

# AGENCY BY ANALOGY: A COMMENT ON ODIIOUS DEBT

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## I

### INTRODUCTION

This brief article focuses on how one might think about the phenomenon of odious debt from the standpoint of common-law agency. Though this analogy has its flaws, some useful insights can be gathered by examining the similarities and differences between the two doctrines, especially when contemplating the theory of liability in the sovereign context.

The odious debt phenomenon itself is well described in other literature.<sup>1</sup> Although aspects of agency doctrine appear to hold promise as solutions for odious debt incurred by a sovereign borrower, this promise may be offset by other agency doctrines. More generally, it is important to keep in mind that agency doctrine is more complex than first appearances may suggest. Its complexity for present purposes stems largely from its reticulated quality that generates web-like interactions among separate doctrines. Each interaction poses dilemmas for the application of agency to the odious debt phenomenon. In particular, identifying the principal within the sovereign-debt context has awkward implications, as does the consensual relationship assumed by common-law agency between the principal (however defined) and the agent.

To illustrate the complexity of comparing odious debt to agency law, this article develops a series of comparisons between the consequences of borrowing by a sovereign and that by a private corporation afflicted with inept or corrupt management. It contrasts the Republic of Ruritania, a sovereign borrower, with Zenda Inc., a publicly traded corporation.<sup>2</sup> Zenda Inc. has a

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\* David F. Cavers Professor of Law, Duke University School of Law. Many thanks to my colleague Mitu Gulati for encouraging me to write this paper and for good conversations about agency doctrine and odious debt. I presented an earlier version of this paper at the 2006 Conference on Law and Business at Vanderbilt University.

1. I rely on the description in Lee C. Buchheit, G. Mitu Gulati & Robert B. Thompson, *Dilemma of Odious Debts*, 56 DUKE L.J. 1201 (2007).

2. Thinking about the odious debt incurred by Ruritania's rulers furnished a good excuse to reread Anthony Hope's novel, *The Prisoner of Zenda*, a late-nineteenth-century classic in the genre of adventure fiction. Its English narrator and hero, Rudolf Rassendyll, impersonates his look-alike cousin, Prince Rudolf of Ruritania, who has secretly been imprisoned in the Castle of Zenda to prevent his coronation as King of Ruritania. Prince Rudolf's imprisonment was the consequence of a scheme on the part of the novel's chief villain, Michael, the Prince of Strelsau, aided by the odious Rupert of

board of directors elected by its shareholders. Its board appoints and keeps in office a cohort of senior officers who incur obligations on behalf of the corporation. Zenda Inc.'s officers include an autocratic CEO, Rudolf, who incurs indebtedness on the corporation's behalf. In contrast, the government of the Republic of Ruritania is elected by voters who are citizens of Ruritania. Ruritania's President, coincidentally also named Rudolf, incurs debt that binds Ruritania. Though far from perfect, these comparisons afford us the opportunity to think critically about the opaque subject of odious debt in the context of more familiar and accessible contract doctrines.

## II

### THE LURE OF AGENCY DOCTRINE

It is not surprising that scholars who examine the odious debt phenomenon turn to domestic agency law as a source of basic concepts and doctrines. Within the common-law and civilian traditions, agency relationships are understood as ones in which one person's actions carry legal consequences for another, who has consented to representation by the actor.<sup>3</sup> Agency doctrine specifies legal consequences for agent, principal, and third parties whose interactions with the principal are mediated by the agent. Most importantly, these include the circumstances that determine whether the legal consequences of the agent's acts are attributed to the principal and the duties that agent and principal owe to each other. Contemporary accounts of agency do not depend on merging the agent's legal identity into the principal's; that an agent retains a legal personality distinct from that of the principal underlies the existence of limits on the scope of the agency relationship and the principal's responsibility for actions taken by the agent. In contrast, in earlier accounts of agency—most notably that of Justice Holmes—an assumed identity between principal and agent was crucial.<sup>4</sup> More contemporary accounts of agency thus appear to correspond to the distinction between a sovereign state and its officers or members of its incumbent government, who through their official actions represent the state but who retain legal personalities distinct from that of the state itself.<sup>5</sup> Contemporary accounts of agency also must take into account the

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Hentzau. "Anthony Hope" was the pseudonym of Anthony Hope Hawkins (1863–1933), a barrister who also succeeded as a novelist.

3. As defined by the Restatement (Third) of Agency, "Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006). For definitions within a contemporary civilian code, see LA. CIV. CODE art. 2987, 2989 (Supp. 2004). On the history of the agency provisions in the Code, see Wendell H. Holmes & Symeon C. Symeonides, *Representation, Mandate, and Agency: A Kommentar on Louisiana's New Law*, 73 TUL. L. REV. 1087 (1999).

4. See OLIVER WENDELL HOLMES, *THE COMMON LAW* 232 (1923).

5. For this distinction in the context of the odious debt phenomenon, see Ashfaq Khalfan, Jeff King & Bryan Thomas, *Advancing the Odious Debt Problem* 36 (Centre for International Sustainable Development Law Working Paper, Mar. 11, 2003), available at <http://odiousdebts.org/odiousdebts/>

temporal dimension of a principal's assessment of the consequences of any agent's actions—that is, the principal's assessment necessarily reflects how it understands its interests at the time of making the assessment, which may diverge from any assessment made by the principal at the earlier time of the agent's action.

Agency doctrine addresses two central problems that are relevant in the sovereign-debt context. First is the risk that a principal will use the situational advantage that any agency relationship creates as a basis for opportunistic speculation to the detriment of third parties with whom the agent deals on the principal's behalf. Time typically elapses between action taken by an agent and the point at which the principal may assess whether the legal consequences of that action are beneficial or detrimental to the principal's current interests. A principal may find it advantageous to deny that an agent lacked authority to take an action at an earlier time when, in retrospect and with the advantage of knowledge of subsequent developments, the consequences are ones the principal wishes to avoid. Acting through an agent might enable a principal to take opportunistic advantage of third parties with whom the agent deals on the principal's behalf because the specifics of the relationship between the agent and the principal—and in particular the scope of the agent's authority as communicated to the agent by the principal—are not transparent to the third party.<sup>6</sup> And if an agent takes action without authority that subsequently appears advantageous to the principal, the principal is not likely to object.

Contemporary agency doctrine mitigates against the risk that a principal will opportunistically deny that an agent acted with actual authority through a robust doctrine of apparent authority, which protects third parties who reasonably believe the agent acts with authority on the basis of manifestations by the principal. These manifestations may include placing the agent in a position that carries a particular title or customarily is associated with authority of a particular scope.<sup>7</sup> Thus, if all CEOs in Zenda Inc.'s industry have unilateral authority to bind their corporation to agreements to refurbish their own office spaces, a contractor whom Rudolf engages to redo his office who does not know that Zenda Inc.'s directors have restricted Rudolf's authority should be able to enforce the refurbishing contract against Zenda Inc.<sup>8</sup>

Second, not all agents act loyally in the principal's interest. Moreover, agents may—perhaps even with the principal's interests at heart as the agent erroneously then understands them—take action that exceeds or in some other way departs from the scope of the agent's actual authority. Agency doctrine

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publications/advancing\_the\_odious\_debt\_doctrine.pdf. On the earlier differentiation between a king and the office he held, see ERNST H. KANTOROWICZ, *THE KING'S TWO BODIES* (1957).

6. For fuller development of this point, see RESTATEMENT (THIRD) OF AGENCY § 2.03 cmt. c (2006).

7. See *id.* cmt. d & § 3.03 cmt. b. Section 1.03 defines “manifestation.”

8. For discussion of the apparent authority of corporate officers and other organizational executives, see RESTATEMENT (THIRD) OF AGENCY § 3.03 cmt. e (2006).

responds to the risks of slippage and disloyalty on the part of agents in many ways, many of which are beyond the modest scope of this paper.

Three general points warrant brief introductions. First, although the agent did not act with actual authority, a principal may assent to be subject to the legal consequences of an agent's prior action. Ratification is a unilateral act on the principal's part and may occur even though the agent's action has not been beneficial to the principal. Second, if the principal does not ratify an agent's unauthorized action, the third party may nonetheless hold the principal on the basis that the agent acted with apparent authority. The principal then has a claim against the agent for loss suffered by the principal; the basis for the claim is the agent's breach of his basic duty to act only within the scope of his actual authority.<sup>9</sup> If the agent breaches other duties owed the principal—in particular the agent's duties of loyalty—many remedies are available to the principal, including ones not tied to any showing of loss.<sup>10</sup> Rescinding tainted or unauthorized transactions that the agent has entered into with third parties is a remedial possibility.<sup>11</sup> Third, if the agent's unauthorized action does not bind the principal—that is, if the principal does not ratify the action and the third party is unable to establish that the agent acted with apparent authority—the third party may have a claim against the agent on the basis that the agent breached her implied warranty of authority that her action would be effective to bind the principal.<sup>12</sup>

#### A. Identifying the Principal

Determining the identity of the principal poses dilemmas within the sovereign-debt context. In terms of the hypothetical entities introduced in this article, Buchheit and his coauthors identify, as the principal, the people of Ruritania, as opposed to either the government of Ruritania or the state itself.<sup>13</sup> But presumably the state of Ruritania, not its people, is the obligor, the party (albeit a legally constructed one) bound to pay the debt resulting from the money borrowed by Ruritania's incumbent government. Likewise, borrowing by Zenda Inc.'s incumbent management results in an obligation that binds the corporation, not its shareholders or its stakeholders more broadly defined. It is Zenda Inc. that is the principal, not those with ownership interests in Zenda Inc. Zenda Inc.'s officers who act on its behalf are its agents in dealings with third parties, such as lenders.

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9. *Id.* at § 8.09.

10. *See id.* at § 8.01 cmt. d.

11. Rescission, of course, carries complications of its own. *See infra*, note 38.

12. *Id.* at § 6.10.

13. *See* Buchheit et al., *supra* note 1, at 36 (“[W]e view Ruritania (meaning the country and its population over time) in the position of the ‘principal.’”). *See also id.* at 37 (“[v]iewing the people of a country as the principal”); *id.* at 43 (“the principal here (the people)”). In contrast, Khalfan and his coauthors identify the state as the principal. *See* Khalfan et al., *supra* note 5, at 37 (“The government would be seen as acting as the agent for the state, which is the principal.”).

In the corporate context, agency doctrine has generated a rich body of cases addressing the consequences that follow for corporate obligors and their shareholders when the corporation is poorly served by its agents, through either ill-conceived or corrupt dealings with third parties. These consequences do not turn on identifying a corporation's shareholders as the principal nor are they diminished by the formal point that a corporation's officers (and directors, for that matter) owe duties of loyalty to the corporation.<sup>14</sup>

It is not self-evident why the principal should be identified differently—that is, as the people, rather than as the state—in the context of borrowing by a sovereign with inept or corrupt officials. Perhaps identifying the principal as Ruritania's people makes more obvious the point that their interests—or at least the interests over time of most of them—have been betrayed by Ruritania's government of the day. Identifying Ruritania's people as the principal also serves to reinforce the point that revenues from taxes they pay will service the debt or, more generally, that debt service will displace other uses of Ruritanian resources that would be immediately beneficial to its people. Such consequences for Ruritania's people are parallel to those that would be borne by the shareholders of Zenda Inc. as a consequence of obligations incurred by its management that bind Zenda Inc. Shareholders, of course, do not pay taxes to the corporation, but cash distributions to shareholders through dividends and share repurchases might well be reduced as Zenda Inc. becomes more indebted.

Moreover, identifying the principal as the people of Ruritania inevitably raises the question, Which people? Only those who pay taxes or who will be adversely affected when Ruritania reduces public services to service its debt? The composition of Ruritania's people will also shift over time, making the people, as opposed the Ruritanian state, less tractable as a principal. This difficulty becomes especially vexing in the face of the standard agency prospect that a principal may ratify prior action taken by the agent that would not otherwise bind the principal. Ratification has the effect of creating, after the fact of the agent's action, the same legal consequences had the agent acted with actual authority.<sup>15</sup>

## B. Responsibility for Sovereign Debt via Ratification

Suppose that, following Rudolf's ouster as CEO of Zenda Inc., his successor and Zenda Inc.'s board of directors—awakened perhaps from their torpor during Rudolf's term—discover that Rudolf has, acting without either actual or apparent authority, committed Zenda Inc. to a still-executory contract with a third party. Might Zenda Inc.'s new CEO and its directors ratify Rudolf's action? The contract, although unauthorized, may nonetheless promise to be

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14. For the basis point, see *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS*, Part V, Introductory Note, at 200 (1994).

15. See *RESTATEMENT (THIRD) OF AGENCY* § 4.02(1) (2006).

beneficial to Zenda Inc. Even if the new regime assesses the contract as a loser from Zenda Inc.'s standpoint, ratifying the contract may still make sense if, for example, Zenda Inc. wishes to retain a reputation as a reliable counter-party or if it wishes not to antagonize the other party to the contract with which Zenda Inc. anticipates future dealings. In any event, ratification requires only unilateral action from the principal through a manifestation of assent—which need not be made to the third party<sup>16</sup>—to be bound by the agent's action. It is not additionally requisite that the principal have benefited through the agent's action,<sup>17</sup> although a principal who knowingly retains a benefit from an agent's unauthorized action may be held to have ratified that action.<sup>18</sup> Knowing retention of benefit functions as a basis on which the principal's consent to the action may be inferred. In any event, which of Ruritania's people may ratify what has been done by a present or prior regime?

Casting the people of Ruritania as the principal raises a further and related dilemma. In all likelihood, some of the people of Ruritania may well have supported the regime that incurred the debt, just as some may have benefited from actions taken by the regime, including the incurrence of debt. Similarly, it is likely that Rudolf, the autocratic CEO of Zenda Inc., enjoys or enjoyed the support of at least some of its shareholders. At what level of popular support, we might wonder, is the conduct of Ruritania's (let us suppose) corrupt officials fairly to be charged to the people of Ruritania? Or should some proportion of the consequences fairly be chargeable to Ruritarians, set as a function of the degree of popular support?

Basic agency concepts, in stark contrast, have a yes-or-no, on-or-off quality that is profoundly incompatible—almost as an aesthetic matter—with proportionality. Likewise, basic agency doctrines operate without regard to determinations of fault.<sup>19</sup> That is, Zenda Inc. either is or is not affected by the legal consequences of its officers' conduct. The degree to which Zenda's shareholders support the officers is beside the point, as is whether Zenda Inc.'s directors or shareholders were somehow at fault in connection with its officer's actions. At least for private-sector principals like Zenda Inc., the stark quality of basic agency doctrines underlies the principal's accountability to third parties for actions taken by its agents.

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16. *Id.* at § 4.01 cmt. b.

17. *But see* Buchheit et al., *supra* note 1, at 43 (in which the *Restatement of Agency* is quoted as characterizing the “general rule of ratification”: “A person may ratify an act . . . by receiving or retaining benefits it generated if the person has knowledge of material facts and no independent claim to the benefit” (quoting RESTATEMENT (THIRD) OF AGENCY § 4.01 (g) (Tentative Draft No. 4, 2003))).

18. RESTATEMENT (THIRD) OF AGENCY § 4.01 cmts. f–g (Tentative Draft No. 4, 2003).

19. I have argued elsewhere that these properties of agency doctrine may help explain its lack of academic fashion for many years. *See, e.g.*, Deborah A. DeMott, *When Is a Principal Charged With an Agent's Knowledge*, 13 DUKE J. COMP. & INT'L L. 291, 319 (2003).

### C. Responsibility for Sovereign Debt and the *In Pari Delicto* Defense

Agency is, of course, not the sole source of general legal doctrine to which one might turn for guidance. In contrast to basic agency principles of attribution, the common-law defense of *in pari delicto* may be applied in a manner that is sensitive to variations among degrees of culpability. Buchheit and his coauthors draw an intriguing analogy between a successor Ruritanian government and a corporate receiver, who may be able to recover assets improperly transferred to third parties by the corporation's former controlling party.<sup>20</sup> *In pari delicto* may become inapplicable when the wrongdoer is no longer in the picture and only innocent investors will benefit from recoveries effected by the receiver. The postreform picture in Ruritania may not, by contrast, be comparably clear because members or supporters of its former government may benefit if Ruritania avoids its debts. Moreover, if the principal, for purposes of analysis, is the people, as opposed to the state, the continuing presence of citizens complicit with the former regime clouds the analogy with corporate receivership.

The larger contrast with agency doctrine is that *in pari delicto* is not insensitive to degrees of responsibility for an underlying wrong. In a well-known illustration of this point, the Supreme Court has held that the common-law defense of *in pari delicto* should not bar an action for damages for securities fraud brought against corporate insiders and broker-dealers by an investor who was induced to invest by the defendants' misrepresentations that they were tipping the investor with inside information about the corporation.<sup>21</sup> To be sure, reasoned the Court, to trade on the basis of what is believed to be an illegal tip of inside information would be wrongful, but corporate insiders and broker-dealers who hatch a scheme to profit by manipulating a stock's price by making misrepresentations to tippees duped into trading are "far more culpable."<sup>22</sup> Along the same lines, even if some members of the newly reformed Ruritanian polity bear some responsibility for actions of the prior regime, the relative degree of their responsibility might be contrasted with that of lenders to the regime.

### D. The Role of Consent

The second set of agency dilemmas is a consequence of the basic point that agency is a consensual relationship. Under the common law, a relationship is not one of agency unless both principal and agent consent that the agent's conduct will carry consequences for the legal position of the other party, the

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20. See Buchheit et al., *supra* note 1, at 53 (citing *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995)).

21. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 319 (1985).

22. *Id.* at 314. Thus, *in pari delicto* bars a tippee's claim only when the tippee bears "at least equal" responsibility for "the violations he seeks to redress" and when permitting the defense would not interfere significantly with effective enforcement of the securities laws. *Id.* at 312-13.

principal.<sup>23</sup> Of course, it is not necessary that the principal consent to be bound by the legal consequences of the agent's conduct on a transaction-by-transaction basis, just that the principal assent to an ongoing relationship with an agent with power to affect the principal's position. The common-law definition also requires that the agent act subject to the principal's control, an element that may become highly attenuated in practice. Thus, neither the shareholders nor the directors of Zenda Inc. may as a practical matter exercise ongoing control over Zenda's senior officers. The consensual quality of agency relationships often justifies holding the principal to the legal consequences of the agent's conduct. The principal elected to have a relationship with a particular agent. It was within the principal's power to choose another agent; to determine how best to structure the relationship with the agent chosen; and to control the agent through incentive structures, monitoring systems, and other control mechanisms within the principal's organization. Common-law agency also empowers the principal to terminate the agent's actual authority to deal on the principal's behalf as the principal's representative, even when the termination breaches a contract between principal and agent.<sup>24</sup> Thus, the principal has a choice on an ongoing basis—albeit one that may be exercised at the price of paying damages for breach of contract—whether to continue to be represented by any particular agent.

Consider now how the role of consent figures in the illustrative contrasts between Ruritania and Zenda Inc. Zenda Inc.'s board of directors has power to terminate the services of its officers, including Rudolf, although perhaps at the price of paying damages for breach of contract depending on the reasons for the termination and the terms of any employment agreement between Zenda and Rudolf. Moreover, the board has this power even if Zenda Inc.'s CEO, Rudolf, has chosen the board's members. Interestingly, a controversial issue at present in U.S. corporate governance is the degree to which Zenda Inc.'s directors should be insulated from removal by its shareholders, and, relatedly, whether each member of Zenda Inc.'s board (in particular, Rudolf) should be removed from the board if a majority of shares cast in an election fail to support the director's re-election.

In contrast, removing Ruritania's incumbent government may prove much more difficult, even if it is, as characterized here, a "republic." Ruritania likely has an elected legislature and a set of executive officers, whether popularly elected or appointed. Once elected or otherwise chosen, Ruritania's public officials have a capacity to remain in office—most likely with the cooperation of Ruritania's military forces—that is unavailable even to Rudolf, the most autocratic of CEOs at Zenda Inc.

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23. See RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) (defining agency as "the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act").

24. *Id.* at § 3.10(1).

The consensual quality of agency relationships creates a dilemma if the circumstances under which a loan could be avoided by Ruritanian citizens turn on the reputation of the Ruritanian regime that incurred the debt. Widespread knowledge of the regime's corruption might place a lender on notice and require it to investigate to determine how loan proceeds will be used.<sup>25</sup> This is because agency doctrine does not protect third parties who are in cahoots with a corrupt agent, or, who know or have reason to know that the agent's action is self-serving or otherwise disloyal to the principal.<sup>26</sup> The dilemma arises as a consequence of ratification, which creates the effects of actual authority after the agent's otherwise unauthorized action.<sup>27</sup> A knowing failure to repudiate what an agent has done is a conventional basis on which the common law finds that a principal has ratified the agent's conduct. Thus, that the Ruritanian regime has a reputation for corruption, which justifies imposing a duty of inquiry on lenders, also calls into question whether the people of Ruritania have ratified borrowings by corrupt officials through knowing acquiescence. If so, then the lenders' conduct appears less problematic. Why should a successor government in Ruritania be empowered to avoid a loan that its citizens may well have ratified? And Ruritania's successor government's affirmative claims against the lenders for inducing a breach of fiduciary duty appear much less compelling when Ruritanians themselves condoned the officials' conduct.

Although Buchheit et al. acknowledge that a principal may condone an agent's self-interested conduct, they characterize as "fanciful" any argument that Ruritania's citizens "would ever have condoned" their official's conduct.<sup>28</sup> But simply not condoning presents a dilemma. Common-law agency does not require a third party to establish that a principal affirmatively condoned an agent's conduct. The determinative question frequently is the inference that third parties will draw from the principal's failure to repudiate the agent's action. It is otherwise too tempting for principals to keep a corrupt agent in place while the agent's efforts seem likely to be worthwhile, then to disown the agent when the balance of advantage to the principal has shifted.<sup>29</sup>

One might resolve the dilemma by recognizing that the citizens of Ruritania lack the power of Zenda Inc.'s board of directors to discipline and discharge

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25. See Buchheit et al., *supra* note 1, at 44.

26. For a fuller explanation see *supra*, Part II.B. See also RESTATEMENT (THIRD) OF AGENCY §§ 8.01 cmt. (d)(1) & 8.02 cmt. E (2006). Third parties in cahoots with disloyal agents who act entirely adversely to the principal are also denied the benefit of claims and defenses that turn on imputing the agent's knowledge to the principal. See *id.* at § 5.04 cmt. b.

27. *Id.* at § 4.01.

28. See Buchheit et al., *supra* note 1, at 44.

29. Within a principal that is an organization, perspectives may differ among managers at different levels of the organizational hierarchy. For a recent example in the securities industry, see Susanne Craig & Tom Lauricella, *Costly Commissions: How Merrill, Defying Warnings, Let 3 Brokers Ignite a Scandal*, WALL ST. J., Mar. 27, 2006, at A1 & A14. Merrill fired three brokers who helped brokerage clients make rapid (but not necessarily illegal) trades in mutual funds, to the disadvantage of long-term investors in the funds and the displeasure of the funds themselves and New York's Attorney General. The brokers succeeded against Merrill in arbitration on the basis that local managers knew about their activities.

agents. Ruritanian citizens' relationship with Ruritanian officials is not meaningfully, for this purpose at least, explained by common-law agency. It may not be consensual (or may have been at one point but not thereafter). Moreover, Ruritanian citizens lack the power to exercise control over their officials on an interim basis that is an additional defining element of common-law agency. Agency doctrine also provides no basis on which to differentiate among Ruritanians, binding only those who assented to the loan.

Indeed, one might consider characterizing the relationship as one in which Ruritania's officials have usurped the position of principal, such that they exercise dominance over their nominal principals, the citizens. Common-law agency recognizes situations in which a principal and an agent should be treated as one: for example when an agent so controls the principal's decisionmaking that the principal is charged with notice of the agent's wrongdoing although the agent has dealt with the principal on the agent's own account.<sup>30</sup> The separateness of the agent from the principal collapses. Somewhat similarly, one might argue that a lender to Ruritania—on inquiry notice that its officials represent only their own interests—should have only the officials as obligors on the debt.

### III

#### SOVEREIGN DEBT AND THE TRUST DOCTRINE

Another way of looking at who is responsible for sovereign debt is examining the relationships between the Republic of Ruritania, officials of its government, and its lenders though a lens defined not by analogies to agency but to trust law or to other situations in which courts impose fiduciary duties on actors. Officers of Ruritania's government, if analogized to trustees, would be subject to fiduciary duties.<sup>31</sup> Thus, a trustee who exercises a power to borrow for trust purposes is obliged to act in accord with the trustee's fiduciary duties.<sup>32</sup>

Like agency law, trust law is relevant in this context, not directly, but by analogy. The relationships involved do not fit precisely within a conventional private-law trust structure. A trust is defined as "a fiduciary relationship with respect to property, arising as a result of a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee."<sup>33</sup> The Ruritanian context appears to lack two defining elements of a trust: (1) a settlor, whose intention it is to create the relationship; and (2) a corpus, the property the trust relationship concerns. As with the agency-framed analysis, it is helpful to acknowledge these gaps and then turn to what may be drawn by analogy from trust law.

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30. See *Munroe v. Harriman*, 85 F.2d 493, 495 (2d Cir. 1936).

31. See RESTATEMENT (THIRD) OF TRUSTS § 2 (2003).

32. *Id.* at § 86 (Tentative Draft No. 4, 2005).

33. *Id.* at § 2.

In some situations, a settlor-like figure can indeed be identified, perhaps most obviously when a government is put in place by a force of liberation (whether internal or external) or when a colonial government confers independence on a colony and sees to the installation of a postcolonial government. And, of course, states themselves do own assets, although property ownership is not (typically) an emolument of government service. One would have to acknowledge that service as a governmental official does not effect a transfer of title to the property to the official. The relationship between governmental officials and a state's property seems more akin to asset management than trusteeship as such. This is so even if a trust is treated as an entity, as do many contemporary authorities.<sup>34</sup>

An alternative that may prove less awkward than trust doctrine generally is the ample body of cases in which courts impose fiduciary duties in relationships not formally or conventionally characterized as fiduciary. The results in these cases tend to turn on an intensive scrutiny of the facts, framed by a test that focuses on such factors as one party's trust in and vulnerability to the other and whether one party elicited the trust of the other. Overall the key issue is whether one party justifiably expected loyal service from the other.<sup>35</sup> At least in some U.S. jurisdictions, the relationship between a public official and that official's constituents has been characterized as fiduciary.<sup>36</sup>

#### IV

#### REMEDIAL COMPLEXITY

Agency doctrine confers a cornucopia of possible remedies on a principal whose agent has acted disloyally. Two remedies carry intriguing implications for the odious debt phenomenon: (1) cancellation of individual loans and (2) remedial pursuit of now-deposed corrupt governmental officials. From the perspective of common-law agency, loan cancellation amounts to rescission by the principal of a contract to which the agent previously bound the principal. Standard agency doctrine dictates that a principal may avoid a contract with a third party who participated in the agent's disloyal conduct.<sup>37</sup> Thus, Zenda Inc. may avoid a loan contract with a bank when a bribe to its former CEO, Rudolf, induced him to commit Zenda Inc. to the loan. But it is also standard restitution doctrine that rescission is conditioned on return of property received from the

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34. *Id.* at cmt. a.

35. See Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 ARIZ. L. REV. 926 (2006).

36. See, e.g., *Hobbs, Wall & Co. v. Moran*, 109 Cal. App. 316, 319 (1930).

37. See RESTATEMENT (THIRD) OF AGENCY §§ 8.02 cmt. E, 8.03 cmt. d (2006). See also RESTATEMENT (SECOND) OF CONTRACTS §§ 193 (promise that tends to induce a breach of fiduciary duty is unenforceable on grounds of public policy) & 178, cmt. d, illus. 12 ("A induces B to make an agreement to buy goods on credit from A by bribing B's purchasing agent. A delivers the goods to B. A's bribe tends to induce the agent to violate his fiduciary duty. B's promise to pay the price is unenforceable on grounds of public policy. See § 193.").

other party to the extent feasible.<sup>38</sup> Moreover, “[r]escission is not forfeiture: the fact that the basis of rescission may be the defendant’s fraud does not permit the claimant to recover what has been transferred without restoring what has been received.”<sup>39</sup> Zenda Inc., that is, may not rescind the loan contract and retain the loan proceeds it has received. When specific restitution cannot be made, the claimant must make restitution of the value of what has been received to the extent necessary to avoid unjust enrichment of the claimant.<sup>40</sup> Determining what is necessary to avoid unjust enrichment could, in the odious debt context, require exploring the extent to which the proceeds of a problematic loan resulted in benefit to the sovereign borrower and its people.

A principal who discovers that an agent has indulged in fiduciary transgressions also has remedies against the agent (most likely the now-former agent). In addition to claims for loss to the principal caused by the agent’s disloyalty and benefits illicitly obtained by the agent, the principal’s remedies include forfeiture of compensation paid or otherwise due the agent for the period of disloyalty.<sup>41</sup> Indeed, the principal’s claims against the agent may not necessarily require showing that the value to be recovered was tainted by disloyal or illegal conduct by the agent.

For example, suppose that the board of Zenda Inc. agrees to extinguish a \$25 million loan it made earlier to its CEO, Rudolf, in exchange for Zenda Inc. shares with a current market value of \$25 million. Unbeknownst to Rudolf (or so he claims), Zenda Inc.’s financial statements contain material inaccuracies. Once this sad fact comes to light, the market value of its shares plummets. Zenda Inc. may rescind its transaction with Rudolf, reinstating the loan and returning the shares to him.<sup>42</sup> Were the exchange not unwound, Rudolf would be unjustly enriched, regardless of whether he knew that the financials were misstated. And *in pari delicto* as against Zenda Inc. should not be an available defense for Rudolf. His responsibilities as CEO included the corporation’s financial statements, which, as an officer of a public company, he signed. To be sure, Zenda Inc. likely is subject to liability to other claimants—including purchasers of its shares during the episode of the misstated financial statements—but Rudolf was responsible to a degree that at least corresponds to that of Zenda Inc.<sup>43</sup>

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38. See RESTATEMENT OF RESTITUTION § 65 (1937); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 53 (Preliminary Draft No. 8, 2006).

39. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 53, cmt. f (Preliminary Draft No. 8, 2006).

40. *Id.* at § 53 (4)(b).

41. See RESTATEMENT (THIRD) OF AGENCY § 8.01, cmt. d(2) (2006).

42. For parallel facts, see *In re HealthSouth Corp. Shareholder Litig.*, 845 A.2d 1096, 1100–04 (Del. Ch. 2003).

43. Nor should it be a defense to Rudolf that subordinates effectuated the fraud. See *id.*

## V

## CONCLUSION

The small number of us who share a keen interest in the common law of agency should welcome any expression of interest in a body of doctrine often either dismissed as intellectually insipid or (even worse in many ways) overlooked altogether. As this paper demonstrates, agency doctrine's direct applicability in the context of odious debt is limited. Nonetheless, agency may be powerful as a source of analogy, furnishing as it does a robust body of doctrine that addresses the many consequences of representation gone awry.