Responsibility for Abusive Granting of Sovereign Loans

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I. ABSTRACT

This article develops two main points in the theory of responsibility for abusive granting of credit: first, the various case laws and doctrines developed in national legal systems (France, Belgium, Italy, Germany, the United States, England, Spain and Argentina) are summarized into a "general theory of the responsibility for abusive granting of credit"; second, it is argued that this general theory can be extended from private law to a general principle of international law, and thus can be applied to sovereign insolvency, and a specific example of such an application of the theory is sketched out. Furthermore, by way of an introduction, we explain the economic causes of sovereign over-indebteness, focusing on the behaviour of creditors.

We conclude that under restricted conditions, with a limited scope, and without disregarding the varied nature of the players (the state and its creditors of various kinds), there would be legal and economic justification for extending the application of the rules established in the original abusive credit context to sovereign debt. In particular, loans granted without following the most elementary prudential guidelines with regard to the analysis of credit risk should be subordinated to those not classified as abusive in the case of bankruptcy.

II. DESCRIPTION OF THE PROBLEM

Over the last few decades, commercial law in Europe and certain countries in the Americas have been confronted with a highly complex issue, both factually and legally: the responsibility of banks for the abusive granting of loans. Legal doctrine, and to a lesser extent case law, has put a lot of thought and effort into developing a balanced approach towards this problem, which remains a salient topic for debate among legal

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The conceptual framework on which the theory of abusive credit has been built arose in the context of private legal relations (banks as lenders and companies as borrowers). Its basic features are as follows: a lending entity that supports a company financially disregards the most elementary rules of credit risk assessment, encouraging investments and loans that are excessive and inefficient. This might cause real harm to third party
creditors who are in a commercial relationship with the recipient of the loans, and also to the general interest in banking activity.

Doctrine and case law that have considered this theory have centered mainly on the position of third party creditors. It has been stated that harm caused by abusive loans can affect both creditors existing prior to the granting of the credit and those subsequently becoming creditors.\(^3\) The former could be harmed by the fact that abusive credit could postpone the filing of bankruptcy. During this delay the financial situation of the debtor company might worsen, resulting in creditors receiving less than if bankruptcy had been declared sooner. Subsequent creditors, on the other hand, could suffer harm from having been seduced into granting credit to an insolvent company based on the mistaken assumption that the financing granted to the company by the financial institution demonstrated its healthy financial situation.

A fundamental characteristic of these types of loans is that they involve an abuse of commercial trust by banks that, either with deliberate intent or through negligence, end up triggering an incorrect assessment of the actual state of the company. The importance of confidence and appearance in the context of the financial market is, therefore, a leading element in the analysis of this type of responsibility.\(^4\)

The earliest case law referring to the abusive granting of credit that concerned credit relations between banks and borrowing companies in France from 1876 to 1881. The theory of abusive credit has since been extended. It is already enshrined in the protection provided to consumers in the case of credit granted abusively by banks and companies supplying goods and services, commonly known as trivialization of consumer credit.\(^5\) The concept here is the same as that originally conceived in the strictly commercial sense: the granting of loans without due consideration of the borrower's repayment capacity. Furthermore, the abusive credit theory has been extended beyond the strict credit concept to include material assistance such as exists in business relationships. This situation could be described as non-financial over-stocking.

In a similar manner, studies of the public sphere have shown that states sometimes also award abusive loans to companies through public financial entities\(^6\). The possibility has even been examined of holding the state responsible for indirect assistance it might provide to companies, either through undue delays in collecting fiscal or social security contributions, or by providing support through assigning or reserving markets (mainly in the field of public services).

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3. See specially the French, Belgian and Italian academic and judicial production quoted supra, note 2.
The notion of the lender has thus been broadened to include not only banks, but also the state itself. Borrowers can be consumers, not just enterprises, and the nature of the credit has grown to include material as well as financial assistance. The common denominator is always the granting of credit (or confidence) regardless of the merit of the borrower as determined by credit risk analysis and how this could cause harm to third parties.

Here we will focus on one particular form of abusive credit, the granting of abusive credit to states, commonly known as sovereign lending. Although a pressing problem, it seems that it has received only limited attention in the past. We will shortly demonstrate that the theory in question could find support (although with varying degrees of acceptance) in the legal doctrine and in the case law of various European countries, the United States and Argentina. In the second section, we will explore the theory, analyze its justification, and highlight the common denominators found in the various domestic jurisdictions. In the third section, we will carry out an analysis in search of general legal principles that could be assigned universal validity and their application to sovereign insolvency. However, first the causes of sovereign over-indebtedness and its development will be described, as they form the basis for the application of this theory of abusive loans.

III. SOVEREIGN OVER-INDEBTEDNESS AND CAUSES OF THE DEBT CRISIS

The relationship between the cycles of the real economy and the evolution of external debt, and, in turn, the way in which debt cycles follow one another, form the overall framework for the interpretation and analysis of the behavior of sovereign debtors and their lenders.

The origins of the current debt crisis can be found in the heavy indebtedness incurred in the 1970s. The apparent reason was a strong systemic inflow of financing from developed nations, which was to some extent due to the massive recycling of petro-dollars that were partly from the euro-dollar market, and to the establishing of a legal system that facilitated and encouraged loans to the countries in the southern hemisphere. On the actor level, lending banks adopted a so-called "loan pushing" policy, granting loans to sovereign nations that did not possess a repayment capacity in accordance with the volume of debt they were contracting.

The dictatorial nature of many borrowing governments contributed to an inefficient use of the loans. This was complemented and reinforced by, among others, capital flight, the financing of unrealizable and unprof-

7. Using the method originally proposed by H. Lauterpacht, Private Law Sources and Analogies of International Law (With Special Reference to International Arbitration) (The Lawbook Exchange, Ltd.) (2002).
itable projects, the maintenance of unviable monetary systems, corruption of public officials, waste of funds, and by the nationalization of private debt. These imbalances accentuated the discrepancy between the debt incurred and real repayment possibilities.

Notwithstanding the early warning issued by the World Bank’s Pearson Commission (1969),

banks and head office regulatory bodies failed to perform elementary evaluations of the real risk implicit in these operations. Loans were granted in violation of basic principles of bank prudence, whether viewed individually or in relation to their overall effect on bank balance sheets.10

At the beginning of the 1980s, the abrupt and significant increase in interest rates for loans, combined with a marked deterioration in the terms of trade for the indebted nations, threw the inability of developing countries to repay the loans into sharp relief. First arrears appeared and lending was subsequently suspended. The risk of collapse faced by leading U.S. banks due to the failure of their debtors to repay sovereign debt led international financial agencies (IFIs) to intervene and sponsor rescue packages for those banks. At the same time, the banks were pressured into continuing to finance these debtors so as to prevent them from defaulting, all of which led to an even higher stock of debt.

Together with the granting of this so-called “fresh money,” structural adjustment programs were implemented based on the false premise that the problem was one of short-term liquidity rather than of long-term solvency. Recognition of the need to reduce the debt came with the Brady Plan, which made it possible to transfer this portfolio of “hot loans” to other private investors once bank reserve levels had recovered.11 The Brady Plan provided structural adjustment programs with continuity, reinforcing Washington Consensus policies, and, in particular, foreign direct investment in response to deregulation.12

After initial optimism, which was soon revealed to be unfounded, the 1990s saw increased financial indebtedness of sovereign debtors who received a significant amount of speculative short-term investment, mainly through sovereign bonds.13 As a result, over-indebtedness was further increased, aggravating in that way the financial vulnerability of these countries, provoked by the short-term and the foreign currency structure

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10. LICHTENSTEIN, supra note 8.
of their debts\textsuperscript{14}. This led to new defaults, to which conditions arguably contributed, and to restrictive adjustment policies. When confronted by defaults, the International Monetary Fund (IMF) reacted by granting financial rescue packages with consequences of dubious benefit.

In repetition of a stylized fact of the 1930s crisis, this period was characterized by the fact that a substantial part of government bonds were issued and acquired without due diligence for the real possibilities of payment by the sovereign debtor. Certain banks and bond-placing agents again appeared to have adopted an opportunistic, and at the same time determining, attitude in executing such actions, channeling the investment of hundreds of thousands of savers to borrowers whose repayment capacity was not always adequate. The IFIs may have contributed to this bubble with an official criterion for external debt measurement that places more importance on payments to be made by the debtor than on arrears on the total debt owed.\textsuperscript{15}

Efforts were made to reduce the debt of the poorer countries (the Highly Indebted Poor Countries initiative)\textsuperscript{16}[cite], but the limited and discretionary use of this plan meant that it was practically ineffective in the face of the problem of sovereign over-indebtedness. This fact, together with the cyclical deterioration in terms of trade and the dependence on external financing which this generated, might have led to a change in the way the debt problem was confronted, inspired by the principles of bankruptcy law. Following these principles, in the case of insolvency, debt is reduced to sustainable levels that are achieved by spreading the financial burden between debtors and creditors. Among the latter, the loss is distributed on the basis of the elementary criteria of justice and equity, principles to which the theory of abusive credit can make a contribution.

IV. GENERAL THEORY OF RESPONSIBILITY FOR THE GRANTING OF ABUSIVE CREDIT

In this chapter I will attempt to systematize and synthesize a general theory of responsibility for the granting of abusive credit, based on the minimum common denominators of the private law systems of France, Belgium, Italy, Germany, England, the United States, Spain, and Argentina.\textsuperscript{17} Clearly, the country sample is not sufficiently large and a more extensive comparative study would be required for results to be generalized. However, it is a representative sample in that it takes into account

\begin{itemize}
  \item \textsuperscript{14} IBD, Living with Debt. How to Limit the Risks of Sovereign Finance, Economic and Social Progress in Latin America, 2007 Report, IBD, Washington, 2006
  \item \textsuperscript{16} See details of this initiative in www.imf.org.
  \item \textsuperscript{17} For a detailed analysis of each of these legal systems and their copious jurisprudence, see J.P. BOHOSLAVSKY, CREDITOS ABUSIVOS. SOBREDEUDAMIENTO DE ESTADOS, EMPRESAS Y CONSUMIDORES (Ed. Abaco Buenos Aires) (forthcoming 2009).
\end{itemize}
most of the legal systems of the main creditor countries to which developing countries are indebted, and the countries whose influential position shapes the international environment in which, as it will be proposed below, to apply these principles.

Specialized doctrine and case law have developed the need for covering the abusive credit topic under the same title, but it should not be considered exclusively as a civil liability issue (although the substantive aspects of abusive credit have mostly been developed in this context). Indeed, bankruptcy rules have made their contribution, in particular with regards to the subordination of credits. For this reason, in this paper "responsibility for abusive credit" implies the duty to rebuild net worth after harm has occurred through abusive credit lending as described by the general theory. Depending on the legal system involved, this could be channelled through civil liability or solutions that are typical of bankruptcy tools, with subordination being the most important of these.

Lenders are not unaffected by the consequences that their loans may have on borrowers and third parties. The externalities generated by such behavior in the market are not minor, and have led to the inclusion of a special deontology for the exercise of the banking profession. In other words, it can be said that there is a general principle based on the protection of legitimate expectations. While admitting a very wide discretionnal margin appropriate to the risk implicit in the activity, banking rules impose minimum standards of professional diligence in relation to the evaluation of credit risk on loans.18

Grantors of credit who act with the intention of harming other creditors must answer with their own wealth for such acts. This relates to loans that deliberately support borrowers who are in insoluble economic difficulties (inappropriate loans), as well as to loans made to those that perform illegal activities (unworthy loans). In the case of inappropriate loans, the irreversible state of economic collapse forms part of the structure of the illicit act, as an unreasonable risk is assumed in providing financial support that can only delay the fatal bankruptcy solution, further eroding the net worth of the debtor's assets.

The second category of loans is defined by the unworthy nature of the customer and the activity he performs, which are covered by the appearance of reliability implicit in the loan as well as by the illicit means used to obtain it19. The first category includes companies with illegal intentions (tax or customs fraud, import of forbidden products, etc.), those that have a legitimate purpose but which carry it out in an illicit manner (typical "dummy corporations" without economic substance, performing economic activities that are not translated into real operations but into fraudulent maneuvers), and those that tend to be linked to or-

19. Id., p. 34.
organized crime. The second category contemplated by unworthy credit is related to the irregular means used to obtain financing.

The margin for contractual freedom operates within the limits imposed by law, fundamentally through the guidelines that have been established by case law. Each legal system imposes differing limits; a (perhaps overly) simplified outline could be that France and Belgium are the strictest, followed by Italy and Argentina, and then Spain, the United States, and lastly, Germany and England.

Negligence, the most frequent case in the evaluation of credit risk, is even penalized in some countries. For example in Belgium (section 1382, C.Civ.), Italy (section 2043, C.Civ.), to some extent in Spain (section 1902, C.Civ.) and Argentina (sections 1109 and 1113, C.Civ.), and to a lesser extent in the United States (Bankruptcy Code section 548). In Germany and England, this penalization only applies under certain limited circumstances.

France is a somewhat particular case. It was in this country where the theory of the responsibility for abusive credit was born and grew vigorously. Its tort law (sections 1382 and 1383, C.Civ.) allows the offended to claim when she was negligently harmed. But a recent July 25, 2005 Act modified section 650 of the French Commerce Code to limit this specific kind of responsibility to cases of fraud. This legislative technique, however, has been defective and there is confusion about the real extension of this legal reform.20

In the United States negligence claims are restricted. With the exception of a situation implying control relationships by banks that require special duties of care, the trustee can only attempt to obtain a declaration of nullity if he is able to demonstrate that the creditor attempted to hinder, delay, or defraud the interests of the remaining creditors (Bankruptcy Code s 548). Subordination of the loan can be claimed if an inequitable behavior resulted in harm the remaining creditors, or if one of them was granted an unfair advantage in detriment to the interests of the rest (Bankruptcy Code s 510(c)).

These limitations on responsibility in cases of intent are rather academic, as the implicit fraud contemplated by section 548 establishes that there is no need to demonstrate the intention to defraud the remaining creditors. All that is required is a lack of proportion with regard to the performance (harm) and concurrence of a situation in which the debtor is collapsing, or, more specifically, an awareness of the lack of repayment capacity of the borrower. All of this indicates the subjective element of the lender.

In Germany it is necessary that a situation of undue privilege in relation to the remaining creditors (Bürgerliches Gesetzbuch [BGB] [Civil Code] section 826) exist. An example would be the Konkursverschlep-pung, whereby a bank puts off filing for bankruptcy against a customer to the detriment of the remaining creditors so as to give the bank time to foreclose on any collateral in its favor that it may have been able to obtain, or on such assets as may still remain in the possession of the debtor. Nevertheless, it will be necessary to monitor the interpretation by the courts that will be given the new text of articles 241 and 311 of the BGB on the matter of contracts with protective effects for third parties.

In the case of England, unless there is a situation where the company is controlled by the bank (shadow director), claims for compensation are only admitted when there is an intention to defraud the remaining creditors and thus to take unfair advantage of them (fraudulent trading, Insolvency Act 1986, section 213).

The lack of an absolute consensus on the matter of responsibility for the negligent granting of credit is only of relative importance in light of the fact that all of the legal systems that were analyzed allow for the proof of intent through evidence. This includes the proximity of the bankruptcy date, the performance of irregular activities, the setting up of excessive collateral, and the high rates of interest being required. All of these effectively provide guidance that removes the drama from the discussion of the required subjective element. What is important is that it should be possible to infer iuris tantum from certain determined events that the grantor of the credit has intended to gain an unfair advantage with its loans or to cause harm to the remaining creditors.

Regarding the measurement of damage, it has to be distinguished between creditors pre-existing to the harmful action and subsequent creditors. In the case of legal systems that recognize civil responsibility for abusive credit, it is well established that in the case of pre-existing creditors the damage is measured in terms of the difference between what they would have received if the debtor’s situation had not worsened as a result of the abusive credit and what they did actually receive in the distribution from the liquidation process. In the case of subsequent creditors, the damage will be determined as the difference between what they should have received according to the contract and what they effectively received once the debt had been reduced as a result of the bankruptcy.

There is also a general agreement that the receiver in the bankruptcy process is the legitimate party to demand compensation for the collective harm caused by the erosion of net worth of the insolvent party from the excessive credit granted by the lending entity (damage to pre-existing creditors). On the other hand, the latter must claim damage to subsequent debtors seduced by the apocryphal solvency generated by the abusive credits independently and autonomously since the damage is individual and specific in each case.
As indicated above, the remedies used to correct the situation arising from abusive credit vary according to the legal system, with the existence of two basic mechanisms: claims for compensation by the means of bringing a legal action for extra-contractual responsibility (France, Belgium, Italy, Germany, and Argentina) and the subordination of credits (England, United States, and Spain). The latter country is unusual in that it contemplates the possibility of subordinating abusive credits (for example, LC articles seventy-three and ninety-two), but at the same time subsequent creditors are able to file claims in accordance with the rules on tort liability (for example, article 1902 C.Civ.). The common denominator can be found in the intention to undo the effects of the credit qualified as abusive on the company’s net worth, and thus on the rest of the creditors.

The controversial case of responsibility regarding the borrower itself (excluding fraud or collusion), and the consequent possibility of direct claims, should not present any major difficulty. Such responsibility would be inadmissible in the central hypothesis of loans granted in an imprudent manner, as the borrower is in the best position to determine its own repayment capacity. Regardless, any claim that the borrower might have brought in would be covered in its purposes and effects by the claims filed by the trustee or the creditors themselves, or in subordination of credit where appropriate, as they too aim for a recovery of the net worth of the debtor.

As the central idea of such claims is based on the notion of compensation for harm, it is plausible to seek to distribute blame and causal links among the various interested parties in the structure of this injurious hypothesis, and consequently, to assign portions of joint responsibility. This includes putting the victims of the consequences of abusive credit into a priority order.

The situation of individual borrowers has also given rise to the setting of limits on the power of banks. A growing body of legislation has addressed consumer over-indebtedness that obliges the parties that made such indebtedness possible to share some of the sacrifice arising from the insolvency of the debtor in order to instigate lenders to make a more careful evaluation of the reimbursement capacity of individuals.21

Several common denominators have thus been found in the sophisticated legal technique applied to the problem of abusive granting of credit; depending on the domestic legal system under examination, this principle is admitted to varying degrees—substantive and procedural—by the respective tort or bankruptcy laws, as well as by consumer statutes. Structural differences in economic areas (higher influence of the banking

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system or of capital markets) of countries with respect to lending institutions appear to have an influence on the development and scope of the theory of responsibility for abusive credit. However, this tends to become diluted in the case of the international financing of states, because, in the field of international sovereign loans, the uniformity of financial activity—and banking in particular—is greater than in the domestic environment. This encourages the drafting of universal rules in the field of sovereign loans.

V. APPLICATION OF THE THEORY OF ABUSIVE CREDIT IN THE AREA OF SOVEREIGN LOANS

The similarities between sovereign and private insolvency justify exploring the possibilities of applying the rules and remedies of collective action problems to the field of sovereign lending. These have been developed fundamentally in the sphere of bankruptcy law.

Of course, sovereign and private insolvency have obvious differences resulting from the fact that states cannot be liquidated and dissolved in the same way as legal persons (at least not as a result of their insolvency). Although with declining effect, they enjoy immunity of jurisdiction and execution. In addition, restructuring of sovereign debt cannot justify the loss of governmental control by the entity, unlike the situation in the private sphere. The reduction of the debt, while in the case of private entities is a legal requirement, is subject to a decision that can be either agreed upon mutually or taken unilaterally in the sovereign sphere.

None of this is an impediment to considering the two situations substantially comparable. Both types of borrowers are unable to repay their loans. The origins of such situations also coincide (the situation has come about as a result of the inadequate use of borrowed funds combined with excessive, hazardous lending by creditors), and, in both cases, creditors must accept a reduction in their claims while borrowers undertake to repay the lower debt agreed on, with suitable collateral, all of which is laid down in an official document (a legally approved reorganization program).

The notion that "states don't go bankrupt" is refuted by the factual existence of hundreds of sovereign defaults, for which the definition of over-indebtedness should be situated in an intermediate point between the technical concept of insolvency (inability to service debts), the special sovereign capacity to generate income, and the limits imposed by law (dignity of debtor), whether domestic or international.

It has been this effort to achieve bankruptcy transposition that has inspired the work of specialists, official bodies and the courts, to define the scope of legal rules such as *pars contictio creditorum*, to suspend legal action once insolvency has been declared, to promote post-bankruptcy credits by means of the recognition of preferential collection, to require the majority of creditors to change the terms of the contracts that document the debts, and to reduce liabilities as a result of the insolvency of the sovereign debtor.

The common denominators outlined in the above section are the basis for attempting to transpose the theory of responsibility for the abusive concession of credit from the domestic legal systems to the field of international law (article 38.1 (c) of the Statutes of the International Court of Justice). Based on a restrictive criterion, the principles derived from the general theory of abusive credit can be summarized in this more specific field as the prohibition of unfair behavior by the granters of sovereign credit.

Regarding the sovereign sphere, this theory seems to fall between the two types of proposals that characterize the current state of legal thinking in the field of sovereign insolvency: the so-called “collective action problems” (in their basic categories, the insolvency models and the collective action clauses), and, on the other hand, the thesis that rejects the validity of debts (on the grounds that they are odious).

Conceptually, the theory of abusive credit is nourished by elements provided by both types of proposals, adding its own particular characteristics. This is how some loans are reprehensible (because of their abusive nature, given the irrational risk implicit in them) but are neither fundamentally void nor reduced as a result of the debtor’s inability to pay. Instead, they are subject to moral reproach, having been contracted in the context of a situation of insolvency, which, as a consequence, justifies a restoration of patrimony.

While there are two procedural options, in the sovereign sphere only the subordination of credits would be applicable because the system of civil responsibility that requires the trustee to bring in claims is not viable. This is because in addition to the lack of such a figure (trustee), it would lead to an endless stream of crossed claims, and for this reason it is necessary to come up with a “self-sufficient system” adapted to the characteristics of sovereign insolvency. Furthermore, the immunity of IFIs (to the limited extent to which it should be formally admitted) regarding claims for compensation makes extra-contractual civil claims as a basic procedural system even more inadvisable. This is because autonomous

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24. It has been recently proposed the application of the debt subordination principle to the sovereign debt field, but it is based only in the US law and related to the odious condition of certain debts. See A. Feibelman, *Contract, Priority, and Odious Debt*, 85 N.C. L. REV. 727 (2007); A. Feibelman, *Equitable Subordination, Fraudulent Transfer and Sovereign Debt*, L. & CONTEMP. PROBLEMS (forthcoming 2008).

claims are then admitted only in the case of subsequent creditors, a hypothesis that in practice is extremely limited as will be seen further on.

In the sovereign case, subordination simultaneously provides a comprehensive solution for all the credits involved in the insolvency and avoids leaving them subject to the vicissitudes common to claims that involve states. As far as substantive aspects are concerned, there are two reasons for a sovereign debt to be rated as abusive. First of all, inadequate risk analysis could be grounded in economic circumstances and lead to lending to a state that from the beginning can be seen to not be in a position to repay the loan (inappropriate lending). This could be the case when the loan is disproportionate in relation to the state’s repayment potential and when it was granted in the context of the debtor’s insolvency. Such a situation could arise, for example, when loans are renewed or debt is rolled over even when it is evident that default is inevitable. These agreements could enable the creditor to obtain better contract terms, including an increase in interest rates, improved payment guarantees, or increased credit.

Secondly, there are so-called “unworthy loans” that generate an appearance of morality that, in the case of the state, implies the concealment of the state’s real economic situation from third parties. Irrational risk has a moral quality and can have economic consequences if the government’s seriously reproachable activity or condition is disguised and if this eventually affects the possibility of collection (for example, in the case of corrupt governments, or if entering into illicit agreements). Furthermore, it can facilitate the occurrence of damage from such activity, covering a spectrum that ranges from human rights abuses by the dictatorial government that has been provided with financial support to environmental damage caused by the activity being financed and the harm derived from collusive agreements.

It is thus in the field of inappropriate lending where the theory of abusive credit can make its greatest contribution to the problem of sovereign debt. In the case of unworthy loans, the doctrine of odious debts has already developed sound arguments to justify the need for lenders to answer to the debtor state and its victims. Therefore, the situation in which unworthy loans assume the greatest significance in the context of responsibility for abusive credit is when they provoke economic repercus-


sions derived from concealment of reality by providing the debtor with an appearance of reliability.

From the 1970s to the present, the ways in which states have been able to borrow money can be categorized as follows: bank loans, which were adopted by the credit market up until the Brady Plan (1989), official financing by IFIs, and the issue of bonds and the atomizing of the debt among millions of bond-holders. Each of these situations is different and thus requires a different focus.

The specific analysis should be evaluated according to criteria established by the general theory on abusive credit: whether there was a duty to act prudently, whether it was deliberately violated, or whether the creditor was harmed due to lack of due diligence (the duty to self-inform). It should also be studied whether the creditor claiming to be a victim has indeed been harmed, and if there was a causal nexus between the abusive credit and the impact on this creditor.

The peculiarities of each class of creditor and each type of operation will determine what will be required for the definition of responsibility. In principle, those creditors with the greatest resources available to evaluate the credit risks of the loans, and which have the largest volume of financing availability, will be more likely to incur this type of responsibility. For example, it will be necessary to take into account considerations such as the fact that banks and investors act for profit, so that their behavior is presumed to be rational from an economic point of view. Therefore, a bank could not claim in its defense that there are extra-economic reasons for its decision to grant loans, unlike the situation that could exist in the case of bilateral loans ("political debt" under the nomenclature of the International Working Group on External Debt Statistics).

Banks could be expected to act with highly skilled diligence in carrying out their lending since their decisions are a signal to the market that must not be sent out arbitrarily as it could generate negative externalities.²⁹ The sphere of sovereign credit is no exception. Although it is true that sovereign risk presents features that are more complex to evaluate than private risks, there are, within certain limitations, technical possibilities of forecasting whether or not a state will be able to pay its debts.

With regard to loans granted by states, they often have a political motivation. Prima facie, they would not seem to be capable of generating false appearances because serious, grounded expectations cannot be placed on them based on any risk analysis preceding the granting of the loan. However, credit granted for commercial reasons could be an exception to this principle. Loans between states frequently do not explicitly indicate the existence of these considerations, so that in their absence it would have to be assumed that what the official lender intended was to

profit from the business. This implies the assumption of precautionary duties that form part of the rules on the evaluation of credit risk.

In the case of IFIs, whether the IMF or international development banks, although their intention is not to make profits from their lending activities, they make money and they aim at doing so. Their respective charters require them to ensure that the loans granted to member countries will be repaid, which presumes a proper evaluation of the sovereign state’s payment capacity. This prudent duty is not adequately encouraged because of the de facto nature of a preferred creditor that the IMF claims.\textsuperscript{30} Loans granted by the IMF, together with its approval of a country’s policies, have on more than one occasion acted as a true solvency credential for the sovereign country (although in the light of the failure of so many programs, this is a principle that needs to be very carefully weighted).

The conditions that IFIs attach to their loans can also contribute to the postponement of definitive solutions with regard to the debts of such countries. These conditions respond to policies promoted mainly by the IMF and the World Bank, and could fail, thereby aggravating the situation of member states. These IFIs often tend to act in the role of consultants, and their recommendations regarding the functioning of the economy in general, and specific projects in particular, could cause severe harm to the country itself and third parties if they fail to comply with elementary rules of prudence. These circumstances could aggravate responsibility for the granting of abusive credit.

The sale of sovereign bonds worldwide can also enable a state to overdraw its account while postponing the inevitable recognition of its inability to face its financial commitments. Nevertheless, there are two weighty factors that lead to the conclusion that bond purchasers could only be assigned responsibility in very exceptional cases.

In the first place, the amount of bonds acquired on the market by each individual investor has an almost negligible impact on the overall economic situation of the debtor. While total bond issue amounts can have decisive influence, this global causality cannot be attributed to creditors holding such truly insignificant credits. As a separate matter, this does not, however, prevent abuses committed by the traders of the bonds, which make them responsible towards the customers who are victims of such financial intermediaries’ behavior.

Secondly, small investors (who are in fact financial consumers in the context of “popular capitalism”), unlike institutional investors, lack the human and technical resources enjoyed by IFIs, governments, and lending agencies when evaluating the risk of lending transactions, making

small bondholders more likely to be victims of abusive lending policies than to be responsible for them. The amount of any bond purchase tends to be proportionate to the technical and economic capacity of the purchaser, and these two circumstances impact on the subjective element and the causal nexus between the behavior of the grantor and the harm recorded by subsequent creditors.

Despite the multiplicity and complexity of factors impacting on the economy of a country, it is intended to isolate the situation whereby in the normal course of events it could be assumed that reduction of the debt as a result of insolvency would be fatal. It is true that it is difficult for a single creditor to grant a loan so large that it could on its own postpone a country’s declaration of insolvency, but in the case of a group of banks (syndicated loans), institutional investors, or IFIs, this is not unthinkable (a case of large clients). As an example, lending creditors agreed on the blindaje financiero (2000) and megacanje (2001) for Argentina.

In the case of the proposed model, it is necessary to bear in mind the logical and procedural sequence of application of the legal filters. In the case of sovereign insolvency, the liability would be determined after deduction of void debt. Once the claimable liability has been determined, distribution criteria would be established for the segment of debt to be discounted as the subsequent step and as a natural consequence of any collective insolvency process. The legal content of that criterion of distribution should respond to general legal principles in relation to abusive credit, operating through the subordination of the loans qualifying as abusive.

It is recommended that the final decision on the subordination criteria and reduction of the debt should remain in the hands of a neutral, specially convened arbitration tribunal. In any case, it is necessary to point out that on a subsidiary basis, the absence of any mechanism or procedure for sovereign insolvency requires the adoption of international custom on the matter. However, this does not apply when the debt contracts foresee waivers in favor of only one foreign jurisdiction, and as long as those waivers do not violate the limits imposed by the constitution. This means that, notwithstanding sophisticated and even official doctrinal proposals, the legal rules on the basis of which the rebuilding of net worth in the case of abusive sovereign credit would be carried out (residually), would not require the passing or modification of domestic or international regulations.

Accordingly, the state, on the basis of fair discussions with creditors, will determine the objective criteria whereby it will assign greater responsibility to certain creditors, leading to their subordination, which in the context of insolvency will in all probability imply failure to collect at least part of their claim.

The possibility that it could be the sovereign debtor itself (or its judges) that finally decides on the distribution criteria, would act as an incentive for all creditors to propose or accept an independent arbitration system. Likewise, states that are not willing to commit to a neutral decision-making system would be pressured by market reaction because of their reluctance to grant such waivers.

In any case, it would be advisable that an international treaty be approved which gathers and organizes the principles referring to the responsibility of abusive lending, thereby providing clearly established rules in relation to sovereign loans.

In the remainder of this section, we will outline one possible way to apply the general theory of abusive credit in the sovereign sphere to a particular case; we chose the Argentine default on its debt in 2001. One possible venue for this approach could be the IMF’s performance in Argentina over the last fifteen years. There exists a notable coincidence with the conditions that the general principles of abusive credit require for a duty to exist to compensate, which would suggest subordination of the debt.

The recent settlement by the Argentine state of the full amount of its IMF debt (2005/6) might seem to indicate otherwise. However, payment was arguably made "under protest" given that it was accompanied by a warning of the pernicious effects of the IMF’s loans and policies. The payment itself could be regarded as justified by the economic, political, and financial benefits for the country following from the independence of IMF conditioning; the abusive nature of the credit thus need not be wiped off.

Future claims for damages against the IMF for the allegedly abusive nature of its loans can thus not be excluded. Nevertheless, the most appropriate and technically correct procedural option for abusive sovereign credit is the subordination of loans rather than claims for damages, in view of the practical and theoretical limitations that such claims could face: Who would be authorized to claim? Is it possible to sue the IMF? Where? Who would benefit from any compensation? How would it be distributed? All this points to the advisability of implementing comprehensive, simultaneous solutions that only the credit subordination system would offer.

Another aspect is the behavior of bond brokers regarding Argentine debt. One element that contributed to the euphoria of the 1990s was the behavior recorded by the agents that brokered the Argentine bonds at the end of the decade and in 2000-2001. They violated the most elementary financial prudence guidelines, as evidenced by the rising volume of case law (Germany, Italy) that has made banks responsible for the harm


caused to their investing clients because they failed to fully and truthfully inform them of the risks implicit in the "Tango" bonds (lack of due diligence in giving advice). Although the general theory of abusive credit considers the concurrence of causes as normal, the adage of res ipsa loquitur arising from the Argentine case allows it to be inferred that as a rule various creditors—and even the debtor itself—would be held responsible for the generation of the harm that it is intended to repair.

Next, we will review a few possible interjections to our proposal. The question of the applicable law is not grave, since regardless of whether one applies the law of the domicile of the creditor, that of the debtor, or general principles of Law, the possibility of challenging the abusive granting of sovereign credit can be admitted in court. Yet, we have to pay attention to the following aspects enunciated below. Rules of conflict of law should be taken into account to determine the competent jurisdiction as well as the substantive rules applicable in cases where responsibility is recognized for the abusive granting of credit.

Furthermore, it should be borne in mind that although it is not a matter that has been developed by pertinent case law, and, although it can be explained by resorting to both international practice on the matter and to the sovereignty principle, when harm materializes in the form of a deterioration of the situation of the debtor (previously-existing creditors) it makes most sense to say that the harm occurred in the debtor country itself. For the determination of the question of jurisdiction, it follows that the sovereign debtor should have jurisdiction over such matters in a subsidiary manner to the setting up of a neutral arbitration tribunal.

On the other hand, if the damage derives from unwarranted trust that abusive credit has encouraged in others, and if an arbitration tribunal is found not to be viable (and/or politically undesirable), the place of fulfillment of the contracts with the creditors who have been harmed will determine the place where the harm has been perpetrated. In any event, the system used for claims by subsequent creditors is of secondary interest, as the claims filed by those who bought bonds (increasingly being syndicated) against the intermediaries who sold them (based on the main hypothesis of false appearances and misplaced confidence) largely satisfy the interests of those creditors who could be classified as "subsequent" in the framework of the theory of abusive credit. When these creditors are not satisfied by these contractual claims, they should be incorporated into the general subordination rules.

In the restricted case of collusion between lenders and officials of the sovereign borrower, where the debtor states themselves may be claim-

ants, it would be necessary to determine where the events took place and where their effects were recorded (again only in the case that it is not possible to set up an arbitration tribunal).

Given that the institutional framework to which sovereign insolvency is connected may change, for example by granting deciding powers to arbitration tribunals, it should be noted that the application of general principles of international law has been admitted not only at the International Court of Justice, but also at international arbitration tribunals.\textsuperscript{37} This means that the applicability of the principles described in this paper will not depend on the nature of the organ or body that defines the distribution of the financial burden according to the criteria that determine the responsibility for abusive credit.

Collective action clauses are unlikely to reinforce the principle of responsibility for granting abusive loans, since abusive creditors can be presumed to not give up voluntarily their claim on liquidated assets in favor of the other creditors. Lacking incentives from the legal framework, this collective action problem cannot be solved spontaneously by its protagonists. This is why all domestic bankruptcy systems foresee a third and impartial party for this kind of conflict.

Finally, we note that the idea proposed in this paper is in line with the requirements of contemporary arbitration jurisprudence regarding the protection of foreign investment: A foreign investor can only invoke the principle of fair and equitable treatment if she carried out the investment on the basis of an adequate risk evaluation; otherwise, the investor is responsible for any damage that arises (caveat investor test).\textsuperscript{38} This elementary legal guideline, in turn, reflects one of the guidelines of modern economics: it is neither possible nor desirable to protect all investments against any act that might affect them because this would be inconsistent with the efficient operation of a modern market economy, which requires the assumption of entrepreneurial risk for the earning of profit.\textsuperscript{39}

\section*{VI. CONCLUSIONS}

We attempted to show in this paper that, under restricted conditions, with a limited scope, and without disregarding the varied nature of the players (the state and its creditors of various kinds), there would be legal justification for extending the application of the rules established in the original abusive credit context to sovereign debt. We furthermore

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claimed that this would also impose higher standards of good practice on the participating parties—both public and private—in international finance and would therefore enhance the efficient functioning of market economies.

It should be pointed out that the theory of abusive credit, in both private and sovereign spheres, is based on a market failure. Abusive credit is a manifestation of imperfect and asymmetrical information, generating a negative externality for other market participants (for instance, former and subsequent creditors). This behavior violates the norms of professional prudence. Applying the legal tool of responsibility for the abusive granting of credit, protecting confidence as an ethical and legal principle is a corrective remedy for this market failure. It demands greater rigor from market agents in obtaining, processing and transmitting information, which will presumably impact on their financial behavior.

The theory under analysis is of particular interest when this credit phenomenon arises in the context of insolvency, where it becomes a typical class action problem common to such processes. Once some actors detect the real situation of the debtor, they might attempt to gain an unfair advantage over others. This is the point where the persuasive and reparatory mechanism of responsibility for abusive credit intercedes, promoting a constructive attitude by all creditors.

We note that our proposal does not address problems and inefficiencies that arise from the side of the borrower. Governments contract sovereign loans, and for this reason legal tools must be developed to prevent inefficiency and corruption, which would call for special regulations that limit these excesses. While exceeding the scope of this paper, this would be an interesting venue for future research.

Despite the fact that procedural aspects and the implementation of the principle of responsibility for granting abusive loans might need further development in which political variables would play a crucial role, we believe that the legal principle of responsibility for abusive granting of sovereign credit as examined in this paper can be applied in the international field, and that it would imply a sound rule of law for the economic players.