Directive encompasses the scenario that a deposit-guarantee scheme might be unable to pay qualified claims.[331]

For the obligation of the State during a systemic crisis, the EFTA Court finds:

> (…) [T]he obligation on the EEA States is limited to the maintenance or adoption of rules that provide for an effective right to file an action against the guarantee scheme particularly in the case of non-payment (...). Consequently, it must be held that Article 7 of the Directive does not lay down an obligation on the State and its authorities to ensure compensation if a deposit-guarantee scheme is unable to cope with its obligations in the event of a systemic crisis.[332]

This means, States are obliged to introduce a working deposit-guarantee scheme but there is no obligation to bail it out if it reaches its limits.

Apart from the Court's argumentation it should be added here that this is not the only safety mechanism banks have to observe. The Basel Accords determine that a bank that hands out a loan has to increase its capital, whereas a bank receiving a deposit has to increase its reserves. These increases are designed to ensure the liquidity of banks and of course, this risk management leads to expenses. Since there are already two mechanisms in place and as the Directive does not intend to impede the business of banks by deposit-guarantee schemes[333], it could be argued that two safety-mechanisms should suffice and constitute a compromise between safety and expenses. In accordance with the Court, the wording of the Directive, in particular articles 1(3), 9(3) and recital 4 of the Directive, allows only the conclusion that it is aimed at the prevention of difficulties, such as bank runs, when a single bank is affected.[334] Moreover, the Court found out that in its 2010

328 ibid 135
329 ibid 138-140
330 ibid 141
331 ibid 142
332 ibid 143, 144
333 ibid 125-127
334 ibid 150-151

Impact Assessment the biggest failure envisaged by the Commission's services is a failure of a large member bank accounting for 7.25% of eligible deposits. Not even in a test after the enormous financial crisis of 2008 the EU Commission used a sample that came close to this disaster, but stuck to the failure of only one bank.[335] Another important point that speaks against the applicant's claim is the fact that the Directive and its recitals 4, 23 and 25 put the liability to fund the deposit-guarantee schemes on the banks, not the Member States. This makes sense, since it is private banks that take risk, so they should also face and prevent it. Correspondingly, the payment obligation lies with the deposit-guarantee fund.[336] The Directive also demands that depositors can take action against the bank-funded deposit-guarantee fund in case of non-payment.[337] Would the legislator have desired state liability, one could argue, he would have added this possibility. The Court arrives at a similar conclusion from another viewpoint, because state liability would stifle competition. This idea can be developed from article 3(1) of the Directive, based on which the liability of Member States and their local or regional authorities is excluded.[338] The EFTA court even states that moral hazard can only be prevented, if state guarantee remains at a minimum:

> An additional aspect to which regard must be had is mentioned in recital 16 in the preamble to the Directive. There, the European legislature states that it would not be appropriate to impose a level of protection "which might in certain cases have the effect of encouraging the unsound management of credit institutions". This points to the concept of moral hazard. In economic literature the lesson of moral hazard has been described with the words that "less is more". Professor Joseph E. Stiglitz has formulated in this respect: "[T]he more and better insurance that is provided against some contingency, the less incentive individuals have to avoid the insured event, because the less they bear the full consequences of their actions".[339]

This is an extremely important step, since the Court not only defines moral hazard, which could also be described as an economic incentive structure that encourages risky behaviour because it is clear the risk will not be borne by the one who causes it. The EFTA Court also refuses to give banks, depositors, lenders and investors the ability to use moral hazard against the states, because it rejects the two options a state would have in a systemic crisis – guaranteeing a loan that would secure liquidity of the deposit-guarantee scheme, or funding the depositors or the scheme directly, which precludes the existence of the so called obligation of result.[340] From this the Court concludes that the Directive does not envisage that the defendant itself must ensure payments to depositors in the IceSave

335 ibid 152-153
336 ibid 156, 159
337 ibid 160
338 ibid 162-164
339 ibid 167
340 ibid 168

branches in the Netherlands and the United Kingdom, in accordance with articles 7 and 10 of the Directive, in a systemic crisis of the magnitude experienced in Iceland.[341]

The applicant and intervener not only submitted a claim according to which Iceland's non-fulfilment of the guarantee obligations constituted a violation of an "obligation of result". They also allege Iceland had discriminated against customers from the UK and the Netherlands as the depositors in Iceland allegedly received full protection whereas the depositors in the Netherlands and the United Kingdom were left without any or any comparable protection.[342] After their belief, IceSave customers in branches in Iceland and their counterparts in branches in other EEA States were in a comparable situation as regards the protection granted to them by the Directive under article 4 thereof read in light of recital 3 in the preamble to the Directive.[343] The applicant and the intervener state the Icelandic Government made a distinction between domestic deposits and deposits in foreign branches as domestic deposits were moved to a new bank and were covered in full while foreign depositors did not even enjoy the minimum guarantee demanded by the Directive. The applicant and intervener do not criticise the transfer to the new bank itself, the breach is said to lie in the fact that the Icelandic Government provided a compensation payment within the required time limit for domestic depositors as the Directive demanded, but it did not provide for the same protection of depositors in the United Kingdom and in the Netherlands.[344] So, the applicant and the intervener claim Iceland's government has indirectly discriminated against foreign depositors on the basis of nationality, which is prohibited by the Directive read in the light of article 4 EEA Agreement or by article 4 EEA Agreement itself.[345]

Iceland observes that the applicant seeks a declaration that, in failing to ensure payment of the EUR 20 000 per depositor required under the Directive 94/19/EC, the defendant breached EEA law. However, in the defendant's view, this obligation cannot be derived from the principle of non-discrimination. If this argument were to be followed, this would create an obligation for an EEA State to ensure minimum compensation under the Directive in circumstances in which the partially harmonised regime created by the

341 ibid 178
342 ibid 186
343 ibid 187; Article 4 (1) of Directive 94/19/EC reads "Deposit-guarantee schemes introduced and officially recognized in a Member State in accordance with Article 3 (1) shall cover the depositors at branches set up by credit institutions in other Member States." and recital 3 reads: "Whereas in the event of the closure of an insolvent credit institution the depositors at any branches situated in a Member State other than that in which the credit institution has its head office must be protected by the same guarantee scheme as the institution's other depositors;"
344 ibid 188, 190; related to the minimum guarantee, Article 7 (1) of Directive 94/19/EC reads "Deposit-guarantee schemes shall stipulate that the aggregate deposits of each depositor must be covered up to ECU 20 000 in the event of deposits' being unavailable."
345 ibid 189; Article 4 of the EEA Agreement reads "Within the scope of application of this Agreement, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited."

Directive does not require such. In the circumstances of a bank failure, the defendant submits, EEA States may but are not obliged to rescue banks, or branches which are necessary to the functioning of the banking system. What is submitted by the EFTA Surveillance Authority and the EU Commission as discrimination in the present case are in reality the different consequences of the fact that the Icelandic financial system could not be rescued without the domestic branches of Landsbanki. "Although the Directive is a consumer protection measure, it does not address in any way the regulation of bank insolvency and restructuring – they are entirely beyond its scope."[346] The defendant notes further that it is not part of the applicant's case that the transfer of domestic deposits to a new bank as part of the bank restructuring should have been extended to overseas depositors. The applicant and intervener have never questioned the fact that it was not possible to extend this rescue to the overseas branches. From this the defendant draws the conclusion, the applicant does not argue that the two groups of depositors should have been treated equally.[347] Moreover, it is questionable whether the transfer of domestic deposits to the new bank led to a better position of the Icelandic depositors as they were subject to strict capital controls and were unable to convert their Icelandic króna into any other currency, while the króna was depreciating quickly. Unlike them, the priority claimants in the Landsbanki winding up within the EU were about to be fully reimbursed in a fully convertible currency at the time of the court hearings.[348] In any case, the defendant argues that there has been no discrimination in the manner in which the deposit-guarantee fund itself has operated. The two groups – depositors with domestic branches and depositors with foreign branches of Landsbanki – have been treated equally, for none has received any payments under the guarantee scheme.[349]

In a first step, the EFTA Court concludes from article 4 of the Directive read in light of recital 3 in the preamble that depositors at any branches established by credit institutions in other EEA States shall belong to the guarantee scheme introduced and officially recognised in the home EEA State.[350] It also concludes that the treatment of foreign and domestic depositors by the deposit-guarantee scheme must be equal as regards payment of minimum compensation under the Directive in the event of the closure of an insolvent credit institution.[351] Thus, the principle of non-discrimination requires that there is no difference in the treatment of depositors by the guarantee scheme itself and the way it uses its funds. When Landsbanki collapsed on 7 October 2008, the government decided for a

346 ibid 192-195
347 ibid 198
348 ibid 199
349 ibid 200
350 ibid 208
351 ibid 209

restructuring of the banking system, including the transfer of the deposits to a new bank.[352] For the sake of the aims of this thesis, which is to figure out legal means of debt repudiation, this is a relevant step because it helps protect the state from paying into banks that caused uncontrollable risk. Creating this new bank with the deposits of the old could be called a “good bank” that protects the deposits and the banking system, which was formed by the government, as opposed to the common “bad bank”, which protects the bank itself, despite its imprudent risk taking. As the EFTA Court observes, Iceland’s Depositors’ and Investors’ Guarantee Fund was not involved in the transfer of the deposits. The transfer was part of the restructuring of the Icelandic banks that was achieved by a series of measures under the Icelandic Emergency Act, passed by the government and executed by the Icelandic Financial Supervisory Authority.[353] Within the 21 days prescribed in article 1(3) of the Directive, on 27 October 2008, the Icelandic Financial Supervisory Authority made a statement that triggered the obligation for Iceland’s Depositors’ and Investors’ Guarantee Fund to make payments as regards to foreign deposits in branches of Landsbanki (IceSave).[354] The EFTA Court’s analysis also shows that domestic deposits did not become unavailable within the meaning of article 1(3) of the Directive. The transfer of domestic deposits to New Landsbanki was made before the Icelandic Financial Supervisory Authority made its declaration triggering the application of the Directive. Because of that, the depositor protection under the Directive never applied to depositors in Icelandic branches of Landsbanki.[355] As the court stated before, the principle of non-discrimination inherent in the Directive requires that there should be no difference in the way a deposit-guarantee scheme treats depositors with unavailable deposits, and the way it pays out its funds. In the present case, difference in treatment of this kind was not possible because the deposits remained available. As a consequence, the transfer of domestic deposits – whether it leads in general to unequal treatment or not – does not fall within the scope of the non-discrimination principle as set out in the Directive.[356]

In a second step, the EFTA court analyses the violation of the non-discrimination principle solely based on article 4 of the EEA Agreement. Article 4 EEA Agreement requires that comparable situations must not be treated differently and that different situations must not be treated in the same way. A justification for discriminatory treatment exists only where it is based on objective considerations independent of the nationality and is proportionate to the objective being legitimately pursued.[357] The EFTA Surveillance Authority and the EU

352 ibid 210, 211
353 ibid 212
354 ibid 213
355 ibid 214
356 ibid 215, 216
357 ibid 218

Commission did not want the EFTA Court to evaluate the transfer of the deposits, so the court could only evaluate if there was an obligation to ensure a payment to IceSave depositors in the UK and the Netherlands based on article 4 EEA Agreement.[358] Yet, this norm is the general norm in relation to article 4 of the Directive.[359] Since the EFTA Court did not find any discrimination based on article 4 of the Directive in combination with recital 3, it cannot support discrimination based on the more general norm.[360] Moreover, the EFTA Court underlines that EEA States enjoy a wide margin of discretion in making choices of economic policy in the specific event of a systemic crisis which would have to be taken into consideration as a possible ground for justification.[361]

In its decision the EFTA Court dismissed therefore all three pleas related to (i) an infringement of the alleged "obligation of result" under the Directive itself, (ii) an infringement of the Directive and article 4 EEA Agreement and (iii) an infringement of article 4 EEA Agreement alone.[362] The Court holds that, by not ensuring payment of the minimum amount of compensation to IceSave depositors in the United Kingdom and the Netherlands provided for in article 7(1) of Directive 94/19/EC within the time limits laid down in article 10 of Directive 94/19/EC, Iceland has not failed to comply with the obligations resulting from that Directive, in particular articles 3, 4, 7 and 10 thereof, and/or article 4 of the Agreement on the European Economic Area.[363]

The decision of the EFTA Court has received a lot of approval since only the existence of a deposit insurance scheme is the prerequisite for the participation of Europe's single banking market, while there is no legal obligation of a state to bail out banks. The Financial Times wrote the verdict was a "victory for law and economic sense" and that "[t]he ruling makes clear that EU law does not require taxpayers to bail out private banks, the mistake that proved so disastrous for Ireland yet still claims pride of place in European banking policy doctrine."[364]

Had the United Kingdom and the Netherlands been successful with their application, they could have exchanged the bankrupted debtors Landsbanki and the Iceland's Depositors' and Investors' Guarantee Fund for another debtor, Iceland, which would have had more liquidity. Iceland could have paid quicker, on the expense of its citizens. This, however, runs counter to the intentions of the Directive because it would have meant that the risk for

358 ibid 221-223
359 ibid 204, 205
360 ibid 224, 225
361 ibid 227
362 ibid 220, 228
363 ibid 229
364 Editors, '"End of Saga" Says Financial Times' *Iceland Review* (30 January 2013)

private business deals would end up in the realm of the public.[365] Recital 24 of the Directive clarifies that any liability of the Member States for claims of depositors is excluded, preventing this shift of liability. This idea is similar to the no-bailout clause of article 125 of the Treaty of the Functioning of the European Union, and it is worth considering when it comes to the legal means of debt repudiation. But banning the transfer of risk from private businesses to Member States and the prevention of moral hazard are handled differently by the EFTA Court, than by the European Court of Justice. This is a remarkable difference, since both Courts exist parallel and in equal ranking in a Court system that safeguards the uniform implementation of EEA law which is largely identical with European Union law.[366] Differences in the interpretation of the EU and EEA law, however, are fairly frequent, as some research shows[367] and in the interest of debt repudiation it makes sense for states to compare decisions, such as the Iceland case at the EFTA Court and the Pringle case of the ECJ.

3.3. An Outlook on Greece

For the sake of contrast, it is coherent to include a brief analysis of the financial crisis in Greece in this chapter on Iceland. The Greek crisis spans over many years and various governments tried to resolve it, while the number of agreements and policies that affected Greece and her citizens is enormous. This is why this thesis is limited to the analysis of few crucial points of the financial crisis in Greece.

3.3.1. Legal and Economic Consequences of Circumventing Article 125 nr. 1 TFEU

Iceland set up a "good bank" to rescue depositors and refused a bailout of investors abroad which was held legal by the EFTA Court, while the opposite happened in Greece with support of the European Court of Justice (ECJ):[368] The no-bailout clause in article 125 nr. 1 TFEU states the Union or a member state "shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other

365 Recital 24 of Directive 94/19/EC reads: "Whereas this Directive may not result in the Member States' or their competent authorities' being made liable in respect of depositors if they have ensured that one or more schemes guaranteeing deposits or credit institutions themselves and ensuring the compensation or protection of depositors under the conditions prescribed in this Directive have been introduced and officially recognized;"

366 Agreement Between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (Surveillance and Court Agreement), OJ L 344, 31.1.1994, p. 3; and EFTA States' official gazettes; Recital 3 of this Agreement reads: "RECALLING the objective of the Contracting Parties to the EEA Agreement, in full deference to the independence of the courts, to arrive at and maintain a uniform interpretation and application of the EEA Agreement and those provisions of the Community legislation which are substantially reproduced in that Agreement and to arrive at an equal treatment of individuals and economic operators as regards the four freedoms and the conditions of competition;"

367 Jarrod Tudor, 'A Comparison of the Jurisprudence of the ECJ and EFTA Court on the Free Movement of Good in the EEA: Is There an Intolerable Separation of Article 34 of the TFEU and Article 11 of the EEA?', *San Diego International Law Journal* (Vol. 17: 75, 2015)

368 The following discussion is based on Oliver Pahnecke 'Wie schlechte Wirtschaftspolitik Migration verursacht' *Der Standard* (Vienna, Austria 22 June 2016)

bodies governed by public law, or public undertakings of any member State, without prejudice to mutual financial guarantees for the joint execution of a specific project." In other words, neither the EU nor any member state shall be legally responsible for and take over liability for public debt of another state and its bodies. Hence, the EU and her member States are precluded from assuming the debtor position instead of Greece. Bailing out states would foster moral hazard and hamper competition in a free market and therefore bailouts have to be prevented. Yet, ECB president Draghi, German finance minister Schäuble, ESM head Regling and president of the Eurogroup Dijsselbloom decided for a different approach: the use of public funds to buy claims against destitute states, e.g. Greece, permitting banks to unload high risk debt that they had helped create. The European Court of Justice found this shift of liability and risk to correspond with article 125 nr. 1 TFEU in its Pringle – decision[369] although it contradicts the intention and spirit of the no-bailout clause which was supposed to force budgetary discipline on EU Member States through the market[370], instead of lobbying for financial assistance and to protect the EU and her Member States from unpredictable risk and expenses caused by profligate governments. In Pringle, the ECJ stated that the no-bailout clause is not violated by the ESM buying claims of an insolvent state from banks because it is not the ECB purchasing them[371] and as long as Greece and other impoverished states remain the debtors.[372] Article 125 nr. 1 TFEU tried to prevent an exchange of the borrower, so that the governments would not be released from their economic and budgetary responsibility and to prevent that the other Member States would become obliged to pay for the debt instead of the original borrower. Applied to Greece, article 125 nr. 1 TFEU was designed to prevent the Member States taking the place of borrowers, so that they would not be forced to pay the national debt on behalf of Greece; this goal was achieved. What the Troika and leading European politicians arranged for with the construction of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), is an exchange of the lender because these institutions are financed by the Member States in order to buy the national debt held by private banks when a member state is in distress. Here, one can speak of a bailout for privately held banks with public money disguised as an aid package for distressed Member States.

The Troika institutions faced three options: 1. Originally, banks were the lenders and Greece the borrower and the banks could have been required to remain in this position as it was the case in Iceland. 2. The no-bailout clause of article 125 nr. 1 TFEU was meant to

369 *Thomas Pringle v Ireland*, Case C-370/12 (ECJ judgement of 27 November 2012)
370 ibid 135
371 ibid 132
372 ibid 137

prevent the Member States or the EU taking the place of the borrower, therefore this option was excluded. 3. The European leadership decided to replace the banks for the ESM as lender, thus saving the banks, while Greece remained the borrower. Option 2 was obviously illegal and it is unknown why the EU's leadership did not make use of option 1. But choosing option 3 is neither logical, nor economically essential, nor legal for several reasons:

First of all, it does not make any difference to the European taxpayers and the Member States if they pay the banks as a borrower, or if they pay the banks in order to buy their claims against Greece, the expenses can be expected to be similar. Should Greece still have to declare bankruptcy, it does not matter for the European citizens if they had to bail out banks, bail out Greece or write off the bonds on the ESM balance sheet. In any case, the European public will be forced to shoulder the expenses, either as debtor or as purchaser, while the intention of article 125 TFEU – to use market discipline to force budgetary prudence on governments – is eroded. Although legal by virtue of the ECJ, this operation does not make sense from an economic point of view, either, since it rendered the allocation of risk in the European market dysfunctional as the risk is no longer born by the party conducting the business that causes the risk but is taken over by states and international organisations, a measure that distorts competition. In return the Member States become the creditors of Greece (and other distressed Member States), liquidating whatever assets are left by means of memoranda of understanding and by changing domestic laws affecting the budget. This approach sounds like the business model of Singer's Elliott vulture fund which is buying distressed securities of states such as Argentina for next to nothing, hoping to gain control over valuable assets later, with the help of court procedures. At this point a question arises from a practical point of view which is important for the creation of debt that could be repudiated: were the European institutions at least smart enough to buy the PIIGS[373]-bonds from the banks facing bankruptcy as cheaply as Singer usually buys them, as this would be prudent in high-risk investments? In an email the ECB has declined to comment on prices paid and claims purchased in the asset purchase programme,[374] therefore the thesis can only offer an approximation: since the latest study shows only 5 percent of the bail-out money ended up in the Greek budget to generate growth and an overwhelming 95 percent were used to pay for claims and interest, it is more than likely, they weren't. At a rate of 95 percent of money paid to banks, it is likely that bonds were bought at par, meaning, unlike Singer, the Troika

373 PIIGS condescending acronym referring to Portugal, Ireland, Italy, Greece and Spain
374 Angelika Jakob, Directorate General Communications, European Central Bank in an email on 18 May 2016, on file with the author

used taxpayers' money to pay banks around face value for bonds that were hardly worth anything in the market at that time.[375]

Second of all, the option chosen by the people in charge of the European Union could easily become more expensive than expected, even though the ECJ decided it was legal. Had they violated the no-bailout clause, they would only have been obliged to pay Greece's debt once. Instead, they bought the bonds from the banks to rescue them (first expense) and in case Greece would have to declare bankruptcy nevertheless (it is supposed to pay for its debt until 2070[376]) the European citizens will be expected to bail out Greece (second expense). Instead of a one-time payment, it is possible that the decision will trigger a second payment in case Greece becomes bankrupted despite all these efforts. The interpretation of the ECJ is therefore based on the following principle: rescue measures in form of bailouts for a nation are illegal, although a bailed-out state could be put into the position to protect human rights again. Bailing out banks, on the other hand, and burdening the Europeans with debt caused by the risky behaviour of the banks' top management is legal, although it could become more costly and despite the fact that states are not obliged to rescue banks in any international treaty or national law. Iceland, on the other hand, neither violated the no-bailout clause, nor did it force its citizens to pay for the banks' obligations, while also stabilizing its financial economy by creating "good banks" and reducing moral hazard.

3.3.2. Applying Taft to Greece

As the thesis focuses on legal grounds for the repudiation of illicit debt, it is worth taking another look at Taft's Tinoco decision since it can help with the understanding of problems related to Iceland and Greece. In his Tinoco arbitration award, Taft decided that the loan for the Tinoco brothers and the Amory concession were created illegally. The loan for the benefit of the Tinoco brothers had been created in a transaction that was full of irregularities. For example, it violated the Costa Rican law to make the Royal Bank of Canada the depositary of a revolving credit fund, since the law authorized only the Banco International to be made such a depositary. Also, the thousand-dollar colones bills were informal and did not comply with the legal requirements as to their form, signature or registration.[377] The Amory concession was created in violation of the Costa Rican Constitution because only one house permitted the concession instead of both; therefore the concession was also void. For Costa Rica's ability to repudiate the British claims it was

375 Rocholl J and Stahmer A, 'Where did the Greek bailout money go?' *ESMT White Paper No. WP-16-02* (Berlin 2016)
376 ESM Repayments Dashboard on its homepage https://www.esm.europa.eu/financial-assistance/programme-database/repayments
377 Tinoco Arbitration (GB v Costa Rica) (1923) 1 RIAA 393 - 394

decisive that in times of crisis the lender knew about the irregularities and that in times of order the creation of the concession contravened the constitution.

From this can be deduced that Greece would be entitled to repudiate claims if irregularities and the violation of laws were sufficiently common during the Greek financial crisis and lead to additional debt that reduces the ability of the state to take care of its citizens. Also, these irregularities should represent legal violations that carry a similar weight as the ones Taft has determined, such as the violation of the constitution.

3.3.2.1. Irregular ECB-Participation in Troika

When it comes to irregularities, it is likely that the ECB participated in the Troika's activities illegally. Article 6.1. of the Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank (Statute of the ESCB and of the ECB) reads: "In the field of international cooperation involving the tasks entrusted to the ESCB, the ECB shall decide how the ESCB shall be represented." Based on article 12.5. Statute of the ESCB and of the ECB, it is the Governing Council that shall take the decisions referred to in article 6. But in the inquiry of the European Parliament in the role of the Troika, the ECB stated in its reply to question 1 that it was the ECB's Executive Board that had accepted the EU Commission's request to start working on 12 April 2010 with the International Monetary Fund and the Greek authorities on a joint programme, including amounts and conditionality.[378] Therefore, the participation of the ECB in an international cooperation such as the Troika does not meet the formal requirements and happened in violation of the ECB's statute. The same applies to the advisory function of the ECB vis-a-vis the European Union's institutions as well as national authorities, which is also supposed to be exercised by the Governing Council according to articles 12.4. and 4 of the Statute of the ESCB and of the ECB. This means, any kind of advice that has not been issued by the Governing Council during the Troika's work in Greece would have to be considered illegal. The research of Norbert Häring, a journalist working for the German economic newspaper "Handelsblatt" has shown that in March 2010 EU governments had asked ECB director Jean-Claude Trichet to officially declare that Greece had lost access to the financial market to facilitate a credit programme of the IMF. Upon request, however, the ECB could not produce an official decision to that effect of the responsible body, the Governing Council. Based on Mr. Häring's work,[379] there is also no valid decision that the

378 ECB's replies to the questionnaire of the European Parliament supporting the own initiative report evaluating the structure, the role and operations of the 'troika' (Commission, ECB and the IMF) actions in euro area programme countries, available under <https://www.ecb.europa.eu/pub/pdf/other/140110_ecb_response_troika_questionnaireen.pdf>

379 Norbert Häring 'EZB kann nicht sagen, wer ihre Troika-Beteiligung beschlossen hat' *Blog Geld und mehr* (20 January 2014)

ECB was to develop and supervise the implementation of an economic programme in return for financial aid.

Transferred to Taft's interpretation of decision making under the participation of legally incompetent or incomplete bodies, an ECB participating in the Troika without authorization of its Governing Council constitutes a violation of the most important legal framework for the ECB. Eventually this could become relevant for the repudiation of payment claims against Greece.

3.3.2.2. Illegal Attempt to Cause Grexit

For some time during the Greek financial crisis and especially in June 2015, German finance minister Schäuble and others pressed for Greece to leave the Eurozone.[380] They argued, this step would allow Greece to devalue its new currency, supposedly making the country competitive and resulting in economic growth and the ability to repay its debt. Others were more sceptical as the new drachma could become an obstacle to trade, increasing the cost of imports and making it impossible for Greece to ever repay anything. What was missing in the discussion, though, was that even after a default Greece was – and is – not legally obliged to leave the eurozone since there is no legal base for "forcing" a country out of the euro. Since both the Treaty on the European Union and the Treaty on the Functioning of the European Union are designed to strengthen integration, becoming a member of the EU and eurozone is meticulously regulated, while only article 50 of the EU Treaty regulates how a state can leave the European Union. A mechanism for leaving only the eurozone or for expulsion even has not been provided for. Using the euro without being a member of the eurozone or even the EU is widespread: Montenegro, Kosovo, the Vatican City State, Andorra, San Marino and Monaco all use the euro at the moment. These cases are not limited to the euro. The US dollar is currently legal tender in Ecuador, El Salvador, East Timor, several micro-states and Zimbabwe, for example.

If this is common practice, Greece cannot be put into a worse position than states using the euro without being a member of the EU and who did not have to meet the convergence criteria. Keeping a post-default Greece in the eurozone would preserve its access to the eurozone market, avoid the expense of reintroducing a new drachma, and pave the way for negotiations on credit payments in the future – while still remaining in line with the EU treaties. This procedure would also defend the integrity of the euro since all Member States will remain parties to the euro: an important goal if the currency is to be perceived as a stable alternative to the US dollar. Above all, it is possible that the markets are going to test

380 The following discussion about the illegal attempt to force Greece out of the eurozone is based on: Oliver Pahnecke, 'A default doesn't mean Greece being kicked out of the eurozone. Here's why", the Guardian (London, 17 June 2015)

the eurozone's stability by attacking other states – as in 1992, when the European exchange rate mechanism was destroyed. Making use of a weak spot in the system cost European taxpayers billions at that time.

What is more, there is evidence that a bankruptcy of Greece might not turn out to be a disaster for the eurozone or for Greece, as many assume. In 2014, Carmen Reinhart and Christoph Trebesch stated in their paper A Distant Mirror of Debt, Default and Relief[381], "the economic landscape after a final debt reduction is characterized by higher income levels and growth, lower debt servicing burdens and lower government debt". Not only were growth rates after a default substantial, but access to new credits recovered surprisingly quickly: in the 1980s it took on average four years while credits in the 1990s were handed out almost immediately after bankruptcy. This is only logical: if the default already happened, the risk of another default right after is relatively small in comparison to the risk before a default. Additionally, it is still possible to grant Greece access to new and voluntary funding from other Member States or the EU as set forth in the Pringle decision. This effort to impose a Grexit from the eurozone was not crowned with success. Accordingly, there are no additional costs for Greece connected to this proposal, unless it could be demonstrated that it increased Greece's debt burden through worse credit ratings.

But it should not even have come to this, since it is the EU's aim to promote peace and the well-being of its peoples, according to article 3 of the EU Treaty. Another aim, enshrined in article 3 nr. 4 of the EU Treaty, determines the establishment of an economic and monetary union whose currency is the euro. Based on the rule of law[382], the EU should achieve economic growth, price stability, full employment, social progress and solidarity among its member states. Imposing a Grexit is therefore an attempt to deprive Greece of the mentioned benefits as well as a step back in the realization of the aims laid out in the EU Treaty and a violation of constitutional principles in the sense of the Tinoco arbitration. Had this attempt succeeded, this violation of the foundation of EU law might have been sufficient for Greece to repudiate potential payment claims.

3.3.2.3. Troika's De-Facto Governmental Control Over Greece Lead to her Responsibility for Human Rights

With Taft's work, an additional legal option for debt repudiation could be deduced from the Troika's position in Greece. If the Troika assumed governmental powers in Greece and

381 Carmen Reinhart and Christoph Trebesch, 'A Distant Mirror of Debt, Default and Relief' (October 2014) National Bureau Of Economic Research

382 Article 2 of the Treaty on the European Union

used them to the detriment and against the will of the population by banning debt relief,[383] claims against Greece could be questionable.[384] As states are commonly responsible for the human rights of their own citizens, the question is: can those states and institutions that orchestrated the shift of risk from private banks to the European public become responsible for the human rights situation in Greece? They could become responsible for the human rights of the Greeks, if these states would have obtained a de-facto governmental position and established such comprehensive control over Greece that neither the Greek parliament, nor the Greek government could decide on the household and therefore could not decide on human rights related topics as far as these can be improved or worsened through funds or the lack thereof.

Historically seen, parliamentarian control over the budget was an important step towards democracy. Through political struggles, parliaments increasingly gained control over public spending and taxation. Parliaments in Holland and in the UK Parliament were the first in Europe to gain full power to approve spending, borrowing and taxation, while the French parliament asserted this right in 1789 after the revolution. After the Congress of Vienna in 1815, the parliaments of Bavaria, Baden and Württemberg obtained the right to approve taxes and the right to audit spending and the budget, and new government debt required their approval. Prussia established a parliament with the right to approve taxation and budgets as well as the authority to legislate government bonds after the revolution of 1848/49. Once the German Reich in 1871 had been established, the Reichstag had the unrestricted power to approve taxation and budgets, including the right to approve the issuance of government bonds. “This established the democratic legitimacy of government debt and also fundamentally changed the balance of power: parliament went from being a mere protector of the interests of the wealthy bourgeoisie which curtailed government debt through the (monarchical) executive branch to becoming an important decision-maker in its own right with the power to increase government debt as well.”[385]

By now the right of parliament to control the public budget plays a major role in controlling the government. This right is of high importance for the separation of powers and politics in general. For example, in the context of German contributions to the European Stability Mechanism, the German Constitutional Court has decided that the decision on revenue and expenditure of the public sector must remain in the hand of the

383 Euro Summit, *Euro summit statement* SN 4070/15 (Brussels 12 July 2015) 6

384 The following discussion about the obligation to respect, protect and fulfil human rights in Greece is based on Oliver Pahnecke, ‘Wie schlechte Wirtschaftspolitik Migration verursacht’ *Der Standard* (Vienna, Austria 22. Juni 2016)

385 Carl-Ludwig Holtfrerich, Lars P. Feld, Werner Heun et al., ‘Government debt: causes, effects and limits’ Report of the German National Academy of Sciences Leopoldina, the National Academy of Science and Engineering and the Union of the German Academies of Sciences and Humanities (Berlin August 2016) 17, Box 1: The history of parliamentary budget rights

German Bundestag. This excludes an automatic payment obligation even if it is based on a law. Therefore, the German Bundestag must ensure that the mandatory approval by the Bundestag is always obtained again for following payment requests.[386] The Greek parliament has the constitutional right to decide on the Greek household according to article 79 nr. 1 of the Greek Constitution:[387] "In the course of its regular annual session Parliament shall vote on the State budget of revenues and expenditures foe the following year." Thus, any suspension of this right is a violation of the Greek constitution.

The Troika's arrangement of the European Stability Mechanism's (ESM) purchasing Greece's sovereign debt, can be seen as a step towards a position of authority over Greek politics. The UN guiding principles on foreign debt and human rights[388] are very clear about human rights being the yardstick based on which decisions related to foreign debt are to be made:

> 6. All States, whether acting individually or collectively (including through international and regional organizations of which they are members), have the obligations to respect, protect and fulfil human rights. They should ensure that any and all of their activities concerning their lending and borrowing decisions, those of international or national public or private institutions to which they belong or in which they have an interest, the negotiation and implementation of loan agreements or other debt instruments, the utilization of loan funds, debt repayments, the renegotiation and restructuring of external debt, and the provision of debt relief when appropriate, do not derogate from these obligations.

This means, owing to the members of government and the officials that represent the Member States and international organisations, these now have the obligation to respect, protect and to fulfil human rights in Greece due to their decision to become creditors of distressed states.

As explained above, these decision-makers did not violate the literal interpretation of the no-bailout clause but its spirit when buying the claims private banks had against Greece, Portugal, Ireland and other states. But by skirting the no-bailout clause, they not only shifted the risk to the public away from those, who earned well initially through risky investments, they also replaced the banks, which had no obligation to protect and fulfil human rights, with states and international bodies and organisations, which do.

As the Troika consists of the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF), it is necessary to discuss here briefly the legal obligations of the IMF because the IMF appears to be the only international organisation that declares publicly that it believes to be above international human rights law. The IMF

386 Bundesverfassungsgericht Press Release No. 55/2011 of 07 September 2011 on Judgment 2 BvR 987/10 (7 September 2011)
387 The Constitution of Greece, entered into force 7 June 1975 (translation 2022 Hellenic Parliament)
388 United Nations, Guiding principles on foreign debt and human rights, A/HRC/20/23 (10 April 2011)

has repeatedly stated that it considers itself an international organisation separate of its members that is solely responsible for the objectives assigned to it. Other values and objectives could only be imposed on the Fund by changes in its charter.[389] It claims, its task was to provide economic assistance, not to dictate political changes. That the IMF is supposed to maintain independence, is also seen as a reason as to why it is not bound by human rights.[390] Furthermore, the IMF is a monetary agency, not a development agency, hence, its financial role was limited to providing foreign exchange to help its members overcome temporary balance of payments problems[391] and therefore had no ability to decide on its members' domestic policies.[392]

The IMF's argument not to be bound by human rights does not make sense, as states that are members of an organisation whose actions can harm human rights would be immediately be obliged to change its by-laws and its actions for the better. Helping states to overcome temporary balance of payments problems only makes sense if finance and economy are seen as human creations to help mankind. But to meet this end, human rights are indispensable. No argument put forward by the IMF allows the conclusion that the Fund is not bound by human rights. The arguments are merely an explanation of the duties, none of which excludes human rights obligations for the Fund. Moreover, the author who wrote this analysis was the General Council of the IMF and therefore an independent evaluation of the IMF's legal obligations cannot be expected.[393] That the IMF's duties are interpreted by its General Council in a way that releases the Fund of any human rights obligations rather shows that the IMF knows its policies can harm human rights. This position of the IMF has not changed over the years. In a letter to the Independent Expert on foreign debt and human rights, the IMF repeats: "As an institution that is concerned with economic issues, the IMF is precluded from using its powers to support particular political systems or directly engage in the promotion of human rights."[394] Moreover, "[t]he IMF has not accepted the Declaration on Human Rights as the motivating principle of our operations. UN agencies have generally accepted our arguments as establishing the limits of our engagement and obligations on promoting human rights." Accepting the Declaration on Human Rights is not a precondition for and human rights obligations that organisations have to meet that have been set up by States, which are themselves bound by human rights. Otherwise, this would create the possibility to set up international organisations by States

389 François Gianviti, *Economic, Social and Cultural Rights and the International Monetary Fund*, International Monetary Fund (2002) 4-5
390 ibid 5-6
391 ibid 6
392 ibid 7
393 ibid 1
394 Christopher Lane, Letter to the Independent Expert Juan Pablo Bohoslavsky (27 July 2017) available at <https://www.ohchr.org/sites/default/files/Documents/Issues/IEDebt/impactassessments/IMF.pdf>

in order to be exempted from human rights obligations in their actions. Also, there appears to be no official document in which UN agencies and other UN bodies would officially accept that the IMF was not subject to international human rights law. Already the letter of the UN independent experts to the IMF shows that there are serious doubts about this point. Also from an organizational viewpoint, the position of the IMF does not make sense. The International Monetary Fund is a United Nations Specialized Agency, connected to the United Nations through article 63 and article 57 of the United Nations Charter. Article 57 nr. 1 specifies that the specialized agencies, established by intergovernmental agreement, have "wide international responsibilities (…) in economic, social, cultural, educational, health, and related fields (…)." Based on article 63 nr. 2 of the Charter, the Economic and Social Council "(…) may co-ordinate the activities of the specialized agencies through consultation with and recommendations to such agencies and through recommendations to the General Assembly and to the Members of the United Nations."[395] While consultations suggest an equal rank, recommendations mean that the Economic and Social Council is of higher administrative rank in the UN system. In both cases, the Charter supports the view that the IMF is part of the UN system and therefore equally bound by human rights. Also, the Agreement Between the United Nations and the International Monetary Fund[396] does not contain any provision that allows for a different interpretation. Likewise, the Rules of Procedure of the Economic and Social Council list specialized agencies as part of the UN system with no special exemptions, see Rule 4 nr. 3 and Rule 9 nr. 2 (g).[397] That the IMF's founding charter does not contain reference to a duty to promote human rights only means that the description of its financial duties were seen as mere financial mechanisms and that its human rights obligations were seen as obvious for a UN agency, as expressed in article 57 nr. 1 of the United Nations Charter. Because of this norm in the Charter, the Member States would have had to include the exemption from human rights obligations into the statutes, if they had wanted to.

Summing up, it can be stated, that the IMF is bound by human rights, therefore the decisions of all three Troika members are subject to international human rights standards.

Had the Troika's institutions not decided to save the over-indebted banks, Greece would have gone bankrupted along with the banks and international help would have been voluntary. But thanks to the hedge fund-like move, it is possible that these people created a

395 United Nations, *Charter of the United Nations* (1945)
396 United Nations and International Monetary Fund, *Agreement Between the United Nations and the International Monetary Fund* (15 November 1947)
397 United Nations, Economic and Social Council, *Rules of Procedure of the Economic and Social Council*, E/5715/Rev.2 (New York, 1992)

legal obligation to respect, protect and fulfil human rights human rights in the states that are negatively affected by their decisions.

If the Troika members are supposedly obliged to respect, protect and fulfil human rights in general, how is this obligation transferred from the government of the target country – which usually has this obligation – to the Troika? Such a transfer can happen, if the outside force practically replaced the government and used her acquisition of debt to influence politics for her benefit or the benefit of third parties and to the detriment of the human rights situation in the borrowing country. Thus, it needs to be clarified if the Troika used its creditor position to control Greek politics and if she did that for her benefit by forcing the Greek state to use household funds for debt payments rather than for human rights related expenses such as healthcare or pensions.

But why would the Troika be obliged to put the human rights fulfilment in the target country first and contractual obligations second, after all the Latin phrase *pacta sunt servanda* (which can be translated to "contracts are to be fulfilled") was frequently mentioned to give the impression, Greece had to pay off her loan contracts, no matter what?[398] If this assumption was correct, the Troika would not have assumed a quasi-governmental position but would have simply safeguarded the contractual obligation and the test, if the Troika had acted with quasi-governmental powers to the detriment of the human rights situation in Greece, would become redundant.

The proponents of this position did not explain why Greece was supposed to pay for its debt, while banks did not have to pay for the expenses caused by their poor handling of risk in their core business activity in which they should have expert knowledge – Greek debt and the banks' expenses are caused by the same risky business, after all. Apart from this bias in the Troika's approach, it is important to take into consideration the legal ranking of obligations which is determined by the legal ground that the obligation emanates from. *Pacta sunt servanda* clearly refers to contracts. State obligations to protect human rights, however, stem from constitutions and international treaties. These are the foundations, on which the other laws rest, therefore these obligations are the most important ones. If the state enters into a loan contract, this agreement is also a valid ground for a claim against the state. Yet, it does not form an obligation of equal rank in comparison to obligations stemming from international treaties and the constitution. In consequence, the state obligation to respect, protect and fulfil human rights ranks higher and is therefore more important than the obligation to fulfil the loan contract. In practical terms, this means that the state – or anybody who exerts the political power in a given territory – has to take

398 Alexis Papachelas, 'Pacta sunt servanda' *Kathimerini English Edition* (14 January 2015)

care of the human rights of the local population before any other duties. As a result, the household has to allocate a budget that enables the government to respect, protect and fulfil human rights, before it can pay for loans, or, if the state's finances permit, arrangements can be made to meet both targets simultaneously.

Pacta sunt servanda had been so prominent a phrase during the Troika's activity, that it was also discussed at the UN General Assembly. Therefore, the United Nations independent expert on foreign debt analysed its legal importance for international law and international human rights law.[399] Based on his report, this term is mainly in use in commercial transactions, "(…) leading to a generalized assumption that sovereign debt should be treated as any other private obligations."[400] If the principle is transferred from commercial contracts to sovereign debt without understanding the new environment, the principle and its consequences could be easily misunderstood.[401] Any contract is subject to its legal environment and so the contract will not be enforced if it violates the rules of its environment. Therefore, contractual obligations depend on other norms, not only on the contract itself and when it comes to states, which are created and organized by laws as well, these laws also will influence contractual obligations.[402]

The laws organizing any state determine the relation between the government and the citizens. This inner relationship then determines the relationship of the government to the outside, it defines the government's agency in the representation of the state and therefore its citizens vis-a-vis third parties. The constitution determines what kind of government acts are possible and how they have to be performed, while elections determine who will be in charge of the day-to-day work during the legislative period and referenda submit a citizens' decision on a current topic. This interpretation corresponds with article 25(a) U.N. International Covenant on Civil and Political Rights based on which every citizen shall have the right to take part directly in the conduct of public affairs, or through elected representatives, article 25(b).[403] These rights are closely connected to the peoples' right to self-determination enshrined in article 1 Nr. 1 ICCPR, based on "which peoples have the right to freely determine their political status and to enjoy the right to choose the form of their constitution or government."[404] In the context of citizens conferring power to the government and the principle of *pacta sunt servanda*, the United Nations independent expert points out that

399 United Nations, Report of the Independent Expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights, A/70/275 (4 August 2015)
400 ibid nr. 35
401 ibid nr. 36
402 ibid 37, 38
403 William A. Schabas,'Nowak's CCPR Commentary' *N. P. Engel* (3rd edn, 2019) 706 nr. 16
404 ibid 698-699 nr. 1

> (…) contemporary understandings of sovereign statehood often recognize a form of "agency relationship" between government actors (the agent) and the population of the sovereign State (the principal, on whose behalf and in whose interests Government officials must act). This allows for a broad array of governmental forms and does not justify unwarranted interference in internal affairs. Nowadays, it seems clear that a State's population is not merely a resource available for exploitation by the Government. Governments, no matter how they are organized, ultimately have responsibility for and obligations to their population.[405]

Agency is a common feature of contract law, which defines how actions of the agent can be attributed as binding on the principal. "Sovereign statehood can be characterized as a similar and essential (…) agency relationship in the international legal arena." This results in an agency of government that is based on national legal limitations that influence the governmental relationship with third parties, such as lenders. *Pacta sunt servanda*, therefore, cannot be absolute.[406] Juan Pablo Bohoslavsky lists three limitations for governmental agency:

> One set of limitations may arise from the general laws and values that constrain all actors, preventing them from binding themselves or others in unacceptable ways. A second set of conditions may arise from the uniquely sovereign nature of the State itself, and its agency relationship and underlying obligations to its own population. A third constraint may arise from exceptions to the substantive obligation in that the accumulation of interest on debt may have occurred due to conditions outside of the State's control, which could include a widespread global impact, as was the case in the oil shock during the 1970s or could be due to a downturn in terms of trade for a particular State in a competitive global environment.[407]

The position of government acting as an agent and the population as principal is stressed by article 1 of the United Nations Conference on Trade and Development (UNCTAD) Principles on Promoting Responsible Sovereign Lending and Borrowing, which notes under the headline "1. Agency" that, "[l]enders should recognize that government officials involved in sovereign lending and borrowing transactions are responsible for protecting public interest (to the State and its citizens for which they are acting as agents)." A mirror image is article 8 which deals with the viewpoint of the government: "Governments are agents of the State and, as such, when they contract debt obligations, they have a responsibility to protect the interests of their citizens. Where applicable, borrowers should also consider the responsibility of lenders' agents toward their organizations."[408] Furthermore, an interpretation that includes the absolutist view of *pacta sunt servanda* into

405 United Nations, Report of the Independent Expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights, A/70/275 (4 August 2015) 39

406 ibid 40, 41

407 ibid 41

408 United Nations Conference on Trade and Development (UNCTAD) Principles on Promoting Responsible Sovereign Lending and Borrowing (10 January 2012)

international law with a 100 per cent repayment obligation under all circumstances is impossible, simply because it has never been practised. In their book "This Time Is Different", Carmen M. Reinhart and Kenneth S. Rogoff[409] show eight centuries of financial folly resulting in sovereign bankruptcies caused by inflation, currency crashes, and debasement, banking crises and default.

Hence, the principle *pacta sunt servanda* cannot override the obligation to respect, protect and fulfil human rights and anybody governing a territory is bound by human rights.

A prudent lender has to protect the principal in some way and therefore it is in general justified that the Troika institutions would try to request organisational reforms that should facilitate not only the repayment of the loan but also ascertain that the funds go to where it is needed. But the request may not violate treaty provisions that define competences, and it cannot render political processes in the target country redundant. Therefore, one has to clarify if the Troika influenced politics in Greece like a government and if this influence was used to obtain an advantage that was detrimental to the Greek public.

Typically, the Troika would sign a "Memorandum of Understanding" (MoU) with the Member State in need. And while ordinary loans are contracts in which the lender grants the borrower the right to use a certain amount of money (also called the principal) for a certain period of time against payment of interest (the price of money), the Memoranda were different. The Troika's Memoranda of Understanding granted loans for a certain time against interest but also required the implementation of reforms that the Troika had come up with. The reforms were discussed with the target country, also called "Beneficiary Member State", but from the way how the Memoranda were formulated, it is clear that the target country had not much choice, if it wanted to save its economy and its private households. The Memorandum of Understanding of 19 August 2015[410] elucidates the power relationship: "(…) The financial assistance to be provided to the Beneficiary Member State by the ESM shall be dependent upon compliance by the Beneficiary Member State with the measures set out in the Memorandum of Understanding." In a similar fashion, the Euro Summit Statement document states: "The Euro Summit stresses that nominal haircuts on the debt cannot be undertaken. The Greek authorities reiterate their unequivocal commitment to honour their financial obligations to all their creditors fully and in a timely manner." And only if "(...) all the necessary conditions contained in this document are fulfilled, the Eurogroup and ESM Board of Governors may (...) mandate

409 Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different – Eight Centuries of Financial Folly* (Princeton University Press 2011)

410 European Commission (acting on behalf of the European Stability Mechanism) and the Hellenic Republic and the Bank of Greece (acting on behalf of the ECB) in liaison with the ECB and with input from the IMF, *Memorandum of Understanding* (19 August 2015) 2 (D)

the Institutions to negotiate a new ESM programme."[411] At that time it was common practice in the European Union to pressure the new Greek government so it would accept the memoranda – the opposite of the promise that had won the elections for the leftist party Syriza. For example, early on ECB council member Erkki Liikanen threatened Greek banks would be cut off the ECB liquidity support if there was no agreement reached to renew the bailout deal.[412] This pressure on Greece happened in stark contrast to the practice of love letters from Reykjavik. As explained above, love letters were used by the three major Icelandic banks once they had run out of real assets they could use as collateral. They created bonds that they sold to their branches in Luxembourg who used them as collateral to obtain loans from the ECB, the money of which was then transferred back to their headquarters in Iceland. This constitutes an unequal treatment which does not seem to be justified but absent public records that would explain the ECB's decision to accept non-collateral in the case of Iceland but not in the case of Greece, a discrimination cannot be verified.

In her Memoranda of Understanding the Troika made it clear that the Beneficiary Member State would only receive the money to keep its economy and the state's offices working if it would comply with the demands of the Troika. In the 2015 memorandum, the Troika demanded a VAT and pension reform, a revision of the income tax, an ambitious privatization programme and a labour market reform which should entail assistance for labour market policies including tackling undeclared work and codification of the Greek statute book.[413] The pension reform, which is called a "key deliverable" on page 7 of the memorandum, consists of a variety of measures, some of which address the fragmentation of the system and the creation of savings by increasing efficiency.[414] A similar improvement were the broadening and modernization of the contribution and pension base for all self-employed, including by switching from notional to actual income and also the integration of all social security funds under a single entity meant an increase of efficiency that did not harm pensioners but increased the available funds for pensions, instead.[415] Other measures, however, reduced the pensions themselves, some of them without regard for the macroeconomic difficulties. When the memorandum states for example that "[c]ontributions have fallen due to high levels of unemployment at the same time as spending pressures mounted as many people opted to retire early"[416], this does not take into

411 Euro Summit, *Euro summit statement* SN 4070/15 (Brussels 12 July 2015) 6-7
412 Jussi Rosendahl, 'No lending to Greek banks if no deal by end of February: ECB's Liikanen' *Reuters* (31 January 2015)
413 European Commission (acting on behalf of the European Stability Mechanism) and the Hellenic Republic and the Bank of Greece (acting on behalf of the ECB) in liaison with the ECB and with input from the IMF, *Memorandum of Understanding* (19 August 2015) 5
414 ibid 13
415 ibid 14
416 ibid 13

consideration that first of all not everybody can opt to retire voluntarily. With the unemployment rate increasing from 7.76 percent in 2008 to 27.47 percent in 2013,[417] it is fair to assume that those 20 percent that were added to the unemployment statistics in the five years of the financial crisis did not have a choice. To use this as an argument to increase the retirement age without taking into consideration changes in longevity, this measure results in a mere reduction of pensions without taking into account the needs of those who were forced to retire early. Even in 2019 research still recorded a substantial decline in health and mental health expressed by an increase of suicides and depressions because of high unemployment, financial hardship and income loss and accelerated by a healthcare system that is still found to be at the verge of collapse.[418] Introducing a health contribution of 6 percent for pensioners is a mere reduction of the pensions. The other policies in the health care sector also give a mixed picture of increasing efficiency and cutting cost, for example through controlling public expenditure, centralized procurement and improved hospital management, which would increase the capabilities of the health care sector, while the commissioning of private sector health care providers does not necessarily lead to an improved health care, especially not, if there is not sufficient competition.[419] Therefore, privatization cannot be seen as an option that is universally applicable and based on the subsidiarity principle of article 5 nr. 1 Treaty on European Union, it should be up to the local authorities to choose what alternative offers the best solution.

Based on articles 3 and 4 TFEU the measures laid down in the 2015 Memorandum of Understanding do not belong to the areas of exclusive or shared competence. Public health enjoys support and protection in the Union, according to article 168 TFEU: Number 1 demands that "[a] high level of human health protection shall be ensured in the definition and implementation of all Union policies and activities. Union action, which shall complement national policies, shall be directed towards improving public health, preventing physical and mental illness and diseases, and obviating sources of danger to physical and mental health." Such complementary action should happen by monitoring and research. Number 7 of the same article clarifies that "[t]he responsibilities of the Member States shall include the management of health services and medical care and the allocation of the resources assigned to them." Applied to the health and pension policies of the Memorandum of Understanding, it can be determined that the demands of the Troika go

417 Statista, *Greece: Unemployment rate from 1999 to 2022*, available at <https://www.statista.com/statistics/263698/unemployment-rate-in-greece/>

418 Stelios Stylianidis, Kyriakos Souliotis, *The impact of the long-lasting socioeconomic crisis in Greece*, BJPsych Journal International (February 2019)

419 European Commission (acting on behalf of the European Stability Mechanism) and the Hellenic Republic and the Bank of Greece (acting on behalf of the ECB) in liaison with the ECB and with input from the IMF, *Memorandum of Understanding* (19 August 2015) 15

beyond what would be possible based on the EU Treaties. It also can be argued that the memorandum violates the EU tax policy, according to which the authority to tax remains in the hands of the member states, while the EU is limited to the harmonization of taxation, based on the provisions in articles 110-113 TFEU.[420]

By determining taxation, pensions and health care, the Troika consisting of European Commission, European Central Bank and International Monetary Fund decided on matters that were tasks legally designated to the Greek government. This means, they violated these norms and acted as a quasi-government. In the arbitration Great Britain v Costa Rica, Taft had to decide if the Tinoco government, that had overthrown the previous government, could legally bind Costa Rica: “The question is, has it really established itself in such a way that all within its influence recognize its control, and that there is no opposing force assuming to be a government in its place? Is it discharging its functions as a government usually does, respected within its own jurisdiction?” The Troika’s rule was not uncontested, as the elections show that put Syriza into power in 2015 and the Oxi-referendum,[421] two incidents that were democratic procedures to end the Troika-imposed austerity. But unlike in the classic coup d’etat of the Tinoco case, the Troika did not actually aim at becoming the government of Greece. The Troika intended to protect her interests and decided the best way to achieve this goal was to control government and parliament, ignoring the principle of non-intervention, which is based on article 2 nr. 4 of the UN Charter. For this reason, it would be wrong to conclude that the Troika had formed a de-facto government that could legally bind the Greek State, especially since it did not run the day-to-day business, did not take over the armed forces or the police. The Troika rather assumed overall control over every financial aspect in the Greek economy and the related sectors of politics, thus becoming responsible for human rights in Greece which dependend on the state budget.

The Troika proclaimed publicly to exercise control over all relevant areas, so it is not necessary to prove state control from the outside in an analogy to the “effective control” standard established by the International Court of Justice in the case Nicaragua v. United States[422] or the ICTY’s “overall control” standard in the Tadić - case.[423] In the case of Greece, the Troika's representatives repeatedly claimed in public they had comprehensive control over the decisions of government and the parliamentarian procedures in Greece.

420 Jost Angerer, *Fact Sheets on the European Union – General Tax Policy*, European Parliament (April 2023)
421 Robert Peston, Greece debt crisis: Greek voters reject bailout offer, *BBC* (6 July 2015)
422 *Case Concerning the Military and Paramilitary Activities in and Against Nicaragua* (Nicaragua v. United States of America) 1986 I.C.J. 14 (decided June 27, 1986)
423 *Tadić* - United Nations International Tribunal for the Prosecution of Persons Responsible for Serious Violations of International Humanitarian Law Committed in the Territory of Former Yugoslavia since 1991, IT-94-1-T (decided 7 May 1997)

The Euro summit statement clarifies on page 5: “The [Greek] government needs to consult and agree with the Institutions on all draft legislation in relevant areas with adequate time before submitting it for public consultation or to Parliament.”[424]

Through the Memoranda of Understanding and the Euro Summit Statement, the Troika decided on and controlled all relevant actions of government and parliament, something that made her the apex legislator in Greece, one who ignored its own mandate to protect human rights and democracy. Based on Taft’s approach, it is therefore questionable if the Greek government or the Troika had the power to bind the Greek state with the help of the memoranda.

The main goal for the Troika was to secure the payment on the sovereign debt that she had acquired from the private sector and to this end it entered into memoranda of understanding which granted money in return for adjustment policies that meant austerity and privatization. Since the Troika controlled Greece to such a great degree that she could determine how the budget was allocated in the Greek household law, it influenced the funding for human rights related budgetary items, such as education, social security and healthcare. A look at the medical analysis coming from Greece during austerity shows the deep impact:[425] HIV infections, birth mortality and mental diseases are on the rise in Greece since the beginning of austerity policies in 2008 while life expectancy was in decline.

By now, numerous articles in scientific papers support the research of Stuckler’s and Basu’s who prove in their book “The Body Economic” that austerity is harmful to public health and human rights but can also slow down economic recovery. In fact, the data is clear: good health and tackling debt goes well with each other, as “(…) stimulus spending on specific public health programs actually helps to reduce debt by sparking new economic growth. Every $1 invested in these programs returns $3 in economic growth that can be used to pay off debt.”[426] Iceland suffered the worst bank crisis in history and did not record an increase in fatalities because it even expanded its public healthcare system during the crisis. Greece, on the other hand, was strong-armed into the largest cuts seen in Europe since World War II. The crisis in Greece was smaller in Iceland at first, but draconian austerity measures imposed on this member state of the European Union increased the crisis and drove up the human costs, too, as all health programmes were slashed: HIV increased by 200 percent, suicide by 100 percent, homicides increased as well and malaria

424 Euro Summit, *summit statement* SN 4070/15 (Brussels 12 July 2015)

425 Kentikelenis A, Karanikolos M, Reeves A, Prof McKee M, Stuckler D, ‘Greece's health crisis: from austerity to denialism’, *The Lancet*, London 20 February 2014

426 David Stuckler and Sanjay Basu, *The Body Economic – Eight experiments in economic recovery, from Iceland to Greece* (Penguin Books 2013) xii

returned.[427] The Troika's tight grip has had a devastating human dimension impact described in the medical research “Greece's health crisis: from austerity to denialism”, published in the Lancet 2014.[428] This research found out as well that HIV infections, birth mortality and mental diseases are on the rise in Greece since the beginning of austerity policies in 2008. There were only 15 new HIV infections in 2009 among drug addicts, a number which has increased to almost 1000 in 2013. Among the same group the cases of tuberculosis has probably doubled between 2012 and 2013. Depressions have increased steeply, too and the suicide rate has increased by 45% between 2007 and 2011. Between 2008 and 2010, the mortality rate among newborn babies has increased by 43% and this, although the birth rate has decreased in general. Furthermore, the available data suggests also a decrease of the overall life expectancy in Greece. Apart from the medical point of view the data also shows that the increased problems in the medical sector will lead to higher expenses. A healthcare system facing increased expenses and sharp cuts at the same time is incapable of taking care of the citizens it was supposed to care for – and who built it.

But medical data alone does not demonstrate how much the Troika took care of its own interest. Rocholl and Stahmer could prove that only 5 percent of the bail-out money ended up in the Greek budget while an overwhelming 95 percent were used to pay for claims and interest.[429] This means Greece was left with less than 5 percent for human rights and other purposes, while 95 percent of the loan was used in the interest of the Troika. As mentioned above, human rights are obligations for the State based on constitutions and treaties, while contractual obligations rank lower. Using 95 percent of the available money for the fulfilment of contractual obligations, however, has nothing to do with the primacy of human rights obligations based on the ranking of treaties and contracts.

Therefore, it is clear that the Troika not only had quasi-governmental powers in Greece, it also used them to funnel payments abroad to fulfil contractual obligations, instead of fulfilling its human rights obligations in Greece. Therefore, it is conceivable that a Greek repudiation of payment claims would be successful.

427 ibid xiv

428 Alexander Kentikelenis et al, ‘Greece's health crisis: from austerity to denialism’ (22 February 2014) The Lancet Health Policy Vol. 383, Issue 9918, 748-753

429 Jörg Rocholl and Axel Stahmer, ‘Where did the Greek bailout money go?’ *ESMT White Paper No. WP-16-02* (Berlin 2016)

3.4. Summary

Some demands by the Troika were prudent and only served the protection of the loans without violating the target state's competences, such as an improved system for tax collection or increased efficiency in the management of public health or pensions. The other measures covered here, such as taxation, health and pension reforms, were demands of the Troika which not only violated treaties but also infringed upon the sovereignty of Greece so that the incapacitated Hellenic Republic could not respect, protect and fulfil the human rights of her citizens. An additional point can be made that Iceland's decision to save deposits by setting up a good bank instead of creating a bad bank that would protect decision makers from the result of their poor risk management would not only have been economically viable in the case of Greece. It would even have been economically warranted, because this would have protected Greece and the European Union from the increased risk caused by moral hazard. Applying Iceland's method to Greece would also have been in accordance with the no-bailout clause, moreover, the EFTA Court's decision related to Iceland confirmed that the creation of good banks and the transfer of deposits to these banks was legal. As the EFTA Court is of equal rank as the ECJ,[430] its decision bears a lot of weight, and together with the statistics of public health, its decision is more convincing than the ECJ's. As mentioned above, the IMF declared the programme in Iceland a success. Therefore, it would have been useful to transfer the Icelandic blueprint of 2012 to the Greek republic in distress 2015.

This illustrates that human rights-based approaches help citizens and their economy actually more than the guesswork of IMF and EU Commission who for no obvious reasons seem to always return to austerity in a one-size-fits-all approach. Nevertheless, the science seems settled[431]: a strong democracy, capable of protecting social standards and public health does not only protect human rights but also helps with the economic recovery if the right claims are repudiated. Iceland's citizens showed that it can be legally expedient to let those bear the losses who participated in creating them, but that it is also economically desirable.

430 The homepage of the EFTA Court states in the Q & A section: "The EU Courts (Court of Justice of the European Union and the General Court) deal with issues related to the EEA in the EU and the 27 EU States, while the EFTA Court deals with such issues in the 3 EEA/EFTA States. The national courts in the EU and the EFTA States deal with EEA law and refer questions regarding its application and interpretation to this Court and the Court of Justice, as appropriate. (…) The decisions of the Court are final."

431 For further research confirming Stuckler and Basu, see for example: Marina Karanikolos, Philipa Mladovsky et al, 'Financial crisis, austerity, and health in Europe' (13 April 2013) The Lancet Health in Europe 1323-1331 <https://www.thelancet.com/journals/lancet/article/PIIS0140-6736(13)60102-6/fulltext> accessed 20 November 2022; Tinna Laufey Ásgeirsdóttir, Hope Corman, Kelly Noonan et al, 'Was the economic crisis of 2008 good for Icelanders? Impact on health behaviours' (March 2014) Economics and Human Biology <https://pubmed.ncbi.nlm.nih.gov/23659821/> accessed 21 November 2022; Geir Gunnlaugsson, 'Financial crises and child health: reflections from Iceland'(23 August 2017) BMJ Paediatrics Open <https://bmjpaedsopen.bmj.com/content/1/1/e000168> accessed 21 November 2022; Geir Gunnlaugsson, 'Child health in Iceland before and after the economic collapse in 2008' (19 April 2016) Archives of Disease in Childhood <https://adc.bmj.com/content/101/5/489> accessed 12 June 2023

Iceland fulfilled its legal obligations and therefore successfully repudiated the British and Dutch claims for compensation. And if Taft's Tinoco arbitration can be used as a yardstick for the Troika in Greece, then her acts were irregular and illegal under her own laws, the EU treaties, the same way as the loan for personal use and the oil concession. Therefore, there should be sufficient legal grounds for a potential debt repudiation.

4. Portugal

Like Greece, Portugal's economy had been negatively affected by the financial crisis. When Portugal could no longer refinance its foreign debt, it was forced to request financial assistance from the Troika. In May 2011, the Portuguese Government agreed on an Economic and Financial Adjustment Programme with the Troika's institutions. Accordingly, Portugal had to meet the fiscal targets of the Economic and Financial Assistance Programme, improve its economy, while living up to its human rights obligation vis-a-vis the Portuguese citizens.[432]

The crisis increased unemployment up from 7.7 percent in 2008 to 16.7 percent in 2013, forcing many Portuguese into emigration.[433] Like in Greece, the reforms targeted different points in the healthcare system. To increase efficiency, for example, a central procurement agency for medical supplies was created, while hospitals had to cut costs and were merged, where possible. Average prices for medication declined from EUR 13 in 2007 to EUR 10.70 in 2013 and drug expenditure per capita fell from EUR 171 to EUR 144 during the same period. In the years 2010 to 2011 the total savings on drugs amounted to EUR 668 million.[434] On the other hand, the newly introduced user charges cost the patients about EUR 200 million. In times of a tight state budget, this might be seen as an improvement, but on the individual level it would have been better to waive the user charges and to compensate the lack of charges with the savings on drugs, as also salaries and pensions were frozen or cut.[435] Expenses are a massive problem in societies in which people do not seek medical attention because they cannot afford a single day without pay, or do not buy the necessary medication, since they cannot pay for it.[436] And although mergers of hospitals might make sense on paper, they usually go hand in hand with the closure of some of these institutions. Therefore, the access to medical services is restricted, which can be even lethal

432 Constantino Sakellarides et al., 'The impact of the crisis on the health system and health in Portugal' *in* Maresso A, et al. (eds) *Economic crisis, health systems and health in Europe: Country experience*, European Observatory on Health Systems and Policies (2015) 1.3.
433 ibid, emigration increased by 116% between 2008 and 2011
434 ibid 3.3.
435 ibid 3., 3.3.,
436 ibid 4.1.

in case of some emergencies. Based on the Financial Assistance Programmes, the Portuguese society had to shoulder cuts in the health care sector, for example, and while some of them were possible without endangering the lives and health of patients, such as efficiency increases, some others did exactly that. Additionally, a 30 percent increase of depression was recorded during the crisis.[437] A human rights-oriented approach, however, would have meant to extend the state's loan payments and to reduce the interest rates to reach a payment level where the budget would have been sufficient to still protect the medical needs of patients. This assumption is supported by the research of Morais Nunes et al., who found evidence that structural reforms in the health care sector during the Troika period had positive effects in terms of the use of drugs and expenditures reduction while these researchers observed the worsening of access to health care services.[438] But the situation was not as gloomy as it was in Greece. The World Health Organization recorded a significant increase in life expectancy at birth well above the global average from 2000 to 2019 from 76.6 years to 81.6 years – with no decline in the years of crisis.[439] Child mortality declined during the same period from 7.2 deaths per 1000 live births in 2000 to 3.4 in 2019 – although with a stagnation from 2011-2013 and 2015-2016 at 3.7 and 2014 at 3.6.[440] While the conservative government had cut the minimum salary from EUR 505 to EUR 485 during the crisis and raised it only right before the elections in October 2015 back to its original level, the new left wing government increased the minimum salary to EUR 530 in January 2016. Pensions below EUR 629 that had been frozen or even cut were indexed to the inflation. Poverty-struck families received a 10 percent increase in financial aid. The special income tax was cancelled for low incomes, while higher incomes were still burdened with 1 to 3 percent until 2017 and the reduced salaries of public employees were gradually raised back to the old level.[441] According to some, the success of the new Portuguese government was based on dialling back slowly the austerity policies that had been introduced under the conservative government together with the Troika, while avoiding a confrontation with Brussels. Increasing the minimum wage and pensions has helped the economy by accelerating domestic consumption. This, in turn, reduced unemployment and helped the social budget. The measures were so successful that

437 ibid 4.3.
438 Alexandre Morais Nunes et al., "Financial Crisis in Portugal: Effects in the Health Care Sector" International Journal of Health Services (April 2019)
439 WHO Data, 'Portugal - Health data overview for the Portuguese Republic' World Health Organization Data Indicators Countries <https://data.who.int/countries/620> accessed 11 July 2023; based on this dataset Greek life expectancy increased from 78.2 in 2000 to 81.1 in 2019 with hardly any improvement during the Troika years (80.1 - 80.4)
440 UNICEF Data: Monitoring the situation of children and women, 'Country Profile Portugal' UNICEF <https://data.unicef.org/country/PRT/> accessed 11 July 2023; based on this Dataset, infant mortality in Greece sank from 6.4 in 2000 to 3.9 in 2009-2011, just to increase in the following years to 4.4 in 2015-2016 from where it declined to 4 in 2019
441 Ralf Streck, 'Austerität ist nicht alternativlos in Portugal' *Telepolis* (Munich 18 December 2015)

Portugal repaid part of its IMF loan two years early in 2016.[442] Another payment ahead of schedule was made in February 2017, leaving Portugal with only half the loan and a reduced interest burden. Due to this positive development, the EU Commission acknowledged the positive effect of the increased minimum salary and predicted a positive impact on Portugal's unemployment.[443] This successful economic policy of the new government, which dared to try something different when there was no success with the old policies, was also supported by the constitutional court, which declared numerous laws to be unconstitutional.

4.1. Constitutional Issues of the Financial Assistance Programme

Since the policies of the Financial Assistance Programme had to be transposed into law, these laws were repeatedly challenged in front of the Portuguese Constitutional Court, several times by the Portuguese president. This section will be based on the English case summaries of some of the Troika-related cases available on the homepage of the Portuguese Constitutional Court.[444]

4.1.1. Ruling No. 353/12 – 5 of July of 2012[445]

In this case, the Court was asked to decide on the constitutionality of the suspension of the Christmas-month (13th month) and holiday-month (14th month) payments of annual salaries for the period of 2012-2014, both for persons who received salaries from public entities and for persons who receive retirement pensions from the public social security system. This cost-cutting measure of the State Budget Law of 2012 was rooted in the Financial Assistance Programme and the memoranda connected to it:

> The FAP [Financial Assistance Programme] comprises a set of legal instruments, the parties to which are the Portuguese government and the International Monetary Fund (IMF). They include a Technical Memorandum of Understanding and a Memorandum of Economic and Financial Policies, which set out the terms and conditions governing the provision of financial assistance to Portugal by the International Monetary Fund. In addition, the Portuguese government and the European Union signed a Memorandum of Understanding on Specific Economic Policy Conditionality. All these Memoranda are binding on the Portuguese state, to the extent that they are based on international-law and European Union-law instruments (...) that are recognised by the Constitution. These documents require

442 Ralf Streck, 'Portugal als Referenz gegen Austeritätswahn' *Telepolis* (München 30 November 2016)

443 Ralf Streck, 'Es geht auch anders: Portugal zahlt erneut Schulden an IWF vorzeitig zurück' *Telepolis* (München 23 February 2017)

444 Tribunal Constitucional Portugal, *Jurisprudence – Summaries 1987-2023* <https://www.tribunalconstitucional.pt/tc/en/acordaos/> all case summaries last accessed 12 July 2023

445 Tribunal Constitucional Portugal, *Ruling No. 353/12 - 5 of July of 2012* <https://www.tribunalconstitucional.pt/tc/en/acordaos/20120353s.html>

> the Portuguese state to adopt the measures they set out, as one of the conditions for the phased fulfilment of the financing contracts entered into by the same parties.[446]

The Constitutional Court analysed the level of reduction of the salaries in the public sector and pensions that the law in question introduced. As the list of measures shows, the various groups of people were differently affected by the law. Although these payments were the remuneration for work done, it was constitutionally possible to reduce these payments in general as an emergency measure. The measures would also result in the desired shrinking of Portugal's sovereign debt. But the burden to reduce the household deficit and sovereign debt has to be equally shared:

> The Court recalled that the principle of equality with regard to the just distribution of public costs, as a specific manifestation of the principle of equality, is a necessary legislative parameter which the legislator must consider when it decides to reduce the public deficit in order to safeguard the state's solvency. The sustainability of the public finances is of interest to everyone and, to the extent of their capacity to do so, everyone must contribute to the burden of the readjustments that are indispensable if that sustainability is to be ensured. The fact that the measures contained in the norms before the Court were not universal meant that they did not distribute the sacrifices equally between all citizens, in proportion to each one's financial capacity. They required an additional effort exclusively from certain categories of citizen[s].[447]

The Court pointed out that any inequality that is justified by a difference in situations cannot be immune from a judgement of proportionality. According to the Court, the difference in treatment was so substantial and significant that the efficacy-related reasons advanced by the Troika in favour of the measures were not valid enough to justify such a large difference, all the more so in that it was possible to resort to alternative solutions.[448] Article 9 d) of the Portuguese Constitution demands the State "[t]o promote the people's well-being and quality of life and real equality between the Portuguese, (…)." The principle of equality is defined in greater detail in article 13 of the Portuguese Constitution,[449] where Nr. 2 demands that equal treatment would also not exempt anybody from duties. In the context of the Financial Assistance Programme and the State Budget Law of 2012, only certain public employees and pensioners were affected by the measures, while other groups of citizens were not affected by this law, leading to a violation of article 13 nr. 2 of the Portuguese Constitution.

446 ibid
447 ibid
448 ibid
449 Article 13 of the Portuguese Constitution reads: "1. All citizens possess the same social dignity and are equal before the law. 2. No one may be privileged, favoured, prejudiced, deprived of any right or exempted from any duty for reasons of ancestry, sex, race, language, territory of origin, religion, political or ideological beliefs, education, economic situation, social circumstances or sexual orientation."

The Constitutional Court of Portugal therefore decided that the State Budget Law was unconstitutional.

4.1.2. RULING No. 187/13 – 5 of April of 2013[450]

The Constitutional Court declared the suspension of payment for the additional holiday month of public administration staff and public pensions contained in the State Budget Law 2013 to be unconstitutional, because it was in violation of the principle of equality that requires the just distribution of public costs. Again, the Court did not exclude that the legislator could lower the income of Public Administration staff in exceptionally urgent economic/financial circumstances that require a quick reduction of the public deficit, even if such a measure were to lead to unequal treatment compared to persons who earn income in the private economic sector. However, when not matched by equivalent sacrifices on the part of virtually all the other citizens earning income from other sources, the cumulative, ongoing effects of the sacrifices imposed on public sector employees and retirees represent a difference of treatment for which the goal of reducing the public deficit does not provide adequate grounds. “Penalising a given category of people, in a way that is made worse by the combined effect of this reduction in pay and the generalised increase in the fiscal burden, undermines both the principle of equality with regard to public costs and the principle of fiscal justice.”[451]

In reference to the planned contribution payable on unemployment and sickness benefits, the Court declared the norm that provided for a contribution payable on unemployment and sickness benefits to be unconstitutional, because it violated the principle of proportionality. According to the Court, a reduction of social security payments is conceivable, but this reduction may not render the function of social security unviable.

Since the measure was exceptional and transitory, it was possible to view it as constitutional. However, the measure would have led to cases in which the benefit might have fallen below the minimum level already established in legislation, such as the national minimum wage and therefore this measure was also declared unconstitutional due to its disproportionality.[452]

450 Tribunal Constitucional Portugal, *Ruling No. 187/13 - 5 of April of 2013* <https://www.tribunalconstitucional.pt/tc/en/acordaos/20130187s.html>

451 ibid nr. 1

452 ibid nr. 3

4.1.3. RULING No. 574/14 – 14 of August of 2014[453]

In this case, the Constitutional Court decided that a norm that provided for payment reductions of public servants from 2016-2018 was unconstitutional, because it did not determine the amount of the future cuts. According to the Court, "[m]aintaining pay cuts for another three years, at levels that could be as much as 80% of those that had already been in place since 2011, would go beyond the permissible limits on the additional sacrifice that can be demanded of workers paid out of public funds. It would be in breach of the principle of equality, because nothing comparable would affect other types of income."[454]

The Court recalled the essential preconditions it has used in its jurisprudence to determine when the Constitution protects the principle of trust (legal certainty), which include the existence of relevant legitimate expectations. Pay-cut measures imposed since 2011 had been systematically presented as transitional and had generated expectations that their remuneration would improve with time. This expectation was justified by the fact that the Portuguese State had already fulfilled the terms of the Financial Assistance Programme for Portugal, as well as by the improvement in the economic and financial situation reflected in various official indicators.[455] On the other hand, the Court saw the constraints for the government that were based on its international obligations. Therefore, payment cuts for 2015 can remain at the level that could be expected based on the current situation, since they are "permitted by the principle of the protection of trust (legal certainty)."[456]
Official data for 2016-2018, however, show an improvement of the financial and economic situation in the country, thus a positive effect on public salaries can be forecast.

The Court's own case law which permitted payment cuts since 2011 as they were designed to safeguard a public interest that could be justified also under the aspect of legal certainty. But as the Constitutional Court points out: "These are basically conjunctural financial-policy measures chosen by the country's legislative organ – itself legitimated by the principle of democracy seen as representation of the people – and also rooted in the need to respect the international commitments the Portuguese State made when it signed the [Financial Assistance Programme]."[457]

453 Tribunal Constitucional Portugal, *Ruling No. 574/14 14 of August of 2014* <https://www.tribunalconstitucional.pt/tc/en/acordaos/20140574s.html>
454 ibid nr. 1
455 ibid
456 ibid
457 ibid

The Court argues that at that time it was already predictable that the Financial Assistance Programme was coming to an end in 2016 and therefore different grounds for payment cuts would be necessary because from 2011 they were only not unconstitutional because of the overriding public interest during the emergency situation of an impending state bankruptcy.[458]

The Constitutional Court of Portugal also notes that norms contained in the EU's founding law have been implemented by means of derivative-law rules – particularly regulations, especially those in the Stability and Growth Pact but cannot result in concrete payment cuts:

> The Court emphasised that the 'Budget Treaty' is not part of EU Law, and is only applicable to the extent that it is compatible with the founding Treaties and the legal provisions they contain. From a Portuguese Constitutional Law point of view, this 'Budget Treaty' does not enjoy the status the Constitution affords to the Treaties governing the European Union and the norms issued by EU institutions in the exercise of their competences. The latter are applicable in Portuguese Law, subject to respect for the fundamental principles of a democratic state based on the rule of law. The 'Budget Treaty', on the other hand, is a source of Public International Law of the type that is governed by the constitutional norm according to which norms contained in duly ratified or approved international conventions have effect in domestic law once they have officially been published in Portugal and only for as long as they are binding on the Portuguese State.[459]

Similar to the Swiss Bundesgericht and the EFTA Court, the Portuguese Constitutional Court dissects the legal provisions that affect the state's obligations, here those of the EU's deficit procedure. The provisions only submit recommendations without demanding Portugal to take concrete steps but rather list the objectives which must obligatorily be achieved under EU norms that are indeed binding – those included in the founding law of the EU and the derivative law referred to above. The binding nature of European Union Law in this domain does not apply to the means by which the individual Member States actually achieve the goals imposed on them.[460] The Court adds, that the constitutional principles of equality, proportionality and the protection of trust (legal certainty), by which the Court evaluates the constitutionality of national norms form part of the central core of the state based on the rule of law and are included in the common European legal heritage, which is also binding on the European Union.[461]

Absent any concrete calculation or percentage by which the payment would be cut in the years 2016-2018, and by connecting it to a reduction of the number of public servants,

458 ibid
459 ibid
460 ibid
461 ibid

"[t]he Court was of the opinion that when seen in the light of the principle of equality, these reasons were not capable of justifying continued cuts in the pay of staff who are paid from public funds, and their pay alone, for another three years. Given the constitutional requirement that public costs must be shared out equally, it is not constitutionally permissible for the strategy for balancing the public finances to be based on cutting spending by continuing to sacrifice those workers in particular."

As a result, the Court found that the norms applicable to 2016-2018 are unconstitutional.

4.2. Irregularities in the Sense of Taft:

Apart from the Portuguese Constitutional Court's findings related to proportionality, discrimination, equality and legal certainty, there are several other points that are worth mentioning from Taft's point of view that irregularities could lead to the right to refute a claim.

RULING No. 574/14 states that the overall indicators were developing well and that the Financial Assistance Programme was about to come to an end. When the Court stated that the government cannot eliminate the constraints of the state's international obligations, such as the TFEU and the Budget Treaty, it accepts that treaties can influence domestic policies. Here, the Court could have added the argument, that the Financial Assistance Programme was not an international treaty but merely a memorandum. If that memorandum was supposed to determine what laws were to be passed on the payment regulation in the Portuguese labour law, these obligations would have necessitated a different format. As the TEU and the TFEU do not confer on the EU any authority related to domestic taxation and labour law, another treaty would have been necessary, not a memorandum. In the Tinoco arbitration, Taft pointed out that the concession was approved by the wrong body, which violated the constitution and therefore it was not possible to uphold its validity. In the case at hand, is questionable if that formal problem could be healed when it comes to such far-reaching issues such as labour law.

In the same decision, the Constitutional Court stated that basically conjunctural financial-policy measures chosen by the country's legislative organ are in themselves legitimated by the principle of democracy seen as representation of the people. This means, governmental agency is defined by the constitution and assigned by elections. If government decisions violate the constitution, the government could violate its agency. Of course, it is also a question, if the government had the authority to waive the right of the parliament to control the budget – or if the parliament waived this right by enacting that law. But in a situation where the Troika clarifies that they would give money only against alterations in the domestic labour and tax law, one cannot speak of a voluntary act of government and parliament any longer. If the government is forced to change the Portuguese labour law as described above in contradiction to the EU treaties in order to obtain necessary funding, the agency of the government, as defined by the constitution and the elections, has to be considered as violated. Likewise, the EU Commission as the guardian of the treaties based on article 17 TEU and the ECB as an organ of the EU overstepped their mandates as defined in the TEU and TFEU. Hence the Constitutional Court was right to declare these provisions unconstitutional, which then have to be vetoed in accordance with article 279 nr. 1 of the Constitution: “If the Constitutional Court pronounces the unconstitutionality of a norm contained in any decree or international treaty, the President of the Republic or the Representative of the Republic, as appropriate, must veto the legislative act and return it to the entity or organ that passed it.”

4.3. Summary

The Portuguese Constitutional Court frequently held that the attempts to transpose the Financial Assistance Programme’s memoranda into Portuguese law led to norms that had a disproportionate effect on the Portuguese citizens, rendering these norms unconstitutional.

It has to be pointed out here that the Financial Assistance Programme ended in 2016 according to plan. This is proof that none of the decisions of the Portuguese Constitutional Court delayed the Troika’s programme in Portugal, nor did they endanger the Portuguese household. Had these Troika measures been the *conditio sine qua non* to rescue the Portuguese Republic, the decisions of the Constitutional Court would have led to a delay and problems in the household would have been inevitable. But to the contrary, as press reports show, the Portuguese government even managed to repay some of its loans early. This demonstrates that the Troika policies imposed on Portugal were disproportionate, indeed, and rightfully held unconstitutional by the Constitutional Court.

In the context of the repudiation of payment claims and the refusal to implement policies that are designed to secure payment more general, constitutional norms related to equality, non-discrimination and the principle of proportionality could therefore prove to be viable legal tools.

5. Regulatory Causes for Debt Repudiation[462]

At times it is not obvious where sovereign debt originated from and so the State has to be aware if the raised payment claims are justified. The Greek Parliament's president Zoe Konstantopoulou attempted to clarify where Greece's sovereign debt came from and if it could be repudiated with her "Truth Committee On Public Debt".[463] Sometimes not even such an inventory can explain why the debt level is rising. This can be the case where the creation of debt itself is legally questionable and its genesis sufficiently complicated so that time-bound government officials would need more manpower and sometimes additional know-how to understand it. The following chapter explains how debt in general is created, why it is more expensive than necessary and why the financial economy leads to the legal tool that States can use to repudiate that part of debt that is legally not justified.

5.1. Introduction

Risky borrowers pay more for the same loan than low-risk clients due to risk-weighted interest rates. Risk-weighted means that an interest rate consists of a prime rate that is offered to the ideal client only, plus an added premium that depends on the risk every other client poses to the fulfilment of the loan contract. These risk premiums are ubiquitous, having their origins in the work of the Basel Committee on Banking Supervision.

The Basel Committee on Banking Supervision ("Basel Committee") was formed amidst turbulence in national financial markets during the mid-1970s.[464] The Committee recommended aids to co-operation among the supervisory authorities of home states from which a financial institution originates and the host states in which that institution operates through its subsidiaries.[465] The Committee has also established international standards for bank regulation, most notably its accords on capital adequacy, collectively known as the Basel Accords.[466]

462 The following section is largely based on two articles, the author previously published:
Oliver Pahnecke and Juan Pablo Bohoslavsky, 'Interest Rates and Human Rights: Reinterpreting Risk Premiums to Adjust the Financial Economy', The Yale Journal of International Law Online [Vol. 46: 1-46 2021] (New Haven, CT 19 April 2021) which is mainly identical with sections 6.1. - 6.5.
<https://www.yjil.yale.edu/online-essays/features-essays/> and
Oliver Pahnecke and Juan Pablo Bohoslavsky, 'Re-regulating the Risk Premium to Realize the Right to Development' Development – Palgrave Macmillan [Vol 65 Numbers 2-4] (Rome 2022) 145-152 which is the basis for 6.6.

463 Zoe Konstantopoulou et al., 'Preliminary Report' Truth Committee of Public Debt (Hellenic Parliament 2015)

464 Bank for International Settlements 'History of the Basel Committee' <https://www.bis.org/bcbs/history.htm> <https://www.bis.org/bcbs/history.htm> ("[A]t the end of 1974 in the aftermath of serious disturbances in international currency and banking markets (notably the failure of Bankhaus Herstatt in West Germany" the Central Banks of the Group of Ten (G10) Countries established the Basel Committee on Banking Supervision "to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation between its member countries on banking supervisory matters.").

465 Committee on Banking Regulations and Supervisory Practices, 'Report to the Governors on the Supervision of Banks' Foreign Establishments, Bank for International Settlements <https://www.bis.org/publ/bcbs00a.pdf>

466 Bank for International Settlements 'History of the Basel Committee' <https://www.bis.org/bcbs/history.htm>

The Latin American debt crisis of the early 1980s increased international risk while the capital ratios of major international banks were eroding. As a countermeasure, the Basel Committee decided "on a weighted approach to the measurement of risk, both on and off banks' balance sheets."[467] The work resulted in the Basel Capital Accord of 1988, also known as Basel I,[468] which was supposed to strengthen the stability of the international banking system by reducing credit risk and remove a source of competitive inequality arising from differences in national capital requirements.[469] Regarding risk weights, the Committee gives preference to a weighted risk ratio over other approaches, since this makes a fairer international comparison of different risks possible.[470] Basel I states that "[f]or most banks the major risk is *credit risk*," meaning counterparty failure.[471]

As a result of the Basel Committee's work, weighing credit risk has formed part of the architecture of international banking supervision for over three decades. In accordance with the Basel Accords, the world's largest economies – and most jurisdictions trading with them – use risk-weighted interest rates.[472] The Basel Accords are implemented in the G20 member States[473] and today, the Basel Committee on Banking Supervision comprises 45 members from 28 jurisdictions, consisting of central banks and national regulators of the banking industry.[474] The Committee "expects full implementation of its standards by its member jurisdictions and their internationally active banks" and monitors the implementation of the Basel standards to ensure fair international competition among banks.[475] Demonstrating the ubiquity of the Accords in the banking sector, the report of the Basel Committee's 2019 Basel III monitoring exercise includes data from 257 major banks, 29 of which have been designated as global systemically-important banks (G-SIBs).[476] In turn, risk-weighted interest rates have become ubiquitous in the Basel era. In the United States, risk-weighted pricing – composed of a prime rate and a risk premium

467 ibid

468 Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' (July 1988) <https://www.bis.org/publ/bcbs04a.pdf>

469 Bank for International Settlements 'History of the Basel Committee' <https://www.bis.org/bcbs/history.htm>

470 Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' (July 1988) 8

471 ibid 8-9

472 An up-to-date version of the Basel Framework and risk-based capital requirements is also available through the Bank for International Settlements. *The Basel Framework,* BANK FOR INT'L SETTLEMENTS, https://www.bis.org/basel_framework/index.htm.

473 *Implementation and Effects of the G20 Financial Regulatory Reforms: Fifth Annual Report,* FIN. STABILITY BOARD, https://www.fsb.org/2019/10/implementation-and-effects-of-the-g20-financial-regulatory-reforms-fifth-annual-report/#dashboard.

474 *Basel Committee Membership*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/bcbs/membership.htm.

475 *Policy Development and Implementation Review,* BANK FOR INT'L SETTLEMENTS (APR. 14, 2018), https://www.bis.org/bcbs/review_process.htm. Additional monitoring information on the implementation of the Basel III standards by the Financial Stability Board is available as well. *Basel III – Implementation,* FIN. STABILITY BOARD, https://www.fsb.org/work-of-the-fsb/implementation-monitoring/monitoring-of-priority-areas/basel-iii.

476 Bank for International Settlements, 'Basel III Monitoring Report' (2 October 2019) https://www.bis.org/bcbs/publ/d477.htm

that depends on the borrower's risk profile – was prevalent already before 2000.[477] In Austria, for example, risk weighting has been legally required since 1993, and had become an industry practice earlier yet.[478]

In combination with the equally widespread principle of compound interest, risk-weighted interest rates have led to an enormous growth of financial obligations for riskier clients with obvious adverse implications for financial stability, economic growth, and human rights. While this risk-weighted approach treats collateral and risk premium as exchangeable,[479] it is only the collateral that is returned at the end of the contract. This causes different prices based on the risk premium and begs the question: should it be lawful to charge clients different prices for the same product if the only difference between them is their property? While the lender will take many factors into account when assessing risk, by far the most important is the expected default risk. If the collateral can reduce the default risk to almost zero, a corresponding reduction in the cost of the loan can be expected. But the Basel Accords increase the cost (or make loans entirely unavailable) to borrowers with poor credit history, for risky business, or in poor economic environments.[480]

This chapter of the thesis focuses on loans as they are "the largest and most obvious source of credit risk" for most banks, according to the Basel Committee.[481] To compare the impact of risk premiums and their effect on loans, this article works with three identical loans that differ only in the risk profile of their clients *A*, *B* and *C*.

This thesis argues that the risk premium is a collateral *sui generis*, meaning classified as a unique kind of collateral, which must be adjusted to prime-rate levels once (or if) the principal has been paid, eliminating the default risk. Although private loans are generally repaid while sovereign debt is frequently rolled over, loan pricing in both contexts generally follows the basic method described above. Therefore, the analysis and conclusions of this article apply to sovereign debt and private debt alike. The article bases its analysis on the calculation of risk-weighted interest payments and their ultimate impact on financial stability and human rights. While lenders would eventually earn less at the beginning if our recommendations were implemented, they would most likely gain more stability due to more predictable risk and face less defaults, which could ultimately lead to a more reliable revenue stream. States and private parties would retain more money for the

477 Diette M. D., 'How do lenders set interest rates on loans? A discussion of the concepts lenders use to determine interest rates.' (November 2000) Community Dividend Issue 2, 2000, Federal Reserve Bank of Minneapolis
478 Email from Austrian National Bank to author (23 June 2020) (on file with the author).
479 Peter Derleder, Kai-Oliver Knops & Heinz Georg Bamberger eds, 'Deutsches und Europäisches Bank- und Kapitalmarktrecht', Springer (Berlin 2017) § 13 nr. 13
480 ibid
481 Basel Committee on Banking Supervision, 'Principles for the Management of Credit Risk, Basel Committee on Banking Supervision I No. 3' (September 2000) <https://www.bis.org/publ/bcbs75.pdf>

protection of human rights and for economic activity, without compromising risk management in the banking sector.

Banking regulations based on the Basel Accords have largely gone unnoticed by the human rights community,[482] yet contribute to economic structures with negative human rights impacts. Laws based on the Basel Accords affect millions of people around the world, since they make risk-weighted interest rates obligatory.[483] The impact of risk-weighted interest rates on human rights is immense since money or the lack of it has a direct impact on almost all human rights, regardless of who borrows: states, corporations, or households. On the one hand, job creation, robust public health and social policies, as well as development are threatened by unpayable corporate and public debt while funding needed for investment is syphoned off. Empirical studies demonstrate a positive correlation between income inequality, fiscal deficit, and mounting sovereign debt.[484] On the other hand, while household debt is not regarded as a human rights violation *per se*, it forces families and individuals to borrow in order to exercise their basic rights to healthcare, housing, food, water sanitation, and education.[485] Over-indebted persons, in turn, are frequently subjected to abusive contractual terms and collection practices.

These links between interest rates and human rights remain largely overlooked in the academic literature, as it has been by lawyers, economists, regulators and policymakers. While studying these links poses interdisciplinary methodological challenges, this lack of academic interest corresponds with a more general political backwardness and underdevelopment of legal theory (until very recently) addressing the links between finance and human rights.[486] These links do not attract attention from finance industry because human rights law imposes limits on what is economically possible. Notably, most developed countries systematically reject initiatives at the General Assembly and the

482 There are a few exceptions, see for example Motoko Aizawa, Daniel Bradlow & Margaret Wachenfeld ‘International Financial Regulatory Standards and Human Rights: Connecting the Dots’ Manchester Journal of International Economic Law (2018)

483 Another case of regulation that goes generally unnoticed by human rights advocates is bankruptcy law in the context of sovereign debt, see Christopher K. Odinet, ‘Of Progressive Property and Public Debt’, Wake Forest Law Review 1101 (2016); Kunibert Raffer, ‘Internationalizing U.S. Municipal Insolvency: A Fair, Equitable, and Efficient Way to Overcome a Debt Overhang’, Chicago Journal of International Law (2006)

484 See Joshua Aizenman & Yothin Jinjarak, ‘Income Inequality, Tax Base and Sovereign Spreads’, 68 FinanzArchiv: Pub. Fin. Analysis 431-444 (2012) <https://www.nber.org/papers/w18176>; Santo Milasi, ‘Top Income Shares and Budget Deficits’, 10 Centre for Economic and International Studies, Research Paper Series (2013) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2121344>

485 This falls on top of the already precarious and fragile picture in the world where many vulnerable and marginalized people were already having to make choices between adequate food and adequate housing or medical care. See Juan Pablo Bohoslavsky (Independent Expert), Report of the Independent Expert on the Effects of Foreign Debt and Other Related International Financial Obligations of States on the Full Enjoyment of Human Rights, Particularly Economic, Social and Cultural Rights, U.N. Doc. A/HRC/43/45 (Jan. 3, 2020)

486 See Ilias Bantekas & Cephas Lumina (eds), Sovereign Debt and Human Rights (Oxford Academic 2018); Juan Pablo Bohoslavsky & Jernej Černič (eds) Making Sovereign Financing & Human Rights Work (Hart Publishing 2014); Aoife Nola (ed) ‘Economic and Social Rights after the Global Financial Crisis’ Human Rights Law Review (2014); YJIL-Online-Special-Edition Volume 41 Special Edition on Sovereign Debt, Yale Journal of International Law (2016)

Human Rights Council of the United Nations that elaborate the relationship between finance and human rights.[487] At a more technical level, while the economic literature has studied how the premiums should be adjusted based on market considerations,[488] a corresponding literature on the legal nature and economic function of risk premiums has yet to develop.

5.2. The Interest Rates of Loans

The loan is the typical product of banks. In other words, banks are in the business of letting money to clients for a certain period of time, just like landlords let houses or apartments to tenants.[489] The money that banks rent clients is called *commercial bank money*, because it is created by the bank by recording a deposit in the client's account, or *fiat money*, because it is created instantaneously without physical production.[490] Commercial banks have created around 97% of all money in circulation in the United Kingdom.[491] States vest private banks with the right to create commercial bank money, regulating the money's creation in order to facilitate economic growth.[492]

In contrast, money in the form of coins and bills is produced only by a central bank. Although cash has very little intrinsic value and digital fiat money has none, both kinds of money can and are used by the client for purchases and payments, such as for the payment of taxes or debt. As this kind of money is obviously fit for purpose, it cannot be argued that a bank had no claim to payment or to the collateral because it had created the loan merely by an entry into its ledger instead of giving the client real money, like in the frequently

487 See, for example, the way states vote resolutions in the context of the mandate on debt at Special Procedures of the United Nations, *Resolutions and Decisions on the Mandate*, United Nations Human Rights Council

488 For classic and current work on interest rates see, for example, John Meynard Keynes, *The General Theory of Employment, Interest & Money* (Wordsworth Editions Ltd. 2017) (1936) 142; Gabriela Castro & Carlos Santos, 'Bank Interest Rates and Loan Determinants', Economic Bulletin Banco de Portugal (2010); Group Of Ten, 'Saving, Investment and Real Interest Rates – A Study for the Ministers and Governors by the Group of Deputies', Instituto Poligrafico E Zecca Dello Stato (1995); Raghuram G. Rajan, 'Has Financial Development Made the World Riskier?', Kansas City Fed. 313 (2005), https://www.kansascityfed.org/publicat/sympos/2005/PDF/Rajan2005.pdf; Richard Rosenberg, Scott Gaul, William Ford & Olga Tomilova, 'Microcredit Interest Rates and their Determinants' in Köhn D, *Microfinance 3.0*, (Springer 2013)

489 This simplified definition does not make a distinction between the way banks and non-banks (financial institutions without a banking license that do not offer all financial services a bank offers) hand out loans because both financial institutions rely on risk profiles to determine how they treat clients. This reliance on risk profiles leads to differential risk premiums and, therefore, outcomes in contractual obligations. For more details on the funding of banks and non-banks, see American Bankers Association, 'The Business of Banking: What Every Policy Maker Needs To Know' 33, 57 (2013), and Iain Ritchie, 'Funding Liquidity Risk,' Actuary (June 5, 2017)

490 Fiat is Latin for "let there be" or "so be it." For a scientific proof of money creation, see Richard A. Werner, 'Can Banks Individually Create Money Out of Nothing? —The Theories and the Empirical Evidence', International Review of Financial Analysis (Science Direct 2014) 38

491 Michael McLeay, Amar Radia & Ryland Thomas, 'Money Creation in the Modern Economy' Bank of England (2014 Q1) 14-15

492 That a state authorizes private banks to issue commercial bank money is not exceptional: states authorize private entities to conduct sovereign activity in various fields. In some instances, states vest agencies, corporations, or associations with certain sovereign rights in order to execute state tasks. For instance, some states bestow private associations with the mandate to monitor the reliability of cars or industrial machinery.

quoted *Credit River Case*[493] and similar U.S. cases.[494] Such cases were bound to remain unsuccessful simply because domestic currency and commercial bank money are legally used for payments.

While both, national currency and commercial bank money, are used as legal tender, the right of private banking institutions to create commercial bank money is not set in stone, as the right to mint coins originally belongs to the sovereign who can decide to withdraw this right if necessary.[495]

In fact, the practice of private banks creating commercial bank money in the same way as central banks, but in much larger quantity and with little collateral, has long been criticized. For example, Rolf Gocht, former director of the German Central Bank, published a 1975 book on the monetary system in which he assails the sparse scientific discussion on the creation of commercial bank money and criticizes the current model as open for the purposeful manipulation of money circulation and credit supply.[496] Gocht proposes a monetary system without commercial bank money, enabling a strict division of state and economy.[497] Yet, the practice of commercial bank money is unlikely to change in the near future, as the current system helps expand the economy. However, monetary policies can change and a reform similar to Gocht's proposal has already been proposed as a draft law in Switzerland. But when asked in the 2018 referendum on the so-called 'Sovereign Money Initiative' if they wanted to introduce such a new monetary system, Swiss citizens rejected the proposal.[498] For the time being, commercial bank money will therefore remain to be in use and will be handed out in loans against interest.

The price for the loan is the interest rate. In the banking industry's now-obsolete "cost-plus loan-pricing model", the interest rate was composed of four components: the funding cost, the operating costs, a profit margin, and a risk premium to compensate the bank for the degree of default risk inherent in the loan request.[499] Due to increased competition and

493 *First Nat'l Bank of Montgomery v. Daly* (Just. Ct., Credit River Twp., Scott County, Minn. 1968). The decision was nullified on formal grounds because the sitting justice of the peace had only power to decide on claims of up to USD $100 while the mortgage in dispute amounted to USD $14,000.

494 For example, in Tuttle v. Chase Home Finance, LLC, 2008 WL 4919263 (D. Utah Nov. 17, 2008), the plaintiff unsuccessfully argued that banks had no right to claim performance of the loan contract since only gold or silver were legal tender and paper dollars worthless.

495 Deutsche Bundesbank (German Central Bank), 'Coinage prerogative', Glossary https://www.bundesbank.de/dynamic/action/en/homepage/glossary/729724/glossary?firstLetter=C&contentId=653538#anchor-653538 "Coinage prerogative is the sovereign right to design and mint coins. In the past, this was the right of the state ruler (e.g. the king). Today, the coinage prerogative lies with the government or the central bank."

496 Rolf Gocht, Kritische Betrachtungen zur nationalen und internationalen Geldordnung 64, 67 (2d ed. 2011)

497 ibid 65

498 On June 10, 2018, the Swiss electorate rejected the initiative with 24.3% in favour of and 75.7% against the proposal. Schweizerische Eidgenossenschaft, *Bundesratsbeschluss über das Ergebnis der Volksabstimmung vom 10. Juni 2018*, BBl 7757 (2018)

499 Matthew D. Diette, 'How Do Lenders Set Interest Rates on Loans? A Discussion of the Concepts Lenders Use to Determine Interest Rates', Federal Reserve Bank of Minneapolis (1 Nov 2000)

deregulation, banks are now instead using the “price-leadership model” to determine the price of loans.[500] Using the price-leadership model, the bank offers its most creditworthy client for short term loans a *prime rate* (also called a *base rate*), which serves as a yardstick for all other loans offered to less creditworthy clients.[501] Credit scoring and credit rating (in the case of states and corporations) are risk pricing tools to determine the risk premium which is added to the prime rate and must be paid by all riskier clients. Risk pricing enables banks to offer competitive prime rates for good clients and to offer loans at a high premium to high-risk clients, or to reject them.[502] If the clients’ cash flow and the sum of the loan are identical, two main factors influence the risk premium: the collateral offered and the duration of the loan. The lender’s risk decreases if the loan is secured by a collateral, particularly valuable collateral. And since the borrower’s ability to pay the loan is less likely to change in the near term than in the long term, the lender’s risk decreases as the loan term shortens.[503]

Apart from determining risk premium and interest rate, the interest calculation is decisive for the financial burden of the client. Most loans compound interest, regardless of whether the clients are states, businesses or natural persons. This *compound interest* is paid on the principal and the previously accumulated interest. Alternatively, s*imple interest*, where the same percentage rate is calculated as interest from the same principal annually, might also be used. There appears to be no preference or compelling reason for compound interest in economic theory.[504] Nor is there a preference from a legal point of view: freedom of contract equally permits compound or simple interest.[505] In practice, however, compound interest is the finance industry standard.[506] Combined with weighted risk, which is additionally priced into the interest rate if only poor collateral exists or is entirely

500 ibid; *in agreement* Peter Derleder, Kai-Oliver Knops & Heinz Georg Bamberger eds., ‘Deutsches und Europäisches Bank- und Kapitalmarktrecht’, *Springer* (Berlin 2017) § 14 at 5.

501 Matthew D. Diette, ‘How Do Lenders Set Interest Rates on Loans? A Discussion of the Concepts Lenders Use to Determine Interest Rates’, Federal Reserve Bank of Minneapolis (1 Nov 2000). Of course, potential prime rate clients could also face higher risk premiums in case they failed to pay for previous loans. But since this non-payment is either deliberate or negligent and therefore solely dependent on the will of the client, the article does not discuss this option any further.

502 ibid

503 ibid

504 For example, there is no indication of a preference in John Maynard Keynes, *The General Theory of Employment, Interest & Money* (Wordsworth Editions Ltd. 2017) (1936), nor in David Ricardo, On The Principles Of Political Economy And Taxation (Amazon fulfilment 2017) (1817), nor in Rolf Gocht, Kritische Betrachtungen zur nationalen und internationalen Geldordnung (2d ed Duncker & Humblot 2011)

505 Rutsel Silvestre J. Martha, *The Financial Obligation in International Law* (OUP 2015) 304 “given that the obligation to pay interest must have been agreed, there cannot be any presumption one way or the other. The question whether interest payable is to be simple or compound interest is to be approached without reference to any predisposition one may have in favour of simple interest as against compound interest.”

506 See John Yukio Gotandaii, ‘Compound Interest in International Disputes’, 2004 Oxford Comparative Law Forum (2004) <https://ouclf.law.ox.ac.uk/compound-interest-in-international-disputes/#fn2anc> In 2004 most jurisdictions had accepted compound interest as part of the freedom of contract. Following the decision in Sempra Metals Ltd v. Inland Revenue Commissioners & Anor [2007] UKHL 34, [2008] AC 561 (appeal taken from Eng.), English law similarly accepted compound interest.

unavailable, the economic outcome of compound interest is very different in comparison to simple interest.

5.3. The Risk Premium from a Legal Point of View

Courts, governments, and the public accept a higher risk premium as the price that a borrower with a poor credit rating must pay to obtain the same loan that a borrower with good credit would get at a cheaper price. In contrast, the price for rented cars or apartments does not depend on the financial background of the client or tenant but solely on the market.[507] Different prices for the same good or service seem discriminatory if the determining factor is the property of the client,[508] unless the risk premium – as an independent element of the interest rate – offers something in return.

Should the risk premium offer no additional benefit but only be a driver of cost for the borrower, a remedy can be found in the well-established legal doctrines which provide equitable results for the contractual parties where the return for one party proved to be exceptionally low. In Roman law, for example, the concept of *laesio enormis* granted a contracting party the right to nullify a contract if the relationship of price and value or other contractual relations were extremely disproportionate.[509] Common law and civil law jurisdictions contain codified versions of *laesio enormis*, such as adjustment and rescission of contracts. While these practices seem to collide with freedom of contract, they are common practice. For example, article 1168 of the French Civil Code permits the lack of equivalent contractual duties, stating that law can determine otherwise. Accordingly, in article L650-1 the French Commercial Code provides for an adjustment of collateral in case its value is inadequate. Section 934 of the Austrian Civil Code (ABGB) permits rescission in case one party received less than half in value of what it gave in order to fulfil the contract, unless it is compensated by the other party. The Swiss and German civil codes declare contracts void that are contrary to public policy or unconscionable due to advantages that are clearly disproportionate to the performance.[510] And Lord Denning held in the British case *George Mitchell (Chesterhall) Ltd. v Finney Lock Seeds Ltd* that freedom of contract could lead to an abuse of power, if contracts could not be adjusted.[511]

507 The practice of some landlords to verify a prospective tenant's ability to pay by inspecting his bank statement does not influence the rent but is a mere background check.

508 On the prohibition of discrimination based on economic status see U.N., Committee on Economic, Social & Cultural Rights, General Comment No. 20, Non-discrimination in Economic, Social and Cultural Rights, E/C.12/GC/20 (2 July 2009).

509 Latin expression describing an enormous or abnormal injury or damage. See *laesio enormis*, Black's Law Dictionary (11th ed. 2019) (summarizing applications).

510 *See* Federal Act on the Amendment of the Swiss Civil Code, 1911 (Part Five: The Code of Obligations) (SR 220) art. 21; Bürgerliches Gesetzbuch [BGB] [Civil Code], § 155.

511 *George Mitchell (Chesterhall) Ltd. v Finney Lock Seeds Ltd* [1982] EWCA Civ 5.

Thus, it is generally acknowledged that the disproportionality of reciprocal contractual duties has legal limits. In the loan context, that means the bank's client must get something adequate in return for paying the risk premium. The risk premium is supposedly the lender's compensation for the risk of issuing a loan to someone with a lower credit rating. It goes without saying that it is indispensable to secure claims. Where conventional collateral is available in the form of physical goods or legal claims, this security can be easily obtained. But if the price of a loan is supposed to be the same interest rate for all borrowers in order to avoid discrimination and only the risk premium differs based on the risk of the borrower,[512] then it is necessary to analyse how the risk premium works in order to clarify its legal character. This chapter demonstrates the risk premium is neither an insurance premium nor a compensation for regulatory expenses, but rather a substitute for collateral.

5.3.1. The Risk Premium is not an Insurance

The risk premium could easily be mistaken for an insurance premium. After all, it is a premium that borrowers with less property pay on top of the interest rate in order to cover risk. Without that risk premium, the lender would not enter into a loan contract with the borrower.[513] But the risk premium is not paid to an insurer to compensate for defaults.

The prime rate is the lowest interest rate a bank is willing to offer to its most creditworthy clients. This interest rate already contains a price for the risk.[514] Riskier clients must pay a higher interest rate because the higher risk is added to the prime rate in form of the risk premium. But this risk premium does not lead to an insurance coverage. If this were the case, the risk premiums would have to be paid to an insurer, meaning to a third party with insurance license, and lenders could claim the payment of the principal from the insurer in case of a default as long as the insurance premium – the risk premium – had been paid by the borrower. However, the risk premium is not paid to an insurer to insure the default risk of the borrower but it is paid to the lender and in practice no insurer pays for the lender's loss in case of a default based on risk premiums that the lender received. Consequently, the risk premium cannot be an insurance built into the credit contract.

The lender could use part of the revenue from the loan contract in order to obtain a Credit Default Swap (CDS) in order to hedge the default risk, a procedure similar to insurance.[515]

512 Peter Derleder, Kai-Oliver Knops & Heinz Georg Bamberger (eds), 'Deutsches und Europäisches Bank- und Kapitalmarktrecht', Springer (Berlin 2017) § 13 at 3.

513 Similarly, the risk premium is also called the price the borrower must pay for the risk.

514 *see* Matthew D Diette, 'How do lenders set interest rates on loans? A discussion of the concepts lenders use to determine interest rates.' (November 2000) Community Dividend Issue 2, 2000, Federal Reserve Bank of Minneapolis; *see also* Peter Derleder, Kai-Oliver Knops & Heinz Georg Bamberger (eds), 'Deutsches und Europäisches Bank- und Kapitalmarktrecht', *Springer* (Berlin 2017), § 14 at 5.

515 Credit Default Swaps (CDS) are used in order to hedge the default risk of Residential Mortgage-Backed Securities (RMBS) and other financial products. RMBS belong to a class of financial instruments called Asset Backed

This means than an insurance against borrowers' defaults exists but is contained in a derivative product encompassing a multitude of loans, not an individual one. The insurance is not located in the risk premium, but it is provided for by a third party. If the risk premium would fulfil the functions of a CDS and Collateralized Debt Obligations (CDOs), these products would be redundant, and the financial industry would have avoided CDSs as a mere additional expense.

Some lenders demand that the borrower has life insurance, which would cover the remaining payments should the borrower die before the fulfilment of the contract. This practice provides security for both sides of the contract: the lender and the potential heir of the borrower. In an insurance event – the death of the borrower – the insurance pays and fulfils the loan contract instead of its client. Unlike with risk premiums, the borrower thus gets something in return for the paid insurance premium. Again, the insurance is provided by a licensed third party that indemnifies the contractual parties in return for the payment of insurance premiums. And the insured borrower must also cover a risk premium, nevertheless.

Some businesses mix calculations in an attempt to compensate potential losses in one field with profits in the other. In the context of loans, risk premiums could, in theory, be used to cross-finance losses within one risk class or between different risk classes as a form of internal insurance. This means poorer and riskier clients would be forced to subsidize the insurance of other equally risky clients. If the risk premiums were calculated well, the high-risk client class might then be as profitable for the lender as the low-risk client class. Alternatively, low-risk clients could be used to subsidize risky clients. But this cross-financing could be compared to an insurance-like contract without consent. Furthermore, also this approach would mean that the different risk classes are treated in a discriminatory manner, because the low-risk class would then benefit from better prices than the high-risk class, leading to different prices for the same product.

But this is not how risk-based pricing works. As the main advantage of risk-based pricing the Federal Reserve Bank of Minneapolis points out:

Securities (ABS). A single loan's payment would be threatened if the particular borrower defaults, which makes it difficult to sell these loans individually. But if thousands of these loans are pooled in RMBS, on average even a majority of high-risk borrowers are likely to pay. Technically, this pooling of borrowers' risk functions like an insurance. The formerly illiquid asset, like the loan or a mortgage of an individual client, is turned into a commodity that can be sold more easily. In the past two decades Collateralized Debt Obligations (CDO) were developed by combining several ABS or RMBS And in order to protect investors and lenders from defaults on the CDOs a derivative called Credit Default Swap (CDS) was developed which acted as an insurance policy for the CDOs. Ha-Joon Chang, 'Economics: The User's Guide' (Pelican 2004) 291-293, 297, 302 Of course, CDOs can be based on CDS as well and these instruments are not only used to hedge the risk but also to pass on risk by selling it. See also John Lanchaster, Outsmarted, *New Yorker* (24 May 2009) https://www.newyorker.com/magazine/2009/06/01/outsmarted (detailing Blythe Masters' development of the CDS).

> Since a bank is determining a reasonable default premium based on past credit history, borrowers with good credit histories are rewarded for their responsible financial behaviour. Using risk-based pricing, the borrower with better credit will get a reduced price on a loan as a reflection of the expected lower losses the bank will incur. As a result, less risky borrowers do not subsidize the cost of credit for more risky borrowers.[516]

This means that cross financing as an internal insurance is excluded while it is the individual financial behaviour that is sanctioned or rewarded. Interest, therefore, is determined by the individual client's risk and bears no resemblance to an insurance.

5.3.2. Regulatory Expenses Constitute Only a Fraction of the Risk Premiums

Once a bank issues a loan, it must adjust its capital according to the regulatory requirements of the applicable national and transnational laws designed to manage risk.[517] This precautionary measure can increase expenses, which are commonly passed on to the client. In the banking industry risk management regulation is based on the Basel Accords, transposed into national law and administered by national central banks.[518] The current Basel III Accord seeks to increase the banks' resilience against economic and financial crises by strengthening the capital and reserve requirements according to risks. In the European Union, for example, Basel III is implemented through EU Regulation 575/2013.[519] Article 114(4) of this regulation determines that where a commercial bank holds its own government's debt, that debt is weighted at 0% risk, as it is considered risk-free. Any other loan is considered riskier, which leads to higher capital requirements. Capital that is captured[520] by the higher capital requirements according to Basel III is not an expense in the sense of a tax or fee and therefore is not lost. But since it is supposed to be an internal safety buffer, this money cannot be invested elsewhere.[521]

Hypothetically, for a better business opportunity the bank would need to look for a different source of funding, for example by raising capital. Since this captured capital is

516 Matthew D Diette, 'How do lenders set interest rates on loans? A discussion of the concepts lenders use to determine interest rates.' (November 2000) Community Dividend Issue 2, 2000, Federal Reserve Bank of Minneapolis

517 In case a bank receives a deposit, it must adjust its reserves according to the regulatory reserve requirements. If the client would keep the loan deposited at the client's account at the loan-giving bank, the bank would need to meet the reserve requirements additionally, until the loan is transferred or paid out to the client in cash.

518 The Basel Accords describe how different kinds of counter party risk have to be weighted in order to determine how much capital must be allocated to secure the loans in each particular category. They do not describe how the bank must deal with loans on individual level, but the Basel Accords are reflected in the banks' approaches to individual loans, otherwise banks could not satisfy the average requirements in each category.

519 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013 O.J. (L 176). For the intended effects of the regulation, see the recitals at the beginning of the regulation.

520 Captured capital is not available in a special account but it is capital of the financial institution that is designated to be the capital increase which serves as a risk buffer as required by the Basel Accords in case a loan is handed out. *See also supra* fn 519*,* which describes the opposite business, the adjustment of reserves in case the bank receives a deposit.

521 The capital requirement can be generated by outside capital, a fee the bank charges the borrower discounting it from the loan, or a combination of both.

unavailable, the bank's problem is one of opportunity cost. Poorer clients and therefore riskier loans would necessitate larger capital buffers with no or insignificant interest rates, meaning the bank cannot produce additional income with the captured capital. It could thus be argued that risk premiums are supposed to compensate the bank for both the opportunity cost and the poor yield it receives from the larger captured capital in the case of risky loans.

As opportunity costs are based on the capital requirement and therefore on a fraction of the loan, any opportunity cost amounts only to a fraction of the risk premium of the full loan. Moreover, a business that is potentially better and therefore causes opportunity cost is only a hypothetical question and therefore this cost is not protected like property.[522] If a lender decides to give a loan to a high-risk client which entails higher opportunity cost and lower yields, then this was the best possible option at that very moment. It is never certain a better business opportunity in the future would emerge and the lender is also not forced to gather new capital in order to finance the new hypothetical opportunity, either. The lender will do so immediately, if the new business is profitable even if the opportunity costs are to be borne.

The difference between the lender's regulatory expense and the borrower's risk premium is that the lender's opportunity cost is a marginal and hypothetical expense which is not paid by the financial institution to any party. In contrast, the borrower's risk premium is included into compound interest and must, in actuality, be paid by the borrower to the lender. Regulatory expenses are reflected in risk-weighted interest and paid by the clients but are not comparable to the main expenses in the interest rate which are borne by the borrowers. Equally significant is that risk premiums are supposed to be compensation for increased risk due to the absence of collateral, rather than compensation for regulatory expenses. In other words: "The less likely the repayment, the more expensive the credit becomes."[523] Consequently, the dimension of interest in loans is determined by the expected default risk, whereas expenses for refinancing and inflation are insignificant.

5.3.3. The Risk Premium as *Collateral Sui Generis*

Collateral is an asset put up by the borrower as security for a loan. The lender retains the right to use or sell the asset in case a default occurs. If coverage is in danger, prudent lenders sell the asset in order to prevent losses. This collateral is normally returned to the

522 See *infra* Sectionent 6.4.2.2, which discusses how the principal has a similar status to property. Unlike the principal the interest rate is the price of the loan and is determined by the market. Therefore, the interest rate does not enjoy the same level of legal protection as property. A hypothetical price such as the opportunity cost enjoys even fewer protections.

523 Peter Derleder, Kai-Oliver Knops & Heinz Georg Bamberger (eds), 'Deutsches und Europäisches Bank- und Kapitalmarktrecht', Springer (Berlin 2017) § 13 at 3.

borrower once the credit is paid, as it remains in the borrower's ownership while serving as security.

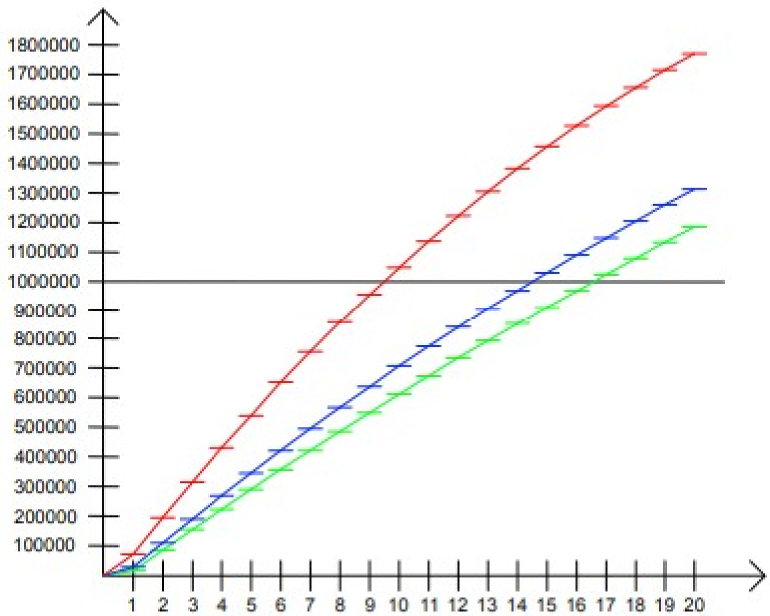
The size of risk premiums is linked to the loan's duration and volume as well as to the borrower's cash flow. These factors being equal among clients, the size of risk premiums will be inversely proportional to the quality of the collateral, with lower quality collateral resulting in higher risk premiums. Risk premiums will be highest in cases involving borrowers without any collateral to offer. On the other hand, the higher the quality of the collateral, the more it can replace the risk premium.[524] This principle holds regardless of whether the borrower is an individual, a business, a bank or a sovereign,[525] even though lenders' practices in the *degree* of replacement differ with each type of borrower. This inverse relationship between risk premiums and collateral is evident in the laws derived from Basel III, which regulates the risk management of banks by increasing the capital requirements for loans to riskier borrowers. Basel III reflects the finance industry's practical approach to lending, enabling poorer clients to obtain credit, if necessary, even if they lack collateral, because collateral can be substituted by a risk premium.

This collateral-substituting character of the risk premium has been ignored by the conventional approach.[526] Correctly applied, the risk premium benefits both parties: the borrower is able to obtain a loan and the lender minimizes overall risk by reducing the amount of time until repayment of the principal. Compounded with interest rates, risk premiums lead to even stronger exponential growth, resulting in an earlier *de facto* payment of the principal. As a result of this acceleration, the last instalment of the principal is paid earlier in cases involving interest rates with high-risk premiums than in loans with no or very low risk premiums. Earlier payment of the principal shortens the time for risk exposure, thus reducing the overall risk to the lender. The graph below, which compares loans with low-, medium-, and high-interest rates, illustrates this relationship between risk premiums, the reduction of time, and overall risk to a lender:

524 ibid § 14 at 8

525 For an up-to-date overview on the policy debates in the context of individual, corporate and sovereign lending, *see* Susan Block-Lieb & Mark C. Weidemaier, 'Lenders' Roles and Responsibilities in Sovereign Debt Market', 2019 University of Illinois Law Review 1589 (2019).

526 For publications about the legal and economic aspects of interest rates and financial products which do not treat risk premiums as collateral *sui generis* and do not demand their repayment or an adjustment of interests over time, *see e.g.* Satyajit Das, *Swaps and Financial Derivatives: The Global Reference to Products, Pricing, Applications and Markets* (McGraw-Hill 1994); Rutsel Silvestre J. Martha, *The Financial Obligation in International Law* (OUP 2015) Roger McCormick, *Legal Risk in the Financial Markets* (OUP 2010).



Instalments of principal paid over time by high-, medium- and low-risk borrowers
Key
Horizontal black line: payment of 1 million from borrower to lender
Loan: 1 million; duration of 20 years; first year redemption-free, payments made quarterly
Interest rate (including risk premium) per annum and time to full payment of principal (redemption)[527]

Borrower	*Interest rate*	*Pays 1 million after (approx.)*
Low-risk borrower A (green)	1.75%	16.5 years
Medium-risk borrower C (blue)	2.95%	14.5 years
High-risk borrower B (red)	7.25%	9.5 years

A comparison of borrower A and borrower B (represented by the red and green curves of this graph) shows that an increase of the risk premium by 5.5% leads in practice to an earlier full payment of the principal by seven years. Since a loan to a borrower with poor collateral becomes riskier the longer the loan lasts, this is a logical—and welcome—consequence. The use of compound interest in the finance industry is therefore justified: with simple interest, the full payment of the principal would happen at a much later stage,

527 Examples based on offers of the Bavarian Development Bank LfA in Munich, Germany, for environmentally friendly construction loans, offer EG7 calculated by homepage loan calculator on June 19, 2018; LfA loans were taken for illustration only; the example in the article does not mean that the LfA will behave as described. In comparison: the Italian 10-year bond yield moved above 7,05% in 2011; see Ben Rooney, ‘Italian bonds flashing warning signs’, *CNN Money* (9 November 2011) https://money.cnn.com/2011/11/09/markets/bondcenter/italy_bond_yields/index.htm.

while the risk premium in combination with compound interest accelerates the payment of the principal.

While risk premiums are used to replace collateral, they are more advantageous in comparison to customary forms of collateral. Risk premiums are not unique in that they are intangible, since patents or other forms of intellectual property rights are also used as collateral, just as real estate and other valuable goods. But all these customary forms of collateral have a market price fluctuating in value. This price fluctuation becomes problematic for lenders if and when they sell the collateral for compensation, making the quality of the asset extremely important. With limited exceptions such as gold and land, all physical goods and rights that could be used as collateral lose value over time, whether through "wear and tear" or becoming outdated. This depreciation is, in turn, reflected in the applicable tax laws.[528]

The risk premium, on the other hand, does not depreciate. To the contrary, the interest rate grows exponentially through compound interest. The risk premium thus proves to be the best form of collateral. As long as the borrower pays, a risk premium appreciates, rather than depreciates, over time.

While high-risk borrower B pays a higher risk premium, the risk premium on its own does not offer the lender the same protection against risk as normal collateral. On the graph above, the portion of the red line underneath the horizontal black line constitutes the period of time during which the lender's risk is not covered. Only once borrower B has paid the principal (shown as the point at which the red line cuts through the black line) does the lender's risk of losing the principal disappear. If borrower B pays the principal amount more quickly (*i.e.*, if the red line increases more sharply), the lender will be better protected from this risk. The beginning of the loan contract is therefore the riskiest period for the lender since a default by borrower B cannot be compensated with the sale of collateral. Understandably, lenders seek to close this gap as early as possible using high-risk premiums. If the lender receives high-quality collateral for coverage, the risk is low from the start of the loan contract, so it does not matter that a prime-rate borrower pays the full principal at a much later stage. In this example, borrower A pays seven years later, which is significant relative to the 20-year loan term. Thus, while an ideal collateral would provide the lender with protection for the entire loan *including* profit from the beginning of

528 Interest rates of any kind (compounded, simple, or risk-based) are not considered goods that can be depreciated, unless they are connected to tangible assets, such as real estate. *See generally* Department of the Treasury-Internal Revenue Service, *How to Depreciate Property*, (March 23, 2020), https://www.irs.gov/pub/irs-pdf/p946.pdf; For the United Kingdom, where depreciation is called capital allowances, *see generally* HM Revenue & Customs, *HMRC Capital Allowances Manual*, (April 16, 2016), https://www.gov.uk/hmrc-internal-manuals/capital-allowances-manual/ca10020.

the loan contract, the risk premium cannot provide for the same level of protection at the start. Lenders regularly evaluate this increased risk as acceptable and enter into loan contracts nevertheless, since the financial situation of borrowers is less likely to change in the near future.

Because it not only replaces the collateral but also has the effect of accelerating payment of the principal, the risk premium constitutes a collateral *sui generis*.

5.3.4. Risk-Weighted Pricing Causes Different Prices for Identical Products

The previous example not only demonstrates how much earlier the principal is paid when a higher risk premium is used, but also how much more a risky borrower must pay over the loan term (here, 20 years) compared to a prime-rate client: [529]

Low-risk borrower A (green): 1.75%, total interest paid: 185,937.50

Medium-risk borrower C (blue): 2.95%, total interest paid: 313,437.50

High-risk borrower B (red): 7.25%, total interest paid: 770,312.50

It is clear that the risk premium not only serves as a substitute for a customary collateral, but also shifts the full payment of the principal to a much earlier stage. Equally clear, however, is that absent a default, high-risk borrower B pays the entire principal plus the interest of the prime rate and the amount of risk premium. Thus, for the lender, the risk premium produces a far better yield than any other possible collateral. In addition, while the money paid by the borrower as collateral based on the risk premium stays with the lender, any conventional collateral is returned to its owner after the loan contract has been fulfilled. Ultimately, once the last instalment of the loan has been paid, high-risk borrower B faces three distinct disadvantages: 1) B will have paid a higher price, 2) B will not have the risk premium returned, although it is a substitute of the collateral, and 3) B will have had less time to use the principal than low-risk borrower A.

Lenders might respond to these disadvantages faced by high-risk borrowers by framing the risk premium as part of the loan price and arguing that a loan to riskier borrowers simply entails more work, such as more detailed credit analysis and closer monitoring. The problem with this claim is that, at the outset of the risk assessment of a potential borrower, the lender does not know the borrower's risk profile. To comply with duties under Know Your Client guidelines,[530] banks must conduct equally detailed and comprehensive risk

529 See figure above, examples based on offers of the Bavarian Development Bank LfA in Munich, Germany, offer EG7 calculated by homepage loan calculator on June 19, 2018.

530 Know your client / know your customer (KYC) guidelines are part of an international attempt to fight corruption and money laundering. They also serve to determine the suitability of banking products for clients. In the UK, for example, they are part of the Money Laundering Regulations 2017, SI/2017/692. In the EU they are based on Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the Prevention of the Use of the Financial System for the Purposes of Money Laundering or Terrorist Financing, 2015 O.J. (L 141) as

assessments for all clients. Thus, regardless of whether clients are perceived as high- or low-risk at the outset, risk assessments result in nearly identical expenses for all clients. Besides, housing bubbles in sub-prime markets attest to the fact that doing business with high-risk borrowers is profitable. The lender usually does not bear whatever additional expense is involved with riskier clients but passes them on to the clients.

Because lenders are obliged to keep their default risk as low as possible, risk premiums force borrowers to pay additional expenses. High-risk borrowers end up paying far more than low-risk borrowers for the same loan in retrospect. If the twin objectives of non-discriminatory loan pricing and security for lenders are to be achieved, the interest rate must be gradually adjusted over time so that the loan remains protected, and the price becomes the same for all borrowers at the end. Alternatively, the sum a risky borrower must pay above the prime rate could be returned just like any other collateral, although this would mean a free credit for the financial institution. Neither of these two alternatives occurs in practice although the risk premium as a collateral *sui generis* remains the borrower's property just like any other collateral. Without adjustment or repayment, the accelerating character of the risk premium—which serves as legitimate protection for the lender at the beginning of the loan contract—becomes an additional burden on the borrower once the principal is paid.

5.4. Lack of Adjustment Leads to Interest Rate-Based Discrimination

After the borrower's duties are fulfilled, the lender must return the collateral (if not, the borrower has a restitution claim against the lender).[531] It follows from the collateral-substituting character of risk premiums that, if risk-weighted interest rates are not adjusted to prime-rate level once the principal has been paid in full, the amount paid in excess of the prime rate based on the risk premium must also be repaid to the borrower. Non-adjustment or repayment of the risk premium – which currently is standard practice – is discriminatory since high-and low-risk clients are treated differently based on their property status, despite posing the same degree of risk to the lender upon payment of the principal (*see* Section V

amended by Directive 2018/843, 2018 O.J. (L 156) In the US, KYC takes the form of the Customer Identification Program (CIP) rule mandated by Section 326 of the USA PATRIOT Act. See 31 U.S.C. 5318(1); 31 C.F.R. 103.121.

531 The restitution claim may be based on the contract itself as the borrower retains ownership of the collateral or on unjust enrichment, which exists as a legal principle in both civil law and common law jurisdictions and establishes the remedies available to the party that suffered a loss of property without legal cause which led to the enrichment of another party. *See*, *e.g.*, Allgemeines Bürgerliches Gesetzbuch [ABGB] [Civil Code], § 877, 1041, 1042, 1174, 1431, 1435 (Austria); Bürgerliches Gesetzbuch [BGB] [Civil Code], § 812 (Ger.); Code Civil [C. civ.] [Civil Code] [art. 1303-1304] (Fr.); or (the ["Jogalap nélküli gazdagodás" of the Hungarian civil code) paragraphs 6:579 – 6:582]. In *Benedetti v Sawiris* [2013] UKSC 50 and *Bank of Cyprus UK Ltd v Menelaou* [2015] UKSC 66, the UK Supreme Court recognized that claims for since unjust enrichment were well-established in common law and turned on a four-question inquiry: "(1) Has the defendant been enriched? (2) Was the enrichment at the claimant's expense? (3) Was the enrichment unjust? (4) Are there any defences available to the defendant?"

for the legal analysis of discrimination based on economic grounds). Under the new approach to interest rates proposed herein, the loan contract would be understood to consist of two phases: the time before the principal is paid, during which prime-rate clients and high-risk clients belong to different risk classes; and the time after the payment of the principal, when these clients belong to the same risk class. Therefore, the time before payment of the principal and after payment require two separate discrimination analyses.[532]

5.4.1. No Discrimination Before the Payment of the Principal

The lender has a right (and an obligation to shareholders) to protect the investment and an interest in making a profit. Therefore, clients wanting to borrow are classified according to the risk they could pose to the fulfilment of the loan contract (*see* Section 6.3.). Only then will the lender be able to sign the contract with the borrower. Once the principal has been disbursed to the borrower, the first phase of the loan begins.

5.4.1.1. Difference in Treatment

Based on the risk classification conducted by the lender, clients will be either offered the prime rate or the prime rate plus a risk premium. This risk premium is the precondition for riskier borrowers to obtain the same principal as low-risk borrowers by accelerating the payment of the principal through the higher interest rate. As a result, borrowers A and B in the example above are treated differently based on their risk classification. Equal in all characteristics except for property status, borrowers A and B have to pay different prices for the same principal.

5.4.1.2. Objective and Reasonable Justification

The difference in treatment could be objectively and reasonably justified if a legitimate aim is pursued and the means are proportional to achieving that aim.

5.4.1.2.1. Legitimate Aim to Protect the Principal

The absence or the poor quality of collateral increases the risk that the lender will be unable to recover the principal in case of a default. In such a case, the lender’s investment, consisting of commercial bank money that is protected by law, similar to property, would be in danger. A higher interest rate accelerates the payment of the principal, thus shortening the first phase of the loan. During this first phase, risk exposure is particularly high as the payment of the principal has just begun and a security is unavailable or insufficient. This accelerated payment of the principal is a necessary security (and, in some cases, the only

532 For further information on the prohibition of discrimination, see for example European Court of Human Rights, *Guide on Article 14 of the European Convention on Human Rights and on Article 1 of Protocol No. 12 to the Convention – Prohibition of Discrimination*, 15 (Dec. 31, 2019), https://www.echr.coe.int/Documents/Guide_Art_14_Art_1_Protocol_12_ENG.pdf.

possible security) for the lender's commercial bank money at that stage. For this reason, compound interest in combination with risk premiums is widely used instead of simple interest. As banks otherwise would not give loans to potential borrowers lacking adequate collateral, this compensation for lenders through a higher interest rate is an acceptable and necessary practice. The risk premium, and therefore the interest rate, must be set in such a manner that they do not constrain clients' economic activity and financial capacity in such a way that would endanger the loan agreement. Consequently, any prudent lender would use risk-weighted interest rates in loaning to risky borrowers. Thus, the use of individual risk classifications to differentiate between borrowers serves a legitimate aim in the first phase of the loan.

5.4.1.2.2. Proportionality of the Use of Risk-weighted Interest

The use of risk premiums is proportionate in the first phase of the loan if the differential treatment of borrowers is the least intrusive means to protecting the lender's property.

As demonstrated above, the higher risk premium is necessary in the beginning of the loan. It is the only available option that shortens the high-risk period by accelerating the payment of the principal, which consists of commercial bank money. Because banks have been legally authorized to create commercial bank money, this kind of money is legally similar to property.[533] Commercial bank money thus benefits from a similar standard of protection to real property upon its creation through a loan contract. The right to property is for example guaranteed by article 1 of Protocol No. 1 to the European Convention on Human Rights, which provides that: "[E]very natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law." The lenders' approach to treating borrowers in a comparable situation differently based on their property status in order to protect the loan is objectively and reasonably justified. Differential treatment during the first phase of the loan is therefore not discriminatory.

5.4.2. Discrimination after Payment of Principal

The current practice of lenders is to treat borrowers throughout the loan contract in the same way as they did at the beginning. Over the course of the loan, however, the risk to the

533 The sovereign decides on all money-related matters, such as legal tender and commercial bank money. That some EU member states have given up their own currency to adopt the Euro and regulated the creation of commercial bank money at the EU-level, *see* Hahn Häde, Währungsrecht (2d ed 2010) 22-23 shows that banks and other financial institutions, as well as their owners, know about the conditionality and cannot argue that the ability to create commercial bank money is protected like an acquired right.

lender's investment decreases as the amount the borrower has paid off increases. This reduced risk needs to be taken into account, particularly since a larger degree of risk determined the size of the risk premium at the beginning of the loan.[534]

5.4.2.1. Difference in Treatment

Once the principal has been paid and no longer must be secured, the second phase of the loan begins. At that moment, prime-rate borrower A and high-risk borrower B pose the same amount of risk to the investment of the lender. Yet, their risk premiums continue to differ considerably.

If neither low-risk borrower A nor high-risk borrower B defaults, they will have paid a different price at the end of the loan agreement, although both obtained the same principal as a loan. Additionally, there are several differences in the treatment of prime-rate borrower A and high-risk borrower B that persist in the second phase of the loan. While low-risk clients like borrower A will receive back the collateral that had been securing the loan, high-risk clients like borrower B will not receive the risk-premium that replaced the collateral. Similarly, low-risk clients can use their funds for a longer time before full payment than high-risk clients. This ability to use funds for a longer or shorter time impacts economic activity since a higher-risk premium and an accelerated payment of the principal may necessitate higher prices. For instance, if prime-rate borrower A and high-risk borrower B ran competing businesses, it is possible that B would need to ask for higher prices in comparison to A in order to satisfy the loan. Borrower A thus has a competitive advantage in not having to pay the principal at the same speed as B and, consequently, could afford to offer lower prices.

5.4.2.2. No Objective and Reasonable Justification

If the risk posed by client A and client B levels out, upholding different risk-premiums for these two borrowers can only be justified if a new and legitimate aim arises and if the means of achieving said aim are proportional to its end. Thus, the question arises: does a legitimate aim exist once the lender's risk has dropped to zero in both cases?

5.4.2.2.1. No Legitimate Aim

Similar to a collateral, the aim of the risk premium is to protect the lender's investment, the principal. According to the individual risk of the borrower, the lender is initially justified in charging A and B different risk premiums. However, once the principal has been paid to the lender, no risk and therefore no legitimate aim remains. The risk premium is only the tool

534 If the high-risk borrower is just as successful in paying the loan as the low-risk borrower, he should be treated identically. The borrower should obtain the same price and a better credit score or credit rating. This can only be determined *ex post* or from the moment the principal was paid—from *ex ante* it is necessary to have a different price. Therefore, it is necessary to perform two discrimination tests.

to achieve the property-like protection of the principal if collateral is insufficient or non-existent, but the right to property does not extend to interest rates and their components.

The right to property is guaranteed in all major human rights instruments, for example in the European Convention on Human Rights[535] and its additional protocols. In *Marckx v. Belgium*[536] the European Court of Human Rights set the scope of article 1 of Protocol No. 1, which applies solely to already existing possessions and "does not guarantee the right to acquire possessions". It could be argued that commercial bank money comes within the coverage of article 1 Protocol No. 1 as long as banks are permitted to create it, since then commercial bank money is akin to central bank money. That means the principal is sufficiently concrete to be protected under this provision. As legal persons also enjoy property rights according to article 1 of Protocol No. 1, any financial institution can act if its property rights have been violated. But unlike the principal, interest is only a derivative, as it is derived from the principal and therefore cannot have a property-like status. It is the price for the product and like any other price it depends on the market's price discovery. Due to price discovery, the price changes constantly and is not concrete. Interest rates, therefore, cannot be protected like property.[537] There is no legal guarantee to be successful in economic endeavours. If success, meaning a profit, would be legally guaranteed, society would be exposed to endless and limitless risk. As a result, interest rates are less protected than the principal.

Currently, the balance treats principal and interest as if they were legally both equally akin to property: in the example at hand, all three clients still owe 526,315.79 after ten years despite the fact that client A had already paid 612,417.76, client C 707,549.34 and client B had paid even 1,048,437.50 because no distinction is made between principal and interest. The conclusion that interest is legally seen not property but a price necessitates a new way to read the balance, based on which the payment of the loan in the aforementioned example can be divided up into two phases with different levels of legal protection: the first phase during which the client is simultaneously paying redemption rates and interest until the principal is paid, and the second phase where redemption rates and interest are simultaneously paid for the interest only. In the diagram above, the first phase is represented by the field below the black 1 million line until it is crossed by the red, blue

535 Convention for the Protection of Human Rights and Fundamental Freedoms, Nov. 4, 1950, Europ.T.S. No. 5; 213 U.N.T.S. 221
536 *Marckx v. Belgium*, 31 Eur. Ct. H.R. Ser. A) at 39 (1979).
537 In comparison, the rent that must be paid for an apartment is never the same as the property claim related to the property, the apartment itself.

and green payment curves. The second phase is the field above the 1 million line after the payment curves have crossed it.[538]

The current approach, however, extends the property protection beyond the principal to encompasses the interest rate. This approach leads to a discriminatory and therefore unlawful outcome by supporting different prices for the same product based on the economic status of the borrowers. To require high-risk clients to maintain payments on risk premiums once they paid the principal to the lender is therefore not a legitimate aim.

5.4.2.2.2. No Proportionality

The use of risk premiums would also be proportionate in the second phase of the loan if the differential treatment of borrowers were necessary to protect the lender's property in the least intrusive manner. However, this is not the case. The lender's property is secured already in the first phase. The only further payment that could be requested from both clients A and B alike would be the prime rate, as it covers the expenses and profit for the lender in the case of prime rate clients. Paying the risk premium in the second phase of the loan is no longer proportional as an interest rate around prime-rate level would be sufficient to reach the same price after 20 years.

5.4.3. Interest Rate Adjustment, a Well-Known Judicial Technique

The justification for using risk premiums in the first phase does not hold in the second phase. Therefore, it is necessary to restructure payments in such a way that strikes a balance between the lender's right to protect its property—the principal—and the borrower's right to be free from discrimination. Certain countries across Latin America, Africa and Asia have attempted to do this by introducing interest rate caps.[539] While interest rate caps have been useful in some instances – such as Bolivia, where they have contributed to more affordable housing[540] – they are not without shortcomings.

Unlike risk premiums which force the borrower to repay the principal early on, interest rate caps extend the time it takes to repay the principal and thus increase the risk posed to the lender's principal. This increased risk is not only detrimental to the individual lender but

538 Paying first the interest and the principal afterwards does not make sense for a prudent lender because that leaves the principal longer in the realm of a potentially risky client. Paying first the principal and the interest after also increases the risk, although less than in the first alternative, as this approach does not combine compound interest with risk premiums in order to accelerate the payment of the principal. Accordingly, the current system which sees the simultaneous payment of redemption rates and interest is optimal for prudent lenders by virtue of its payment-accelerating character.

539 Howard Miller, 'Interest rate caps and their impact on financial inclusion' (February 2013) EPS PEAKS, Helpdesk Request, UK online platform of London School of Economics, University of Birmingham and others 6

540 Bolivian decrees No. 1842 (18 December 2013) and No. 2055 (10 July 2014); Juan Pablo Bohoslavsky, 'Development and Human Rights in Bolivia: Advances, Contradictions, and Challenges', Vol 11 Latin American Policy, (Wiley 2020)

could also damage the credit market. By rendering the principal repayment less secure, interest rate caps could dis-incentivize lenders from participating in the credit market. This, in turn, is likely to deplete the amount of credit available, undermining the interests of lenders and borrowers alike. Most importantly, interest rate caps are as discriminatory as the current practice since capped interest rates will likewise consist of different interest rates and contain risk premiums based on the financial background of the borrower. Thus, interest rate caps do not replace the discriminatory price regime and do not solve the problem that money paid in excess based on risk premiums is not returned like any other collateral.[541] A better alternative would be a new approach that reflects the progressive reduction in risk that comes as more of the principal is repaid.

The current loan repayment model would be far more equitable were it to adjust risk premiums over time. The logic behind this proposal is well established. For example, in *De jure belli ac pacis*, Grotius describes that borrowers are simply released from their obligations proportionally to what the lender has received.[542] Provisions of German and Austrian law adhere to this view as well. The German Federal Court of Justice (*Bundesgerichtshof*), for example, has demanded the release of collateral, proportionate to and dependent upon continuing payments on the principal, in cases where the value of the collateral was excessive relative to the underlying claim.[543] The Court reasoned that excessive collateral unreasonably impairs the economic activity of the borrower. In so saying, the Court found that agreements containing a clause that could lead to excessive collateral could be found unconscionable unless the contract releases the collateral gradually back to the borrower once it is no longer necessary.[544] The Austrian courts have taken a near identical approach to over-collateralized claims.[545] The release of collateral must take place proportionally to the lender's reduced need for a security because Austrian law demands an adjustment in cases where collateral must be supplemented or replaced.[546] This norm explicitly requires the proportionality of collateral and secured claim, so the

541 ibid 129 (Interest rates vary between 5.5% and 6.5% for social housing and from 6% to 11.5% for credits to the production sector).

542 Hugo Grotius, The Rights Of War And Peace Including The Law Of Nature And Of Nations (M. Walter Dunne 1901) Chapter X Nr. 11 at 192 Grotius uses the example of agricultural real estate mortgages to illustrate this claim further. Specifically, he refers to a situation in which the owner of the collateral no longer has access to it and the lender makes use of the collateral's fruit. In doing so he argues that the usufruct produced by the collateral payments should be deducted from the principal; Peter Derleder, Kai-Oliver Knops & Heinz Georg Bamberger (eds), 'Deutsches und Europäisches Bank- und Kapitalmarktrecht', Springer (Berlin 2017) § 29 at 59 Contemporary practice is to use collateral as a means of reducing the claim against the borrower.

543 This kind of excessive collateral is referred to as "Übersicherung" in German.

544 BGHZ 137, 212, 218. The *Bundesgerichtshof* found that the fiduciary nature of security agreements require the secured lender to return the collateral once it is no longer necessary. It also suggested that the lender only has discretion to choose which collateral to return if there are several options, but not over whether or not to return the collateral.

545 Peter Apathy, Gert Michael Iro & Helmut Koziol (eds) Bankvertragsrecht – Band VIII: Kreditsicherheiten, Teil I (2d ed. 2012) nr. 1/170, fn. 612 and 613

546 Allgemeines Bürgerliches Gesetzbuch [ABGB] [Civil Code] (Austria) § 458

release should follow the same principle.[547] As with the German courts, the Austrian courts have found that a contract requiring excessive collateral could be deemed unconscionable and thus voidable, unless it is adjusted according to the gradual reduction of risk.[548]

As loan agreements may turn unconscionable because of excessive collateral, the risk premium may reach a similar effect over time. Keeping the collateral creates a claim against the lender to return it and the growth of compound interest could lead to an unconscionable contract at one point, due to the collateral-substituting character of an interest rate that becomes excessive. But reducing interest to prime rate levels after full payment of the principal accords with the views of the Austrian and German courts that collateral must be gradually released overtime. Alternatively, the sum paid above the prime rate could be returned at the end of the contract.

It is well-established that courts may adjust contracts based on the proper allocation of risk where adjustment is more equitable than annulment of the contract or bankruptcy of one of the contract parties. In *Till v. SCS Credit Corp.*,[549] for example, the U.S. Supreme Court held that the lender's interest in receiving the outstanding payment should be balanced against the borrower's risk that excessive interest rates on the receivables may potentially lead to bankruptcy.[550] The Court's plurality further endorsed a simple and uniform method for bankruptcy courts to use in reforming interest rates, which it referred to as the "formula approach:"[551] starting with the national prime rate[552] and adjusting it to account for the greater default risk which bankrupt debtors typically pose.[553] *Till* not only clarifies that bankruptcy courts may adjust interest rates in situations where they might otherwise endanger the bankruptcy plan's sustainability, but also that the collateral is to remain the property of the borrower, provided the borrower completes its payments in accordance with the bankruptcy plan.

547 Peter Apathy, Gert Michael Iro & Helmut Koziol (eds) Bankvertragsrecht – Band VIII: Kreditsicherheiten, Teil I (2d ed. 2012) nr. 1/171

548 *See* BGHZ 137, 212, 224; *See also* BGHZ 138, 367 (The German Federal Court of Justice set a limit of 150% of the total loan sum as a rule of thumb. The actual value is exceeded by 50% because it acknowledges the necessity of the lender to cover expenses for the sale and eventual legal expenses); *But see* BGHZ 137, 212 c) (1) - (4) Bruno Rimmelspacher, Michael Stürner, *Kreditsicherungsrecht* (C.H. Beck 2017) at 155 nr 42: if both parties are able to prove that this limit is either enough or insufficient and could demand a reduction or increase based on the market value.

549 *Till et ux. v. SCS Credit Corp.*, 541 U.S. 465 (2004). The respondent in this case was required to pay 9.5% in interest on the monthly payments: 8% constituted the prime rate and 1.5% reflected the risk premium.

550 Justice Stevens, writing for the Court's plurality, relied upon Chapter 13 of the U.S. Bankruptcy Code which enables bankruptcy courts to modify the rights of any lender whose claim is secured by an interest in anything other than "real property that is the borrower's principal residence." ibid 475

551 ibid 466

552 The national prime rate refers to the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the loan's opportunity costs, the inflation risk, and the relatively slight default risk.

553 The Court suggests that, when undertaking this analysis, bankruptcy courts must choose an interest rate that is sufficiently high to adequately compensate a creditor for undertaking their risk but not so high as to doom the bankruptcy plan. ibid 466-67

Existing judicial practice establishes that collateral and interest rates may be adjusted to reflect the economic interests of the parties. It would be a logical extension of this existing case law to permit the adjustment of risk premiums as well. Only existing property, meaning "lawfully acquired possessions", is protected by the law.[554] Future profit automatically generated by compound interest and risk premiums beyond any equitable security is not protected. Therefore, it would not violate lenders' property rights to adjust risk premiums by operation of law. Alternatively, the lump-sum repayment of all interest paid above the prime rate could take place at the end of the loan period, just as all collateral must be handed back.

While both practices would improve the current system, courts deciding between these solutions should weigh three considerations: (1) the different levels of property protection that apply to the principal and to the interest rates; (2) the varying risk posed by borrowers by virtue of their economic background; and (3) the changing levels of risk over time as borrowers complete their payments on the principal. The status quo ignores that risk changes over time and that pricing cannot be discriminatory in a free market that abides by the rule of law and human rights. The only proportionate, non-discriminatory means of protecting lender's property is the adjustment of interest rates over time.

It goes without saying that if the lender must adjust the risk premium over time in order not to discriminate against the borrower, it can adjust its risk management *vis-à-vis* the supervisory institutions – in most instances, the central bank. A commercial bank would otherwise be trapped in a situation that leads to reduced revenue from the client and the obligation to manage risk as though the client were still high-risk. But under the Basel III regime, the bank must anyway perform frequent stress calibrations on their entire portfolios with current market data in order to adjust counterparty risk.[555] Paragraph 61 of Basel III states: "In all cases, the data must be updated quarterly or more frequently if market conditions warrant." This not only means that the adjustment of risk management and risk premiums can go either way, but that it is already done on a regular basis.[556] Commercial banks are required to collect the necessary data and are able to adjust their capital accordingly, but the cost savings which these risk calibrations yield are not passed on to their clients.

554 For example, Charter of Fundamental Rights of the European Union, art. 17(1), 2010 O.J. (C83) 389

555 Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems', December 2010 (revised November 2011), II. A. 1. 98. §§ 25(I) & 61, pp. 30-31 <https://www.bis.org/publ/bcbs189.pdf>

556 This is also supported by the Guidelines On ICAAP And ILAAP Information Collected For SREP Purposes of the European Banking Authority, EBA, EBA/GL/2016/10 §§ 57(a)-(b) (Feb. 10., 2017), which state that risk changes are tracked, and that the banks' risk management must reflect these changes.

5.5. Legal Aspects of Discrimination Based on Property

Under the Basel Accords, banks typically apply risk-weighted interest to all loans, sovereign and private alike. This article urges a re-interpretation of the law whereby risk premiums function legally as a replacement of collateral which banks must adjust over time according to the diminishing risk. This prescription would apply with equal force to sovereign and private loans. This chapter discusses a variety of legal issues that arise in cases where the protection of property and the prohibition of discrimination are applied to private individuals and entities, as well as to states.

5.5.1. The Prohibition of Property-Based Discrimination Against Private Borrowers

Cases where risk premiums lead to prices dependent on a client's property bear similarity to legal provisions and cases where a difference in pricing is based on sex or ethnicity. The Equal Treatment in Goods and Services Directive 2004[557] prohibits business practices in the European Union that discriminate on the basis of sex. The *Test-Achats* case, where the Court of Justice of the European Union held that gender-specific pricing violates the non-discrimination and gender equality provisions of the EU's Charter of Fundamental Rights (CFR),[558] led to gender-neutral insurance premiums.[559] The European Convention on Human Rights prohibits discrimination based on property in article 14 in combination with Protocol 12, as does the CFR in article 21(1). Some constitutions, such as the Hungarian Constitution in article XV (2), have similar provisions. Additionally, several international conventions establish the prohibition of discrimination.[560] The general prohibition of discrimination as codified in the major international and regional human rights conventions is, of course, applicable in the financial field.[561] This implies that an adjustment of pricing in order to avoid discrimination is not only possible but legally required.

An authoritative source is General Comment No. 20 of the Committee on Economic, Social and Cultural Rights, which also deals with discrimination based on property which is prohibited based on article 2 of the International Covenant on Economic, Social and

557 The Council of the European Union, Council Directive 2004/113/EC of 13 December 2004: Implementing the Principle of Equal Treatment Between Men and Women in the Access to and Supply of Goods and Services) (2004), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32004L0113. Official Journal of the European Union, L 373 (2004), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2004:373:TOC.

558 Charter of Fundamental Rights of the European Union, articles 21, 23, 2010 O.J. (C83) 389.

559 Case C-236/09 *Association belge des Consommateurs Test-Achats ASBL v Conseil des ministres*, 2011 E.C.R. I-773.

560 Article 28 African Charter on Human and Peoples' Rights CAB/LEG/67/3 rev. 5, 21 I.L.M. 58 (1982), Articles 1 & 24 Organization of American States (OAS), American Convention on Human Rights "Pact of San Jose, Costa Rica" (B-32), 22 January 1969, Article 2 International Covenant on Economic, Social and Cultural Rights and Article 26 of the International Covenant on Civil and Political Rights.

561 *See generally* Motoko Aizawa, Daniel Bradlow, & Margaret Wachenfeld, 'International Financial Regulatory Standards and Human Rights: Connecting the Dots' Manchester Journal of International Economic Law (2018).

Cultural Rights.[562] States that ratified that International Covenant must "immediately adopt the necessary measures to prevent, diminish and eliminate the conditions and attitudes which cause or perpetuate substantive or de facto discrimination."[563] Apart from direct discrimination that this article's example with clients A, B and C illustrates, today's risk-weighted interest rate system also results in indirect discrimination, as defined in the relevant European anti-discrimination directives as a system that creates a disparate negative impact for a certain group of people.[564] In the case of risk-weighted interest, the disparately- and negatively-affected class includes anyone who does not get the prime rate, a class in which minorities, women and people with lower incomes are over-represented.

This point bears repeating: while the system of weighted interest seems objectively fair, it has a negative effect on all but prime-rate clients. All others pay for the full risk estimate, even if they prove to be less risky than the lenders' forecasts had anticipated. Since risk premiums are currently not understood as a collateral *sui generis* that compensates for inadequate or missing collateral, they cause direct and indirect discrimination. Also, since the lack of property is frequently regarded as an individual problem rooted in laziness rather than being "deeply entrenched in social behaviour and organization, often involving unchallenged or indirect discrimination", risk premiums also contribute to systemic discrimination: "Such systemic discrimination can be understood as legal rules, policies, practices (…) in either the public or private sector which create relative disadvantages for some groups, and privileges for other groups."[565] In this regard, the UN Special Rapporteur on extreme poverty and human rights, Magdalena Sepúlveda Carmona, has demanded that States "take all appropriate measures to modify sociocultural patterns with a view to eliminating prejudices and stereotypes."[566]

Financial technology (fintech) algorithms that are based on conventional credit scoring methods represent a modern form of systemic discrimination. The World Bank's Technical Guide to Credit Scoring in Financial Inclusion, for example, recommends predictive

562 General Comment No. 20, Non-discrimination in economic, social and cultural rights (art. 2, § 2, of the International Covenant on Economic, Social and Cultural Rights), Committee on Economic, Social and Cultural Rights, U.N. Doc. E/C.12/GC/20 (Jul. 2, 2009).

563 ibid § 8(b).

564 The Race Equality Directive 2000/43/EC of 29 June 2000 states in Article 2 Nr. 2 (b) that "(…) indirect discrimination shall be taken to occur where an apparently neutral provision, criterion or practice would put persons of a racial or ethnic origin at a particular disadvantage compared with other persons, unless that provision, criterion or practice is objectively justified by a legitimate aim and the means of achieving that aim are appropriate and necessary." The Equal Treatment in Goods and Services Directive 2004 (2004/113/EC) of 13 December 2004 defines indirect discrimination as a situation "where an apparently neutral provision, criterion or practice would put persons of one sex at a particular disadvantage compared with persons of the other sex, unless that provision, criterion or practice is objectively justified by a legitimate aim and the means of achieving that aim are appropriate and necessary."

565 General Comment No. 20, Non-discrimination in economic, social and cultural rights, Committee on Economic, Social and Cultural Rights, U.N. Doc. E/C.12/GC/20 (Jul. 2, 2009) para 12.

566 Final draft of the guiding principles on extreme poverty and human rights, submitted by the Special Rapporteur on extreme poverty and human rights, Magdalena Sepúlveda CarmonaA/HRC/21/39 para 21.

analytic methods that merely perpetuate the *status quo* in credit scoring.[567] But since the claim to the principal no longer needs to be protected once the principal is paid, maintaining risk premiums afterwards is neither reasonable nor objective, no matter if the decision is made by a bank clerk or an algorithm. Unadjusted risk premiums leave the permissible scope of differential treatment, that is valid for conventional as well as modern forms of discrimination.[568] General Comment No. 20 clarifies that property status, as a prohibited basis of discrimination, is a broad concept and includes all sorts of property, or the lack of it.[569] Risk premiums have an effect on those with property and on those without. As wealthy clients are more likely to use good collateral, they benefit in three ways: (1) by obtaining a cheaper interest rate, (2) by having the collateral returned at the end, and (3) by being able to use the principal for a longer time. In turn, a shorter availability of the principal, a high-risk premium and its full payment without having it returned at the end is the sanction for not having sufficient collateral. In the present example, B pays 770,312.50 while A pays only 185,937.50 for the identical loan and has his collateral returned on top of this. Once B paid the full principal, he must shoulder 584,375 more than A,[570] just because there is no collateral. This different treatment based on property in business practice is not proportional and therefore discriminatory.

Human rights are frequently understood as a defence of the individual against the state, but under established jurisprudence, human rights law may develop a direct effect between individuals and private entities.[571] For example, in *Deaconu v. Romania*, the European Court of Human Rights asserted its competence to review a national court's interpretation of a private contract where it appears inconsistent with rights protected by the Convention.[572] A growing body of property-based discrimination cases is developing, involving discrimination by and against the state and private entities. The next section offers a sample of court cases of national and international courts from European and North American jurisdictions that deal with discrimination based on property.

567 Fernandez Vidal, Maria, &Barbon, Fernando, 'Credit Scoring in Financial Inclusion – How to use advanced analytics to build credit-scoring models that increase access' Consultative Group to Assist the Poor 1, 24 n.5 (2019).
568 General Comment No. 20, Non-discrimination in economic, social and cultural rights, Committee on Economic, Social and Cultural Rights, U.N. Doc. E/C.12/GC/20 (Jul. 2, 2009) § 13.
569 ibid 25
570 770.312,50 (B) – 185.937,50 (A) = 584.375, -
571 The discussion on different aspects of the relationships between private individuals in the context of human rights is also known under its German legal term *Drittwirkung*. For an overview, see András Sajó & Renáta Uitz (eds), 'The Constitution in Private Relations: Expanding Constitutionalism' (Eleven International Publishing 2005)
572 *Deaconu v. Romania*, no. 66299/12, [2019] ECHR 98, para 24.

5.5.1.1. Property-Based Discrimination Against Individuals: Overview of Jurisprudence

5.5.1.1.1. Shelter Corp. v. Ontario[573]

At issue in this case was the respondent landlords' use of income criteria to deny rental accommodation to lower-income applicants. The landlords maintained a policy of refusing to rent to prospective tenants who would pay more than 30% of their gross income in rent on the assumption that such tenants were likely to default. The Ontario Human Rights Commission and complainants challenged this practice on the grounds of discrimination based on age, sex, and income because the application of this rule results in the exclusion or the restriction or preference of designated groups. The respondents claimed the law did not prohibit landlords from screening tenants based on their ability to pay. They also disputed the discriminatory or selective character of their criteria and argued that without the ability to screen tenants and thereby limit their risk, landlords would face undue business hardship.

The Ontario Board of Inquiry (now the Human Rights Tribunal of Ontario) found that the housing expenditure-to-income ratios yielded invalid and unreliable results due to a variety of theoretical and conceptual errors. Moreover, it observed that over 30 % of households in Canada spent more than 30 % of their gross income on housing. Additionally, the Board found no evidence connecting rent-to-income ratios with default.[574] Rather, the Board found that "the evidence supports a conclusion that it is unexpected changes in one's circumstances after entering into a tenancy which are the most common cause of a tenant's default."[575] On review, the Ontario Superior Court of Justice, Divisional Court confirmed the Board of Inquiry's approach and its findings of indirect discrimination.[576]

5.5.1.1.2. Chassagnou and others v. France[577]

A French law forced smaller landowners to cede their hunting rights to large hunting associations. The law granted compensation to landowners who lost income because of the compulsory transfer but made no provision for those who opposed hunting and planned a different use of their estate. Additionally, owners of large estates were able to refuse the transfer of hunting rights. Ms. Chassagnou and her fellow claimants were smaller landowners who opposed hunting, wished to ban it on their properties, and unsuccessfully petitioned the French courts to prevent the transfer of hunting rights.

573 *Shelter Corp. v. Ontario (Human Rights Comm.),* 2001 CanLII 28414 (ON SDC).
574 *Ontario Human Rights Commission and Kearney et al v. Bramela Corporation et al*, Board Of Inquiry 98-021, 221998. ibid at 44 ("There is no relationship between the percentage of income that a person spends on rent and the probability that such person will default in the payment of rental obligations.").
575 ibid 46.
576 *Shelter Corp. v. Ontario (Human Rights Comm.),* 2001 CanLII 28414 (ON SDC).
577 *Chassagnou and others v. France* [GC, 29. April 1999], nos. 25088/94, 28331/95 and 28443/95, ECHR 1999-III.

The European Court of Human Rights held that the compulsory transfer of the hunting rights of smaller landowners, such that others could use the property in a way that collides with the owners' beliefs, constituted a disproportionate burden, without justification, on their right to property, and thus violated article 1 of Protocol No. 1.[578] The Court found a violation of the right to property in conjunction with discrimination (article 14 of the Convention) because, unlike the smaller land owners, those with large estates could decide on the use of their land freely and could therefore prohibit hunting on their land. In addition, the Court held there was a discrimination based on property within the meaning of article 14 of the Convention, since the difference in treatment between large and small landowners results in granting only the former the right to use their land in accordance with their conscience.[579]

The Court held that the arbitrary decision as to who is sufficiently small to have their hunting rights transferred against their will is not only a violation of property rights but also a discrimination based on property, as this decision is based on the size of the property, meaning its value.[580] French law impermissibly discriminated against Ms. Chassagnou based on her smaller-sized property. Similarly, banks impermissibly discriminate against lenders by setting risk premiums based on a borrower's smaller property or lack thereof, and thereafter failing to adjust the risk premium as the risk decreases.

Following this criterion, if a lender were permitted to keep the proceeds from the risk premium once the principal was paid, courts would extend the property rights of lenders beyond already existing property. This extension would affect all borrowers that are not prime-rate clients, meaning all those with lower financial and lower social status, for no legitimate reason. On the other hand, low risk prime-rate borrowers, who could provide for customary collateral are not affected because their property must be returned by law once the loan agreement was fulfilled. There are two extremes in pricing: low-risk prime rate client A with excellent collateral and high-risk client B without collateral. Once the lender's risk vanishes due to the payment of the principal, two different prices exist. Basel III and other laws seem to offer no reason why credit agreements for prime rate clients would justify lower prices while loans for riskier clients would necessitate higher prices after the payment of the principal as the risk of loss and the duty of prudent lenders to protect the principal has dropped to zero at that point. These laws and recommendations are therefore at odds with the prohibition of discrimination. In fact, the prohibition of

578 ibid § 85
579 ibid § 95
580 ibid § 93

discrimination demands that both situations are to be treated equally once they become equal, otherwise this practice forces borrowers to use the funds they legally own for payments on a risk-premium that has turned redundant.

5.5.1.1.3. Decision No. 42/2012 (XII. 20.) of the Hungarian Constitutional Court on the Annulment of Certain Provisions of the Act on Legal Aid[581]

A 2011 legal reform in Hungary established a requirement of legal representation in constitutional complaints. Previously, unrepresented persons could draft their own submissions to the Constitutional Court. But as the law regulating legal aid was not amended simultaneously, legal aid for constitutional complaints remained unavailable.

In a 2012 judgment, the Hungarian Constitutional Court decided that this situation resulted in discrimination based on a litigant's financial situation. According to the Constitutional Court, it is the state's constitutional duty to facilitate the defence and enforcement of an individual's rights. Consequently, the state is obliged to provide for a court system accessible to all.[582] In order to maintain access for parties in disadvantageous financial positions, the state provided for legal aid in lower instance courts, except for constitutional complaints. Therefore, all potential parties to such a complaint were indiscriminately excluded. Nevertheless, the Hungarian Constitutional Court found this situation to be discriminatory: someone who could afford to pay an attorney had an advantage over one who could not since the latter was not able to start any proceedings and was therefore barred from accessing the court system.[583] The Court could not find any constitutional reason for a different treatment of the two groups,[584]and stated that article XV.2 of the Hungarian Constitution[585] does not presuppose a test of necessity or proportionality but prohibits discrimination altogether.[586] Article XV.2 of the Hungarian Constitution contains a non-exhaustive list of grounds for discrimination, including property. These grounds are mostly unchangeable characteristics of an individual. Property, like political opinion and religion, could eventually change over time but not in every case at will.[587] According to the Court, differential treatment based on a characteristic that cannot be changed at will or that is hereditary is discriminatory without detailed examination because it restricts a

581 Magyar Alkotmánybíróság [Hungarian Constitutional Court] Dec. 18, 2012, 42/2012 (XII. 20.) AB határozat (Hung.); http://www.codices.coe.int/NXT/gateway.dll/CODICES/precis/eng/eur/hun/hun-2012-3-008 (English summary).

582 ibid 14

583 ibid 32-33

584 ibid 35

585 Magyarország Alaptörvénye [The Fundamental Law of Hungary] art. XV (2) reads "Hungary shall guarantee the fundamental rights to everyone without any discrimination, in particular on grounds of race, color, sex, disability, language, religion, political or other opinion, national or social origin, property, birth or any other status."

586 Magyar Alkotmánybíróság [Hungarian Constitutional Court] Dec. 18, 2012, 42/2012 (XII. 20.) AB határozat (Hung.) at 39

587 ibid at 40

human right based on a constant characteristic.[588] The Constitutional Court found that the requirement to have an attorney differentially affected those who were able to pay attorney fees and those who could not and therefore amounted to differential treatment based on property. This differential treatment was the direct consequence of the law on legal aid.[589]

In so holding, the Hungarian Constitutional Court acknowledged property as a personal characteristic which can form the basis of discrimination because poverty cannot be traded in for wealth at the very moment in which a submission of a constitutional complaint becomes necessary. The rationale of the Hungarian Constitutional Court applies with equal force to the business practice of financial institutions of requesting high risk premiums from poor clients and low rates from the rich.

5.5.1.2. Property-Based Discrimination Against Private Legal Persons

Article 1 of Protocol No. 1[590] protects property owned by private legal entities (for instance, corporations, but also non-profit organizations that build housing for people living in poverty), the use of which can be only restricted or regulated according to the law. Legal persons and natural persons alike have property rights, as reflected in article 19(3) of the German Basic Law: "The basic rights shall also apply to domestic legal persons to the extent that the nature of such rights permits."[591] Property ownership by corporations is legally undisputed, and the recent case law recognizes that corporations may also be the subjects of discrimination. Bilateral investment treaties, tax and competition laws, world trade regulation by the World Trade Organization, and domestic constitutions and jurisprudence all materialize the prohibition of discrimination against private legal entities, which also can be borrowers.

But the fact that the property rights of corporations are legally protected against discrimination does not mean these legal entities hold and exercise human rights the same way as individuals do.[592] Of course, companies can be treated differentially if there is a legitimate reason. For instance, in the context of the COVID-19 crisis, states can decide

588 ibid 41

589 ibid 44

590 Article 1 of Protocol 1 to the European Convention of Human Rights reads: "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a state to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties."

591 Grundgesetz [GG] [German Basic Law] art. 19(3), *translation at* <http://www.gesetze-im-internet.de/englisch_gg/index.html>

592 Even when Article 1 of Protocol No. 1 to the European Convention on Human Rights seems to indicate otherwise, *see* Marius Emberland, 'The Human Rights of Companies: Exploring the Structure of ECHR Protection', Human Rights Law Review (2006). *See also* Stefanie Khoury & David Whyte, 'How Human Rights Law Has Been Used to Guarantee Corporations a 'Right to Profit'', The Conversation (Mar. 15, 2017) <https://theconversation.com/how-human-rights-law-has-been-used-to-guarantee-corporations-a-right-to-profit-74593>

that companies that pay out dividends, buy back own shares, or are registered in tax havens should not be eligible for any of their financial support programs, as the Austrian, Danish, French and Polish governments did in April 2020.[593] But discriminating (or tolerating discrimination in private contractual relations) based purely on the economic status of borrowing legal entities is not legally permissible.

Similarly, in *White Glove v. Methodist Hospitals,* the U.S. Court of Appeals for the Fifth Circuit held that a staffing corporation had statutory standing to bring a racial discrimination claim under section 1981 of the Civil Rights Act of 1866, which guarantees the right of all persons, regardless of race, to make and enforce contracts.[594] The U.K. Employment Appeal Tribunal granted a corporation standing in a discrimination case in *EAD Solicitors LLP v. Abrams*.[595] Mr. Justice Langstaff held that the term "person" in the Equality Act must include also a corporate body, "for it is familiar to any employment lawyer that many corporations are alleged to be discriminators and no one has so far considered that is inappropriate."[596] Likewise, the Justice held that the Equality Act did not restrict the term "person" to an individual,[597] and that this finding was in accordance with the European Equality Directive and the Race Discrimination Directive, Council Directive 2000/43.[598] Hence, discrimination against corporations exists. When they are borrowers, they can also be discriminated against based on their property.

5.5.2. The Prohibition of Property-Based Discrimination Against States

A foundational provision in the UN Charter is that all states are equal under international law regardless their economic or military power.[599] More specifically, the 1970 Friendly Relations Declaration provides that "[a]ll states enjoy sovereign equality. They have equal rights and duties and are equal members of the international community, *notwithstanding differences of an economic*, social, political or other nature."[600] This state equality principle

593 *See, e.g.* Morten Buttler, 'Denmark Extends Business Aid to Increase Spending By $15 Billion', Bloomberg (Apr. 18, 2020) <https://www.bloomberg.com/news/articles/2020-04-18/denmark-extends-business-aid-to-increase-spending-by-15-billion>; Editors, 'Francia tampoco rescatará a las empresas registradas en paraísos fiscales', Página 12 (Apr. 24, 2020) <https://www.pagina12.com.ar/261931-francia-tampoco-rescatara-a-las-empresas-registradas-en-para>

594 *White Glove Staffing, Inc. v. Methodist Hospitals of Dallas*, 947 F.3d 301, 305-08 (5th Cir. 2020)

595 *EAD Solicitors LLP v Abrams* [2015] UKEAT/0054/15/DM (Eng.)

596 ibid § 9

597 ibid §§ 21, 25

598 ibid § 30

599 U.N. Charter art. 2, para 1; *see also* R. P. Anand, 'Sovereign Equality of States in International Law' (Sage Pub 2008) discussing states' equality under international law per the U.N. Charter.

600 Declaration on Principles of International Law Concerning Friendly Relations and Cooperation Among States in Accordance with the Charter of the United Nations, G.A. Res. 2625 (XXV) (Oct. 24, 1970) (emphasis added). Yet, see United Nations General Assembly Resolution 36/103 of 9 December 1981 (Declaration on the Inadmissibility of Intervention and Interference in the Internal Affairs of States ['1981 Non-Intervention Declaration']), to which most developed States opposed.

must be read in conjunction with the principles of international cooperation[601] and non-intervention,[602]which add economic content to the behaviour expected towards states.[603]

In this vein, the 2019 Guiding Principles on human rights impact assessment of economic reforms[604] determine that states, international financial institutions,[605] and non-state actors should not exert undue influence (including through the use of economic measures) to secure from other states advantages of any kind that undermine the ability of those states to protect human rights.[606] Similarly, the Millennium Development Goals resolution had established that states were "committed to an open, equitable, rule-based, predictable and non-discriminatory multilateral trading and financial system."[607]

Though this topic is underdeveloped in the legal literature, discrimination against states–unequal treatment without legitimate reason–is not permissible under international law. This principle is explicit and well-developed in a number of areas, such as the World Trade Organization and the Paris Club.[608] If anything, differential treatment is possible in order to promote international cooperation.[609] Loan contracts with discriminatory interest-rate terms, especially when combined with regulatory policies that erode a country's fiscal space, have grave implications for human rights, in particular for resource-sensitive economic and social rights.

Judicial review of loan agreements between states and non-state actors is unproblematic because such agreements generally provide for sovereign debt to be auctioned off to the lowest bidder in accordance with private-law contracts. Citizens in comparable situations are protected by consumer protection laws, and their human rights are protected by constitutions and international treaties, but the same does not necessarily apply to states.

601 *See* U.N. Charter art. 55; International Covenant on Economic, Social and Cultural Rights arts. 1, 2, 11, Dec. 16, 1966, 993 U.N.T.S. 3

602 *See* U.N. Charter art. 2

603 For an updated study of the implications of this principle in the context of Third World Approaches to International Law (TWAIL), see Jochen von Bernstorff & Philipp Dann (eds) 'The Battle for International Law. South-North Perspectives on the Decolonization Era' (OUP 2019).

604 *See* Human Rights Council Res. 40/8, U.N. Doc. A/HRC/RES/40/8 (5 April 2019); Human Rights Council Res. 40/57, U.N. Doc. A/HRC/40/57, at 14-15 (19 December 2018)

605 The IMF applies surcharges of 2% or 3 % based on how long payments are overdue and once a certain threshold has been reached. These are not risk premiums, but a closely connected discriminatory practice, since usually only the poorest countries are burdened with these surcharges. In times of near-zero or even negative interest rates, these surcharges, which are not market driven and depend solely on the IMF, are strikingly high. They are not a collateral *sui generis* accelerating payment as discussed in this article but merely a sanction for being poor that is applied against the poorest countries, thus driving them even more into debt. As they do not help protect the IMF's investment, the existence of these surcharges is not justified, and their use should be abolished. *See also* Kevin P. Gallagher, The IMF's surcharges are unfit for purpose - It's time for a rethink, Financial Times (4 March 2021)

606 Guiding Principles, Principle 14 and commentary 14.1. On the relevance of the policy space in the economic realm, see also Sustainable Development Goal 17.15; Addis Ababa Action Agenda of the Third International Conference on Financing for Development, annex, § I, para 9; and General Assembly resolution 25/2625

607 G.A. Res. 55/2, United Nations Millennium Declaration, U.N. Doc. A/RES/55/2, at para 13 (Sept. 18, 2000).

608 *See generally* William Davey *Non-discrimination in the World Trade Organization* (Brill 2012); Alexis Rieffel, 'The Paris Club, 1878-1983', Columbia Journal of Transnational Law (1984)

609 Philippe Cullet, 'Differential Treatment in International Law: Towards a New Paradigm of Inter-state Relations', European Journal of International Law 549, 571-72 (1999)

However, recovery and unjust enrichment claims will nevertheless apply to state parties to a private-law loan contract. As a result, governments must insist on non-discriminatory treatment in comparison to prime-rate states after the principal has been fully paid. But discrimination does not only take place between private actors, nor are natural persons alone subjected to discriminatory state actions. Discrimination may also occur among states or between states and other public and private institutions.

The U.S. Supreme Court recognized inter-state discrimination of this sort in *Franchise Tax Board v. Hyatt*.[610] California had sent officers to Nevada in order to investigate Hyatt's change of residence as it assumed he had not paid taxes in California. These California officers examined his mail, harassed him and his friends in Nevada, and in return Hyatt sued for damages. Despite the general principle of state immunity, a Nevada state court exercised jurisdiction over Hyatt's suit on the basis of a controversial 1979 U.S. Supreme Court ruling, *Nevada v. Hall*, which held that a state's immunity does not extend to private suits in other states.[611] The Supreme Court in *Hyatt* deadlocked on whether to overrule *Hall* and thus affirmed the Nevada court's jurisdiction over California's Franchise Tax Board. But the Supreme Court also held that the Nevada court violated the U.S. Constitution's Full Faith and Credit Clause by awarding higher damages against a California state agency than it would have awarded in a comparable situation against a Nevada agency:

> A constitutional rule that would permit this kind of discriminatory hostility is likely to cause chaotic interference by some States into the internal, legislative affairs of others (...). It is difficult to reconcile such a system of special and discriminatory rules with the Constitution's vision of 50 individual and equally dignified States. In light of the "constitutional equality" among the States (...). Nevada has not offered "sufficient policy considerations" to justify the application of a special rule of Nevada law that discriminates against its sister States.[612]

In *Shelby County v. Holder*, which invalidated the coverage formula for states subject to the preclearance requirement of section 5 of the Voting Rights Act of 1965, the U.S. Supreme Court ruled that the coverage formula effected a "dramatic departure from the principle that all States enjoy equal sovereignty" because "the Act required [only some] States to obtain federal permission before enacting any law related to voting—a drastic departure from basic principles of federalism."[613] This case does not relate to a

610 *Franchise Tax Bd. v. Hyatt*, 136 S. Ct. 1277 (2016)
611 *Nevada v. Hall*, 440 U.S. 410 (1979)
612 *Franchise Tax Bd. v. Hyatt*, 136 S. Ct. 1282 (citations omitted)
613 *Shelby County v. Holder*, 570 U.S. 529, 535 (2013)

discriminatory practice between states but between the federal government and some states.

Franchise Tax Board v. Hyatt and *Shelby County v. Holder* arise in very different contexts but are both based on general principles such as comity and the sovereign equality. These principles, which are also enshrined in the Friendly Relations Declaration, apply in both the federal and international contexts.[614] Judicial review of cases that involve loans and discriminatory treatment between states or states and international financial institutions or similar organs is therefore conceivable in courts as well.

5.6. State Obligation to Correct Laws

This sixth section showed that legal structures exist that perpetuate discrimination, for States, as well as for people and corporations. But although States are obliged to protect and fulfil human rights, it seems legal leverage points are missing to improve the overall situation, just as to correct the poor structure of the Basel Accords. Yet, Financial regulation and practices lead to human rights violations and impair the right to development of borrowing countries' individuals and populations, if they generate fiscal constraints that are caused by payment obligations which are created by a financial mechanism that is neither legally nor economically justified.[615]

To understand the impact in economic and fiscal terms that the misuse of risk premiums in sovereign debt has on the right to development,[616] we need to keep in mind that the link between the risk premium and the debt level (as a percentage of GDP) introduces an important self-reinforcing mechanism.[617] As a consequence, an increase of global sovereign debt by 10% this year to a record $71.6 trillion had been reported by April 2022.[618] In his database, Country Default Spreads and Risk Premiums, Prof. Aswath Damodaran gives an overview of the States' risk premiums from which it can be deducted that those States that are forced to pay the highest interest rates[619] are those which need their money most: Argentina pays an 11.87% country risk premium in comparison to Germany, which pays 0.00%. According to this database, Cuba, the Korean Democratic Peoples' Republic,

614 United Nations General Assembly Resolution 2625 (XXV), U.N. Doc. A/RES/2625(XXV) (Oct. 24, 1970)

615 Oliver Pahnecke and Juan Pablo Bohoslavsky, 'Re-regulating the Risk Premium to Realize the Right to Development' Development – Palgrave Macmillan [Vol 65 Numbers 2-4] (Rome 2022) 149; section 6.6. is mainly identical with the article from p. 149

616 Gail Hurley 'Sovereign Debt and the Right to Development' *in* Bantekas I, Lumina C (eds) *Sovereign debt and human rights*, 248–266 (OUP 2018)

617 Cinzia Alcidi, and Daniel Gros, 'Public Debt and the Risk Premium: A Dangerous Doom Loop', EcononPol - Europe Opinion (2019)

618 Janus Henderson, 'Global sovereign debt to rise almost 10% to new high in 2022' *Reuters* (6 April 2022)

619 Aswath Damodaran, Country Default Spreads and Risk Premiums, New York University, Stern School of Business (2022)

Myanmar and Somalia belong into the same risk class as Argentina. The risk premium for Lebanon, Sudan, Syria and Venezuela amounts to 20.34%. In January 2022, Greece paid 3.56%, Iceland 0.84% and Portugal 1.88%. Based on the World Bank data for risk premiums on lending,[620] for example, Sweden had to pay in 2005 a risk premium of 1.8%. In comparison to low-risk borrower Sweden, South Africa paid 3.7%, Albania's risk premium aggregated to 7.6% while Romania had to shoulder even 12.1%. In the latter case, this means a drastic difference of 10.3% that was paid as a risk premium on top of the prime rate. Yet, this risk premium should have remained the property of Romania's since it is legally qualified as a collateral *sui generis* and therefore should have been either returned at the end or adjusted over time. As there was no analysis of the legal character of risk premiums available until now, that money was kept by the lenders and restricted the State's budget which should have been devoted to expenditures and investments with direct impact on the right to sustainable development, instead. In this database that collected the risk premiums of 186 States, only 12 States are prime-rate clients with a 0.00% risk premium, while the other 174 States are left with premiums of 0.39% up to 20.34%. This means that 174 States are paying more than they legally should as premiums are not recalculated when debtors turn out to be good payers. Among these countries are the poorest, having to repay much more than they possibly can if one considers the States' human rights obligations towards their populations. This also means that risk premiums are frequently the reason for borrowing States not only remaining poor but ending up over-indebted, too.

Also, sovereign debt itself is responsible for poverty as it strains the budget to such a great degree that Jamaica had to use its entire tax revenue from 2000 to 2010 to satisfy lenders. In order to meet its human rights obligations, Jamaica had to borrow additionally.[621] Likewise, sharp increases in food prices, such as during the global food price crisis of 2008, increase the need for States to borrow in order to subsidize staple food and lead to malnutrition as well as less education for children, for example and to shift to export-oriented agriculture, in order to pay public debt that had grown out of control.[622]

Once public debt passes a certain (country-specific) upper threshold, interest rates increase rapidly, so that debt suddenly becomes unsustainable.[623] So is not the debt in itself but the risk premiums that are demanded by lenders that make sovereign debt unsustainable. It is

620 World Bank. 2022. World Bank Open Data <https://data.worldbank.org/indicator/FR.INR.RISK?end= 2021& locations= AL- ZA- SE- RO&start= 1960& view= chart>

621 Gail Hurley 'Sovereign Debt and the Right to Development' in Bantekas I, Lumina C (eds) Sovereign debt and human rights, 248–266 (OUP 2018) 253

622 De Schutter, Olivier. 2018. Sovereign Debt and the Right to Food *in* Bantekas I, Lumina C (eds) *Sovereign debt and human rights*, 248–266 (OUP 2018) 186, 194

623 Kris James Mitchener, Christoph Trebesch, 'Sovereign Debt in The 21st Century, Working Paper 28598', National Bureau Of Economic Research (June 2022) 10

therefore of paramount importance that risk premiums are legally treated as property pledged by the borrower as a result of their collateral-replacing character. Many States participate in the development of the Basel Accords and most transpose them into domestic law to use them for the supervision of banks in their jurisdiction. If these State-developed Basel Accords contain mistakes that reduce public budgets to the detriment of human rights related State obligations, States have to take action - internally, internationally and collectively- in order to fulfil their international human rights obligations.[624] The incorrect use of the risk premium is such a regulatory mistake that leads to a financial practice that brings about human rights violations. States will therefore have to stop the application of that regulation in their jurisdictions, in IFIs they will have to vote against its further use, vote for any improvement, change the terms of the sovereign bonds issued and eventually have to negotiate or sue in international fora, if there is no other measure available.[625]

To get beyond the legal obligation of States, however, a concrete legal claim against States is necessary. The Child Rights Convention could provide for such a claim, as long as the State is a member of the Convention. The Child Rights Convention is explicit in article 4 in terms of why and how States should actively regulate certain activities (including financial contracts) in order to facilitate the realization of human rights.[626] The Committee on the Rights of the Child has given an outline on public budgeting for the realization of children's rights in its General Comment Nr. 19.[627] The Committee not only points out that investment in early childhood development breaks poverty cycles and brings high economic returns.[628] It also underlines that States must generate revenue[629] in order to mobilize and allocate sufficient funds[630] to realize the rights guaranteed in the Child Rights Convention.[631]

To prevent debt vulnerabilities for children, it is therefore necessary that States implement measures that help adjust the risk premiums.

624 U.N. Human Rights Office of the High Commissioner. 2016. Frequently Asked Questions on the Right to Development, Fact Sheet No. 37

625 Oliver Pahnecke and Juan Pablo Bohoslavsky, 'Re-regulating the Risk Premium to Realize the Right to Development' Development – Palgrave Macmillan [Vol 65 Numbers 2-4] (Rome 2022) 149 – 150; Mark Gibney suggests state legal responsibility in accordance to voting rights in IFIs: If France has 10 percent of World Bank votes and supports a project resulting in massive human rights violations, "(…) the French government should bear 10 percent of the responsibility for these wrongs." *See* Mark Gibney, *International Human Rights Law – Returning To Universal Principles* (Rowman & Littlefield 2008) 47

626 ibid 150

627 Committee on the Rights of the Child, 'General comment No. 19 on public budgeting for the realization of children's rights (art. 4)', CRC/C/GC/19 (2016)

628 ibid nr. 50

629 ibid nr. 57

630 ibid nr. 42

631 Oliver Pahnecke and Juan Pablo Bohoslavsky, 'Re-regulating the Risk Premium to Realize the Right to Development' Development – Palgrave Macmillan [Vol 65 Numbers 2-4] (Rome 2022) 150

5.7. Incorrect Legal Mechanism as a Legal Ground for the Repudiation of Sovereign Debt

The practice of charging a risk premium on top of the prime rate is legally justified since it serves as a protection of the lender's property (or its commercial bank money) in a riskier environment by accelerating the return of the principal. But to the extent that risk premiums lead to interest rates that harm the economic abilities of the borrower by infringing his property rights or by distinguishing between clients based on their financial status in a discriminatory manner, they must be adjusted. Once the risk premium has lost its purpose of ensuring the loan repayment, the price difference loses its justification and turns into a discriminatory practice, placing a greater burden on clients previously classified as risky compared to low-risk clients. This price difference thus leads to discrimination and the infringement of the right to property, against which all states and courts are obliged to take action. This demand is in line with the UN guiding principles on extreme poverty and human rights:

> States must ensure that persons living in poverty are equal before and under the law and are entitled, without discrimination, to the equal protection and benefit of the law. States must repeal or modify laws and regulations that are biased against the rights, interests and livelihoods of persons living in poverty. All forms of legislative or administrative discrimination, direct or indirect, on grounds of economic situation or other grounds associated with poverty must be identified and eliminated.[632]

It is in the public interest to protect the principal, which is generated as commercial bank money, because this provides for a flexible credit supply. Upholding risk-premium payments fully throughout the duration of the loan agreement, without adjustment corresponding to the decreasing default risk, runs contrary to the public interest, violates the prohibition of discrimination, and frequently infringes upon borrowers' human rights. It reduces economic activity since it captures funds that could be used either for consumption or investment.

The current interest rate system is not proportionate, either, since the adjustment of interest rates over time would be a less burdensome alternative. At the moment, the Basel Accords confuse price and property because they treat interest rates and risk premiums as the property of the lender, although the first is the price and the latter is the property of the borrower. Only the principal is the property of the lender, despite the current practice in finance. This should be regarded as an exploitative financial mechanism. At present the commercial application of risk premiums collides with the right not to be exploited as enshrined, in a very explicit way, by article 21 of the American Convention on Human

632 Human Rights Council Resolution 21/39, U.N. Doc. A/HRC/21/39, at para 19 (19 July 2012).

Rights, which states that "[u]sury and any other form of exploitation of man by man shall be prohibited by law."[633]

Adjusting interest rates and risk premiums after the full payment of the principal prevents discrimination by securing the equal treatment of all borrowers once they have fulfilled their principal payment obligation. It would free up resources of the poorest borrowers to improve their living conditions, enable sovereign borrowers to implement poverty eradication policies, and facilitate businesses and create wealth for corporate borrowers. Using payment in full as a precondition for equal payment conditions among borrowers strikes the balance between the interest of the lender and the borrower. This approach creates no additional burden for lenders; it simply corrects a poorly constructed finance practice without interfering with freedom of contract or market forces by treating interest rates as prices rather than property.

Therefore, the adjustment of risk premiums in accordance with the real risk is one option for States to repudiate payment claims by lenders to the same degree, as the risk premium has not been adjusted in relation to the real risk and in comparison to those states that are premium borrowers such as Germany.

633 American Convention on Human Rights, art. 21(3), Nov. 22, 1969, O.A.S.T.S. No. 36, 1144 U.N.T.S. 123.

Fourth Chapter: The New Approach – Repudiating Sovereign Debt without Odiousness

As a result of its structural shortcomings, the odious debt doctrine has never been applied in practice and this is not likely to change in the near future. International consent for a treaty[634] has not been reached, despite of the massive support it received repeatedly; in recent years this happened especially in the context of Iraq's sovereign debt after Saddam Hussein's demise. Consequently, it is necessary to exchange Sack's unpractical, narrow but eye-catching dictator-focused odious debt doctrine for a practical approach in cases of debt repudiation that is based on the legal norms that already exist. This way the focus can be changed to the validity of loan contracts and the legal preconditions that could lead to their repudiation in some cases. Then topics can finally be dealt with that have been ignored previously, such as over-indebtedness that is mathematically impossible to be paid or regulatory demands that introduce automatic debt growth. These are some areas that were excluded from the discourse because of the detrimental focus on state succession after so-called illegitimate régimes.

Even influential actors in the finance industry have recognized the necessity of debt relief and repudiation, although their demands could not be supported by adequate legal means at that time. "Der Spiegel" for example, a German weekly paper, reported in 1988 that the Chairman of the Deutsche Bank, Alfred Herrhausen, was an outspoken advocate for debt relief and had recommended the cancellation debt of third world and developing countries during IMF and Bilderberg meetings. He summarized the trap third world countries find themselves frequently: debtor states have to use scarce tax money for meeting their debt obligations instead of investing their taxes productively. If they wanted to invest to grow their economies, they would be forced to default on their payments. In Herrhausen's opinion, the developing world offers a great economic growth potential that neither debtor states nor industrialized countries cannot afford to leave permanently unexploited. Moreover, debt cancellation would not harm the creditworthiness of these countries, after all their creditworthiness is already destroyed. But a debt cancellation would release the financial means for investment and growth which would increase the trust of lenders, so the Deutsche Bank chairman. Herrhausen agrees that a reduction of debt could influence payment morals negatively, but this danger is dwarfed by the dangers for peace and welfare in the world, should the claims against these countries be upheld.[635]

634 In order to codify the legal approach to odious debt, a draft treaty has been proposed for example by Friedrich Benjamin Schneider, 'The International Convention on the Prevention of Odious Agreements: A Human Rights-Based Mechanism to Avoid Odious Debts' (2015) Leiden Journal of International Law 557-578

635 Editorial, 'Die "Schnapsidee" des Alfred Herrhausen' *Der Spiegel* (Hamburg, Nr. 40/1988) 137

This chapter will sum up the different legal means discussed in the previous chapters, to give an overview as to what options all States have should they believe that some of the claims against them are unjustified and therefore should be repudiated.

1. Agency and Unconscionability

As sovereign debt is frequently based on the law of contractual obligations, any government or parliament has to evaluate whether the loan was in the interest of the state and if the debt connected to it should be acknowledged as valid or if there any reasons for its repudiation.

The classic definition of odious debt requires for the loan that it was not used for the benefit of the debtor state's citizenry. When it comes to the evaluation of the validity of the debt, it is obvious those should be consulted who were not asked when the credit agreement was signed, the people. As this thesis shows, public support in dictatorial regimes such as the Tinoco regime looks different than in democracies, yet in both cases the public support is sufficient for the government to bind the country with a contract. When the Chief Justice of the United States of America, William H. Taft, was asked to decide the Tinoco Claims Arbitration of Great Britain v. Costa Rica,[636] he confirmed the British view that Tinoco had formed a "sovereign" and "*de facto* government". This happened initially with public support enabling the Tinoco government to function as an uncontested administration based on its new constitution, which lead to the recognition by many Latin American and European governments. While it enjoyed popular support, it could enter contracts on behalf of Costa Rica until another popular uprising contested its status as a government during the period leading up to its fall.[637]

In democracies, free and democratic elections should ensure a parliament that reflects the will of the people, so the yardstick for democratic sovereign debt is different. The Portuguese Constitutional Court defined the power to represent the citizens – and with that governmental agency – in its decision No. 574/14 14 of August of 2014: "the country's legislative organ – itself legitimated by the principle of democracy seen as representation of the people".

This means, dependent on the kind of State, there are different preconditions for agency. But if the conditions mentioned here are met, a state can be legally bound by its government under normal circumstances because the government has agency to represent

636 *Tinoco Arbitration* (GB v Costa Rica) (1923) 1 RIAA 369
637 ibid 380

the citizens of the State. "Chapter 1 Section 4.4. Agency and Unconscionability – Odious Debt Ignores Contract Law" clarified that agency consists of two relationships. On the inside, citizens give the government the agency to represent them through elections and for the legislative period the government's actions are bound by the constitution. On the outside, the agency gives the government the ability to enter into contracts with third parties, independent of their legal nature. Agency also exists in common law where an agent "(…) is a person that has the power to create, change or terminate the legal relations of another, the principal."[638] The common law agent is obliged to obey the lawful instructions of the principal, may only act within the limits of the agency agreement, must avoid conflicts of interest and has to use reasonable diligence and care.[639] *Bristol & West Building Society v Mothew* [1998] Ch 1 para18, characterizes the fiduciary obligations of an agent in the following fashion:

> A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. Should the agent exceed its authority, it will be liable to its principal for loss caused by the unauthorised actions. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal.[640]

Because the citizens have decided to entrust the government with agency, the government is in the position of a fiduciary. As a fiduciary, the government has to use its discretionary power over the property and well-being of its citizens prudently. Moreover, the government has superior knowledge and ability in comparison to the citizen who has a legal claim that the government will act in his interest.[641] Hence, the government enjoys a fiduciary position for the citizenry as a whole, which brings about obligations such as the duty of care, of loyalty, of impartiality, accountability and to preserve the public's trust in government.[642] When it comes to loan contracts, governmental actions can be evaluated according to the law of agency, which are more defined in common and civil law. Agency of public representatives in contractual manners is normal as the example with mayors in Germany highlighted.[643]

638 Practical Law Commercial, 'Common Law of Agency' *Thomson Reuters Practical Law* UK (2021) 6
639 ibid 33-35
640 ibid 34
641 Hana Callaghan, 'Public Officials as Fiduciaries – The values behind government ethics laws', Markkula Center for Applied Ethics (31 May 2016)
642 ibid
643 Palandt, 'Bürgerliches Gesetzbuch', *Verlag C.H.Beck* (Munich 2014) 180 nr 5

Again, there are several options how the government can fail to bind the State despite having agency. Taft for example ruled out the validity of the Amory concession because it was not passed by the rightful body, as demanded by its own new constitution. Therefore, the concession was void on formal grounds.[644] The concession is not the same as a payment claim but since it was connected to tax exemptions and profitable oil exploration, it had a pecuniary value and claiming it is comparable to demanding payment. Therefore, this thesis suggests treating loans and comparable claims in a similar fashion and one should rather use the more general term of claim repudiation, if other claims also are questionable.

The second option would be a violation of the duties that any agent has vis-a-vis the principal. Under normal circumstances the lender would give the government funds, with the help of which the government would invest in infrastructure, for example. This chain of transfers also works the other way round: when people work, they pay taxes, and these funds are used by the government to pay the principal and interest to the lender. If the government does not fulfil its duty as an agent, however, this payment scheme is disrupted: one option is the direct embezzlement of funds through the government. This is a criminal offence and if the lender knows about this, for example, because the government officials have bank accounts with the lender, then the validity of the underlying loan contract is already questionable. The second option would be even more clearly voidable: if the lender and the government agree on a kickback for the government or any other benefit, so that the government incurs the loan that would otherwise be unnecessary or at least cheaper, then both parties conclude a loan contract with the intention to let the population pay for it.

This constellation is called collusion in German law. It constitutes a contract to the detriment of third parties and it is a violation of the agency agreement that renders the contract void in accordance with § 138 (1) BGB (German Civil Code) due to the unconscionable agreement.[645] The third party has no ability to express her will under these circumstances and therefore there cannot be a contract.

Even where there is no explicit collusion of two parties to the detriment of a third because there is an agency agreement, it is possible that the effect on the principal is limited or even excluded, if the agent oversteps the limits of the agency. In one such German case[646] the defendant had received a power of attorney for the bank account of the plaintiff. When the defendant had withdrawn all funds from the account and used them to pay back his own loan at the same bank. When the defendant was sentenced to a prison term because of fraud, he agreed to pay part of the sum to the plaintiff. After that, the plaintiff demanded

644 *Tinoco Arbitration* (GB v Costa Rica) (1923) 1 RIAA 398
645 Palandt, 'Bürgerliches Gesetzbuch', Verlag C.H.Beck (Munich 2014) § 164 nr. 13, 14
646 BGH, Urt. v. 29. 6. 1999 XI ZR 2 77/98 (Nürnberg)

the payment of the remainder from the bank. This was not a damage claim because the plaintiff argued the bank had not performed her payment duty vis-a-vis the plaintiff which was based on the account. So, the Bundesgerichtshof had to decide if the internal agency agreement between plaintiff and defendant could limit also the outside relationship between the defendant and the bank.

The Court decided here that the plaintiff had a payment claim against the bank due to her deposit on the account. And this claim exists despite the power of attorney because based on the circumstances, it must have been obvious for the bank that the defendant did not act within the agency the plaintiff had given him. The plaintiff had given her general practitioner a power of attorney over her new bank account and as soon as her money had arrived on her new account her doctor used this money to pay his own debt that he had with the bank in question. Under these circumstances the Court found it imperative that the bank would ask the owner of the funds if she agreed with that use to make sure she agreed to it. Especially, as it would have been easier had the plaintiff simply transferred the money directly to the bank in order to pay off the doctor's debt, instead of first setting up an account and only then giving the doctor a power of attorney so that he could obtain the necessary funds. Under these circumstances, the bank would have had to put aside her own financial interest in the repayment of the loan that she had previously granted to the doctor. The bank could not claim that she could have made the payment trusting in the validity of the agency of the doctor. Therefore, the bank did not fulfil her contractual obligations when she permitted the doctor to withdraw the funds and the plaintiff's payment claim based on the bank account remained valid.

This case would be similar to a government making use of the opportunity that it can pay for a loan with tax funds while enriching itself. In this situation, a bank would also have little incentive to question the necessity of a loan, if it is profitable. The German Bundesgerichtshof worked with knowledge and so did Taft, since he argued the bank must have noted the irregularities surrounding the financial arrangements for the Tinoco brothers when the government was in demise although this thesis showed that knowledge of the lender is not decisive, but rather an indicator if public support is still likely. For the repudiation of claims, it is more important to focus on the benefit of the population. This would focus the legal discourse back to the individual level and the expression of the public will through elections, which would have a positive effect on democratization.

It should be noted, too, that agency by election and by constitution means that debt has to be incurred and used in accordance with the laws of the country. If it isn't then it could be argued that the debt is automatically personal debt of the ruler or government as there is no agency at that moment. The migration of debt, that Sack suggests in his doctrine, does not take place if this proposal of agency is followed because in such a case, the ruler took out the loan personally. This is reflected in Grotius' approach, according to which agents that overstep their public mandate will be personally liable: Noteworthy for the repudiation of sovereign debt are the cases where somebody represented the population without public authority becomes personally liable for damages and interest:

> But it remains to be considered how far the acts of those, who have engaged for the people, without any public authority, are binding. Perhaps it may be said that the contracting parties have discharged their responsibility when they have done all in their power towards the fulfilment of their obligation. That might be the case in promises, but the obligation in public contracts is of a stricter kind. For the party contracting requires something in return for the engagements he makes. Hence the civil law, which rejects all promises made by one person for the performance of some act by another, renders him who engages for the ratification of a thing liable to pay damages and interest.[647]

Without agency, also a state could not be bound legally. The only reason why the incumbent government does not pay for the debt is because the state is forced to pay on their behalf at that moment. This means that claims to payment and damages or compensation (such as payments on principal and interest rates) automatically have to be directed against the previous ruler, not the State.

As this thesis researches contracts with private lenders only, norms related to agency and unconscionability are therefore options for sovereign debt repudiation.

2. State Obligations

In the Leukerbad case, the Swiss Bundesgericht held that the State had no obligation to protect the interests of the corporations (which is also confirmed by Grotius, see above, second chapter, section 2.2.) but only had to safeguard the interests of the State and its citizens. The EFTA Court decided in a similar setting that Iceland had fulfilled her duties that she was obliged to meet based on the European regulations.

What these two cases have in common is that in both the alleged obligation that the plaintiffs based their claim on did not exist in reality. This is nothing special as such, but it is worth looking into legal obligations and options whenever there is an attempt to circumvent the spirit of a law or to shift the responsibility from one actor to another, who was not responsible. As it turned out in Leukerbad as well as in Iceland, excessive government spending and private lending had an impact on the citizens, nevertheless. But

647 Hugo Grotius, *The Rights Of War And Peace Including The Law Of Nature And Of Nations*, M. Walter Dunne 1901, 180 nr. X. 168 nr. II. and III.

in both instances, the population was not hit as hard as the Greeks. As the medical data show, even Portugal did better, partly because of good economic policies that avoided austerity where possible, just like Iceland, partly because of the precisely working Constitutional Court.

Another point that is worth considering is the legal ranking of State obligations. First and foremost, they are human rights related obligations that emanate from the constitution or fundamental laws, as well as from international treaties. After that come the national laws and only then come the contractual obligations. *Pacta sunt servanda* is therefore true, but they come only third in line. To say it with Grotius, the state is responsible for the well-being of its citizens and therefore all creditors of the state have to bear losses in times of emergency, thus contributing to the needs of the state (see above, second chapter, section 2.2.). Leukerbad's citizens, as well as those of Portugal and Greece had to bear their share of hardship, but the burden has to be shared equally.

The Greek Truth Committee on Public Debt made the argument that good faith was a part of *pacta sunt servanda* according to article 26 and article 69 (2) of the Vienna Convention of Treaties. The Committee claims that the memoranda violated the Greek constitution and therefore they lacked good faith.[648] Good faith can be disputed, while the ranking of norms and obligations can not.

The Truth Committee also bases its argument for the precedence of human rights over contractual obligations on the UN Charter, article 103 and the Guiding principles on Foreign Debt and Human Rights.[649] It points out as well that there was no rule under international law that prevents States from declaring bankruptcy.[650] This appears to be correct.[651] But from a tactical point of view it seems to be better to repudiate payment claims because the claims of the lenders are legally flawed, rather than to decide on a bankruptcy unilaterally because this does not resolve the legal problem on which the legal dispute is based. After all, a unilaterally declared bankruptcy should result in a worse credit ranking than a dispute resolution based on the rule of law.

When it comes to the repudiation of claims, the ranking of norms and State obligations is therefore an important factor to be considered.

648 Truth Committee On Public Debt, 'Preliminary Report' (2015) Hellenic Parliament, Athens, Greece 58 nr. 1
649 ibid 59 nr. 3
650 ibid 61 nr. 2
651 Sabine Michalowski, *Unconstitutional Regimes and the Validity of Sovereign Debt – A Legal Perspective* (Ashgate 2007) 35

3. The Right Allocation of Risk and the Radbruch Formula

In the cases of Leukerbad, Iceland, Greece and Portugal, one could observe the attempt to reallocate risk from those who caused it, to those, who didn't – the citizens. In the context of risk, one could argue that one aim of law is to either sanction risky behaviour or to allocate risk correctly so that it would be borne by those who caused it. The principle of liability for one's actions is also a cornerstone of the free market economy. If nobody had to bear the consequences for their risky behaviour, there would be no limit to risk. Radbruch's starting point for his article "Gesetzliches Unrecht und übergesetzliches Recht"[652] was the political abuse of criminal liability based on the German criminal code during the Third Reich. But his work is also valid beyond criminal justice. He argues expedience for the common good, justice and legal certainty were the aims of law. Legal certainty could eventually lead to a conflict with the aim of justice because not every law that is certain is also just – which is also reflected in the discussion about the rule of law v. the rule by law. Radbruch writes "where justice is not even attempted, where equality, which constitutes the core of justice, has been deliberately denied in the establishment of positive law, the law is not only "incorrect law", but rather lacks any legal nature at all. For law, even positive law, cannot be defined in any other way than as an order and statute which is intended to serve justice."[653] He argues, a judge would therefore need to decide against the positive law if it violates the principle of equality and for a just solution. Radbruch discussed the application of his formula in the context of norms that were unjust, especially criminal law norms. Yet, by way of analogy it can be argued that the attempt to legally shift the risk from a party that caused it, to a party that was not involved in the risky activity is similar to a norm that disregards equality and therefore justice, since the party that caused the risk gets preferential treatment by the judiciary or by the government, if such a legal shift of risk takes place. Equality before the law would require that the one who causes the risk also bears the liability. But not only the Radbruch formula works in this context, this approach can be likened to a contract to the detriment of third parties. There is very little research on this topic,[654] probably because each legal order seems to agree that there needs to be an expression of will and an intend to be bound, or an activity that results in legal liability. Absent of a will or an activity, it is impossible to assign legal responsibility.

652 Gustav Radbruch, 'Gesetzliches Unrecht und übergesetzliches Recht' Süddeutsche Juristen-Zeitung (1946) 105

653 Ibid 107 III the original reads: ""wo Gerechtigkeit nicht einmal erstrebt wird, wo die Gleichheit, die den Kern der Gerechtigkeit ausmacht, bei der Setzung positiven Rechts bewußt verleugnet wurde, da ist das Gesetz nicht etwa nur "unrichtiges Recht", vielmehr entbehrt es überhaupt der Rechtsnatur. Denn man kann Recht, auch positives Recht, gar nicht anders definieren denn als eine Ordnung und Satzung, die ihrem Sinn nach bestimmt ist, der Gerechtigkeit zu dienen."

654 See for example: Balázs Tőkey, *A szerződések hatásai harmadik személyekre* (Wolters Kluwer 2020) and Benjamin Porat, 'Contracts to the detriment of a third party: developing a model inspired by Jewish Law' University of Toronto Law Journal (2012)

In the *Pringle* decision, the ECJ screened off the banks from their responsibility for their bad lending decisions and shifted the risk to the European Stability Mechanism, the expenses of which have to be borne by the European citizens, which had nothing to do with the banks' poor management. The ECJ facilitated the transfer of liability from some private lenders to the citizens of the EU, so it gave banks a preferential treatment. This is not the only unequal treatment in this decision because while the ECJ upheld the liability for Greece, its judges also forced liability onto the other Member States who are responsible for the European Stability Mechanism, while these judges prevented the application of market discipline to banks. Above, in the second chapter, section 2.2., Grotius is quoted with "Treaties of an odious kind are those which lay greater burdens on one party than on the other, (...)."[655] This, it seems, is also the case with the ECJ decision here.

From the viewpoint of the repudiation of claims, a refusal to support the European Stability Mechanism with any further contributions, for example, could eventually be supported by this argument against the legally wrong allocation of risk.

4. Summary

Summing up, the thesis explains that the odious debt doctrine does not work because its elements are not defined properly and because it mixes criminal and contract law elements without considering economic mechanisms, while promising a simple legal solution that is based on the moral deficit of despotic regimes. On top of this, it does not clarify if odious debt is systematically more or less than a bankruptcy. After analysing court decisions, arbitration awards, financial regulations, contract law and human rights law, the thesis establishes that the odious debt doctrine is redundant, since there are sufficient standard legal tools available for the repudiation of sovereign debt and other claims, if necessary. Instead of trying to utilize a dysfunctional odious debt doctrine, it makes sense to work with the complete Tinoco Arbitration Award of Taft's, with the court decisions from Switzerland, Iceland, Greece and Portugal listed here as blueprints for various situations and last but not least to work with financial regulations and human rights law, if the repudiation of potentially questionable payment claims becomes necessary.

655 Hugo Grotius, *The Rights Of War And Peace Including The Law Of Nature And Of Nations*, M. Walter Dunne 1901, 180 nr. X.

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