Hidden Sovereign Finance

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ABSTRACT

Recent scandals in the sovereign debt market have highlighted the risks associated with hidden debt transactions. These are sovereign debt transactions in favour of a central government, sub-state entity or state-owned enterprise, whose entire existence or whose terms have not been fully disclosed in violation of local administrative or constitutional requirements. The phenomenon was first reported with regard to the Mozambique hidden loans case, but it likely extends to many other countries.

The multifaceted nature of this phenomenon makes it difficult to provide a coherent picture. Lenders involved in hidden debt include private banks, state-owned banks, governments, and commodity traders. Products include loans, government guarantees, derivatives, and trade financing schemes linked to commodities exports. The goal of the paper is to provide a framework to analyse the legal and regulatory landscape applicable to these transactions with specific focus on the legal obligations of lenders.

At present, there are a number of voluntary standards and guidelines for lenders. These include the UNCTAD's *Principles on Promoting Responsible Sovereign Lending and Borrowing*, the recently approved IIF/G20 *Voluntary Principles for Debt Transparency*. This essay argues that hidden sovereign finance is a multifaceted legal problem, which presents three distinct components: the violation of the borrower's laws governing public financing, the possible presence of corruption, and the active hiding of the transaction. This means that any effective policy to tame this phenomenon must rely on these three pillars: civil litigation in commercial courts, criminal prosecution of corruption, and loans disclosure to put sovereign finance under closer public scrutiny. In order to make the analysis simpler, I focus on English law and on the practice of English courts.

1. INTRODUCTION

In recent years, a few well reported incidents rocketed the world of sovereign finance. In early 2015, the Malaysian Government was suddenly exposed to a potential debt hole of around US$ 13 billion. The scandal, commonly known as '*1MBD*', acronym for *1 Malaysia Development Berhad*, the sovereign wealth fund at the centre of everything, was the result of a financial fraud involving the highest levels of the Malaysian government and a number of western banks, including Goldman Sachs.[1] Not long after that, journalists uncovered a series of secret loans made by Credit Suisse and VTB Bank PJSC to three state-owned enterprises in Mozambique. The US$ 2 billion loans, which were guaranteed by the central government, have been allegedly obtained by a series of frauds and briberies involving the highest level of the Mozambique government.[2] The revelation of a massive financial black hole in the government budget triggered an economic crisis in the African state that eventually led to it defaulting on its external debt and to the intervention of the IMF. Similar situations occurred also in Congo, Chad, and other African countries.

These events have very different origins and connotations. Yet, they have brought the dangers associated with hidden sovereign finance to the attention of policymakers and civil society. At present, there is no specific definition for this phenomenon. In the reporting on the topic, it is sometimes addressed as 'hidden loans', although the problem extends to other types of financial transactions and services.[3] In this essay, I define hidden sovereign finance as a sovereign debt transaction in favour of a state, sub-state entity, or state-owned enterprise, whose entire existence or whose terms have not been fully disclosed in violation of local administrative or constitutional requirements. In other words, the debt deal is somehow under-reported under the state's own internal accountability mechanisms. It is the other side of the hidden debt coin. But instead of focusing on the debtors' reporting obligations to international organizations, it deals with the non-disclosure or partial disclosure of the debt deal under local (debtor's) law, which creates a number of governance and fiscal management issues. The very hidden nature of such transactions makes it difficult to understand the size of the hidden debt market, and the legal and financial patterns associated with hidden lending. Everything seems to suggest that the cases emerged so far are not an isolated phenomenon.

Hidden sovereign finance is a multifaceted and, not surprisingly, opaque phenomenon. It implicates different actors, including banks, commodity traders, and state-owned lenders. It involves various classes of borrowers, from central governments, to local governments and state-owned enterprises. And unlike classical sovereign finance, it features different financing instruments. These span from simple loans, to public guarantees, or more complex trade financing schemes. In all reported cases, the ultimate outcome is that sovereign financing becomes more expensive or, in the worst-case scenario, an unsustainable burden on public finances hijacking other structural economic reforms. The problem is definitely much worse for small or less developed economies such as Mozambique which have naturally much less fiscal space to accommodate a sudden financial loss and suffer from weaker economic governance.

[1] See, Tom Wright and Bradley Hope, *Billion Dollar Whale* (Scribe, 2019)
[2] David. Williams, "The Mozambique Hidden Loans Case: An Opportunity for Donors to Demonstrate Anticorruption Commitment", (2018) U4 Brief 2018:6, U4 Anti-Corruption Resource Centre
[3] Jubilee Debt Campaign, *Transparency of Loans to Governments* (April 2019)

As a result of the recent scandals, pressure has increased from various fronts to find legal solutions that protect sovereign borrowers.[4] The goal of this article is to analyse the legal and regulatory landscape applicable to these transactions. Most of the debate on the topic focuses on the adoption of transparency standards for lenders.[5] Initiatives to disclose public debts are not new. However, with few exceptions, they mostly target borrowers and suffer from various limitations.[6] Disclosure requirements for lenders are much less compelling. Since 2012, the United Nations Conference on Trade and Development (UNCTAD) has recommended the adoption of its *Principles on Promoting Responsible Sovereign Lending and Borrowing*, a set of recommendations for lenders and borrowers to enhance the sustainability of debt finance.[7] Civil society organizations like Eurodad and the Jubilee Campaign have also proposed voluntary codes for responsible finance, such as the *Responsible Finance Charter*.[8] More recently, in June 2019 the G20 has approved the *Voluntary Principles for Debt Transparency*, a set of principles applicable to lenders developed by the Institute for International Finance to reduce the risks of hidden debts.[9]

This essay instead argues that transparency is only one of the various legal mechanisms, and perhaps the least effective, at our disposal to tame hidden finance. As a relatively new topic of discussion, hidden sovereign finance has never been framed as a stand-alone legal concept. As this essay shows, hidden sovereign finance is a multifaceted problem, which presents various legal aspects of which the lack of transparency is only the most visible element. This essay argues that hidden sovereign finance presents three distinct components: the violation of the borrower's laws governing public financing, the possible presence of corruption, and the active hiding of the transaction. Not all of them are always present in the same transaction. This means that any effective policy to tame this phenomenon must rely on these three pillars: civil litigation in commercial courts, criminal prosecution of corruption, and loans disclosure to put sovereign finance under closer public scrutiny. In order to make the analysis simpler, I focus on English law and on the practice of English courts and authorities.

The essay will be structured as follows. In the next section, I introduce the reader to the world of hidden sovereign finance, by explaining the nature of the phenomenon, the entities involved, and its legal and financial characteristics. In the following three sections, I then analyse hidden finance under each three legal pillars. Thus, section three deals with the legal position of lenders with regard to debt disclosure. It explains the new voluntary transparency codes for the financial industry, in particular the G20 *Voluntary Principles of Debt Transparency*, and it analyses the role of transparency as a key tool in support of civil and criminal litigation. Section four deals with the role of civil litigation in dispute concerning a hidden debt. It explains how the legal doctrines of capacity and authority can help borrowers to invalidate a hidden debt transaction in commercial litigation. Finally, section five deals with the potential role of corruption in hidden debt and the role of anti-bribery laws.

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[4] Andrew Shutter, Sui-Jim Ho and Barthélemy Faye, "Sovereign Debt: Coming into the Light?", (2019) Emerging Market Restructuring Journal 9

[5] Ibid.; Jubilee Debt Campaign (n 3)

[6] Andrea E. Kropp, W. Mark C. Weidemaier and Mitu Gulati, "Sovereign Bond Contracts: Flaws in the Public Data?", (2018) Journal of Financial Regulation 190; Anna Gelpern, "About Sovereign Debt…Who Knows?', (2018) Capital Markets Law Journal 321

[7] UNCTAD, *Principles on Promoting Responsible Sovereign Lending and Borrowing* (2012);

[8] European Network on Debt and Development, *Responsible Finance Charter* (2011)

[9] IIF-G2o, *Voluntary Principles for Debt Transparency* (2019)

2. THE PROBLEM

The problem of hidden debt came to prominence primarily with regard to the controversial lending practices of certain banks, which secured loans to foreign state-owned enterprises in violation of the legal and financial requirements applicable to public borrowing in the borrower's jurisdiction. The most prominent example is probably the Mozambique Tuna Bond scandal. In the course of a sovereign debt restructuring of the Mozambique outstanding debt, in 2016 the IMF discovered two large unreported loans, amounting to US$1.15 billion – around 9% of the entire country's GDP. The loans were part of a larger financing operation, that included an additional US$800 million loan with government guarantee, organized by two state-owned enterprises.[10] The discovery of the hidden loan created a budget hole of around US$1 billion, which plunged the African country into default. The subsequent investigation reported that the guarantees were not subject to any scrutiny by the Ministry of Finance before being approved nor were they subject to oversight by the Parliament.[11] The outcome of the scandal was that Mozambique was denied market access by markets and could not obtain additional finance from the IMF. A similar situation occurred with regard to loans extended by commodity traders to the Republic of Congo.[12]

Different Shades of Grey

As the name suggest, the foremost characteristic of hidden sovereign finance is that transactions are not disclosed. However, the non-disclosure of the debt can take different forms, not all of which are relevant to the present discussion. From an international perspective, a hidden debt transaction matters only when the borrower fails to report it to the various disclosures mechanisms set up by the IMF, the World Bank, or other international organizations.[13] While this might cause various problems to creditors and other stakeholders, it does not create the type of governance and legal problems associated with hidden sovereign finance. Indeed, a transaction that is not reported to international organizations, could still be totally legitimate under local law and be disclosed to local stakeholders.

Hidden sovereign finance, on the other hand, is essentially a question of national law. It arises when a sovereign debt transaction is not fully reported internally, according to the applicable local administrative and fiscal procedures. This ultimately results in the debt not being fully accounted for in the state internal budget. Very often, although not necessarily, the non-disclosure of the debt transaction also means that the transaction was not fully authorised. Indeed, public budget laws often require that debt deals are scrutinized by multiple state organs before being fully approved. Depending on each country, these organs could be the central bank, or the Council of Ministers, the budget office, or even the Parliament.

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[10] IMF, "G20 Note: Improving Public Debt Recording, Monitoring, and Reporting Capacity in Low and Lower Middle-Income Countries" (14 June 2018), at 17

[11] IMF, "Republic of Mozambique: Diagnostic Report on Transparency, Governance and Corruption", (2019) IMF Country Report No. 19/276

[12] Bate Felix, "Congo Republic Seeks Debt Deal with Glencore, Trafigura Before IMF Review", Reuters (10 March 2020)

[13] Gelpern, (n. 6)

It would be tempting to analyse hidden finance as a black or white phenomenon in which financial deals totally disappear from public records only to resurface years later dragging public budgets into a financial black hole. This would occur, for example, if an international lender and the CEO of a state-owned enterprise signed a loan to finance a development project without the knowledge and the approval of the Central Bank or the Minister of Finance. Undoubtedly, the Mozambique scandal is not the only one, and a few more will surely emerge in the future. However, the reality of hidden sovereign finance is probably much closer to shades of grey.

While a few sovereign debt transactions have gone totally unreported to both the international community and the local budget office, most hidden financial transactions are actually only partially hidden. To be clear, I am not referring here to the errors in legal coding and reporting on debt transactions by commercial databases such as Bloomberg or DCM.[14] Instead, I refer to the lack of disclosure of financial conditions of the loan or key legal terms of the contract as prescribed by the local legal requirements. This might include the ranking of different classes of creditors, the choice of law and jurisdiction applicable to the contract, the presence of contingent liabilities, or the actual financial mechanism of the loan such as repayment terms.[15] For instance, a loan taken by a state-owned company might be under-reported to the competent Minister for approval by avoiding mentioning the real financial commitments such as the presence of separate derivatives deals or the use of future rights or revenues as collateral.[16] Even though only certain elements of the transaction are hidden, the lack of proper scrutiny drastically increases the financial risks associated with the transaction for the borrower country.

The Players

The opacity of the hidden sovereign debt market is the result of a combination of factors which affect both the lenders and the borrowers' incentives not to disclose. I will not deal here with the borrowers' side as it has been already analysed extensively in the fiscal governance or corruption literature.[17] With regards to lenders, two issues in particular are worth mentioning: the presence of a new class of lenders, and the use of unorthodox financing schemes. When it comes to the supply side of murky finance, the market is, unsurprisingly, very crowded. While one might be tempted to think of banks as the main originators of hidden loans, the reality is that different actors also participate in offering different financial products to sovereigns. These include not only rogue private lenders but, increasingly, government lenders. Indeed, as recent research shows, non-G2o states – notably China, Russia, and the Gulf States – are highly involved either directly or through public-owned banks in the business of lending to states.[18] Chinese policy banks have routinely

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[14] Kropp et al., (n 6)

[15] Gelpern, (n 6) at 327-332; Lee C Buchheit and Mitu Gulati, 'The Gathering Storm: Contingent Liabilities in a Sovereign Debt Restructuring', in L. C. Buchheit and R. Lastra (eds.), *Sovereign Debt Management*, (Oxford University Press, 2013), pp. 241–54

[16] David Mihalyi, Aisha Adam and Jyhjong Hwang, "Resource-Backed Loans: Pitfalls and Potential", Natural Resource Governance Institute (February 2020), 19-21

[17] See, Susan Rose-Ackerman and Bonnie J. Palifka, *Corruption and Government: Causes, Consequence, and Reform* 2nd Ed. (Cambridge University Press, 2016); George Kopitis, Restoring Public Debt Sustainability : The Role of Independent Fiscal Institutions (Oxford University Press, 2013); IMF,

[18] Mihalyi et al., (n 16), at 11-15; Gelpern, (n 6), at 331-332; 5

provided loans to developing countries in the context of infrastructure development projects.[19] According to recent study on resource-back loans, two Chinese state-owned banks have supplied around 77% of the loans to sub-Saharan African countries and Latin American countries.[20]

Anecdotally, we also know that a few non-Paris club governments have offered emergency financial assistance directly to other governments in financial difficulties, such as Venezuela or Sudan. While extremely relevant, bilateral finance from non-Paris Club countries leads to a series of geopolitical implications that cannot be fully discussed here due to their complexity. This essay will analyse them only as long as they can be legally construed as standard commercial transactions. In addition to that, the shadow banking sector is also increasingly involved in lending to government. Commodity traders, in particular, have recently acquired a special role in the market for sovereign debt.[21] The shadow-banking nature of these lenders also leads to additional complexities. Commodity traders operate totally outside the financial industry and they are not subject to the level of regulatory and reporting requirements that banks are subject to. This makes operating in the dark very easy for them.

The Transactions

The few scandals on hidden sovereign finance uncovered so far show that loans and public guarantees to central governments, state owned enterprises, or other public entities are very easy to abscond. However, more complex financing deals, often linked to the selling of commodities, are also on the rise as a source of debt finance. Increasingly, resource-backed loans and specially arranged trade finance schemes have come to occupy a very special place in the sovereign debt galaxy. These financial transactions, while not strictly loans in a classical sense, are now an extremely common way to finance infrastructure projects and other public spending by commodity exporter nations.[22]

Resource-backed loans are very common with commodity exporting countries in Latin America and Africa. Unlike standard loans, in which the borrower commits to repay the loans in cash, commodity-backed loans are essentially loans repaid in natural resources.[23] The sovereign borrower – typically a state-owned oil company – obtains an advance payment by the purchaser in exchange for the future delivery of the commodity. Other similar loans are repaid through the proceeds of the selling of the commodity to third parties or the assignment of extraction rights. Pre-payment transactions are trade-financing schemes provided by commodity traders to sovereign borrowers.[24] In a pre-payment, the typical role of the borrower (the sovereign entity) and the trader are reversed. As in the previous case, the commodity trader will originate a loan to the borrower in exchange for a future delivery of commodity. However, the trader will not provide

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[19] Policy Banks are Chinese state-owned banks established under the Policy Bank Law to implement the economic policies of the Chinese government.

[20] Mihalyi et al. (n 16)

[21] Natasha White, "Regulators Must Now Look at Commodity Trading", Financial Times (27 April 2020); Natasha White, "Hey Big Lenders", Globalwitness Blog (30 November 2018), https://www.globalwitness.org/en/blog/hey-big-lenders/

[22] Trafigura, "Prepayments Demystified: An Addendum to the Commodities Demystified Guide" (2020); Mihalyi et al. (n 16)

[23] Ibid.

[24] Ibid.

the money alone, but instead will act as the arranger of a syndicated loan. The trader will typically provide only for a small portion of the loan, but it will take all the risks. Hence, it will practically act as a middleman between the sovereign borrower and the banks.

The Impact on Debt Sustainability

Hidden finance leads to a number of problems which affect both the sovereign borrowers and their citizens as well as the broader financial system. Probably the biggest risk connected to hidden finance comes from the impact that hidden debt has on the sustainability of public finances and on economic governance. In two of the recent reported cases of hidden debt, Mozambique and Congo, the sudden discovery of a budget hole in the public finances is estimated to have contributed to bringing an already precarious financial situation to breaking point.[25] While the discovery of hidden debt was not the only factor underlying the debt crises, both countries eventually had to be rescued by the International Monetary Fund.[26]

In this light, hidden finance brings an additional risk to what is already a very fragile fiscal governance framework. The literature on sovereign debt has shown that states very often end up in a fiscal position where the level of indebtedness towards creditors outstrips their ability to repay, thus leading to a risk of defaults.[27] Moreover, far from being a pure domestic sustainability problem, hidden finance can also lead to broader systemic risks for creditors. Like any other financial product, sovereign debt entails counterparty risk for the lender. In a perfect world, before committing to a credit facility, a lender would assess the borrower's credit risk by examining its outstanding financial commitments in addition to other macroeconomic and legal elements. Hidden debts, however, increase counterparty risk as they prevent lenders from assessing financial risk correctly.[28] Indeed, lenders would not know the total exposure of their sovereign counterparties and, therefore, would underestimate the borrower's ability to repay on time. In the best case scenario, lenders might price financial products cheaper than what they should be had they known the real exposure of their counterparties, thus taking a loss.[29] In the worst case scenario, the above-optimal access to credit might worsen an already ballooning debt sustainability situation, which might force them to take a loss in the event of a default.

The Reasons Behind Hidden Finance

According to the neoclassical economic account of international lending, a creditor will disburse funds to a sovereign debtor only when the risk of sovereign default is lower than the possible profits for the lender. [30] Given the relatively higher risk of default attached to hidden financing

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[25] Tim Jones, "Hidden Debts Contribute to Crisis in Congo", Jubilee Debt Campaign (18 October 2017)
[26] Joe Bavier, "IMF approves Congo Republic bailout after China debt deal", Reuters (11 July 2019)
[27] Carment Reinhart and Kenneth Rogoff, *This Time is Different: Eight Century of Financial Folly* (Princeton University Press, 2011)
[28] Dan Awrey, "Complexity, Innovation, and the Regulation of Modern Financial Markets", (2012) Harvard Business Law Review 2; Robert Bartlett III, "Making Banks Transparent", (2012) Vanderbilt Law Review. 293; Donald Morgan, "Rating Banks: Risk and Uncertainty in an Opaque Industry", (2002) American Economic Review 874; Group of Thirty, *Enhancing Public Confidence In Financial Reporting* (2003), at 21
[29] Gelpern (n 6), at 324-327
[30] Eric Posner, Stephen J. Choi & G. Mitu Gulati, "Political Risk and Sovereign Debt Contracts", (2011) John M. Olin Program in Law and Economics Working Paper No. 583.

deals due the reasons explained above, and the danger that the possible uncovering of the transaction might lead to a reputational scandal or criminal prosecution, it is important to question what motivates a lender to take such serious legal and financial risks.

First, as reported by Buchheit and Gulati, lenders might agree to a loan for non-commercial objectives, such as promoting the geopolitical influence of the lending country or to access natural resources.[31] In other circumstances, the loan can be part of a broader business strategy of the lender to get better market positioning in the borrowing country or to acquire the favour of local institutions, for instance with the ultimate objective of establishing a local presence there. In this light, while the financial aspects of the loan would not *prima facie* justify its disbursement, broader business strategic considerations make the transaction worthwhile.

Second, the loan might have been approved by a loan officer who is acting beyond its duties, thus violating the corporate code of conduct of the lender. Although not debated as much as other aspects of corporate misconduct, corrupted lending is a well-known phenomenon in banking, mostly with regard to state-owned banks. It identifies the situation in which the approval of the loan has been granted by the loan officer in exchange of bribes or for other personal gains. [32] Thus, the officer manages to escape the internal mechanism of control imposed by the bank's compliance and risk departments, effectively abusing its powers. This situation is not dissimilar to that of a trader who places a risky order without its direct manager's consent, thus imposing a loss on the financial institution he is working for.

Finally, in other circumstances, misaligned incentives within the banking structure might lead to over lending. For instance, this would be the case if the lending officer would benefit from large bonuses tied to the volume of loans approved rather than its successful repayment. The same would apply if the bank acts as an underwriter of the sovereign bonds, as in both cases the compensation package of bank officers, which is tied to the income of the bank for the year, does not fully reflect the long-term profitability of the investment for the bank. [33]

Hidden Finance from a Legal Perspective

If we look at hidden debt from the lenders' side, unsurprisingly, there is no coherent legal framework able to conceptualise and address the phenomenon in all its forms. From a legal perspective, hidden sovereign finance presents multiple facets, which make it a particularly complex issue to regulate. Far from being simply a question of lack of transparency, hidden sovereign finance touches on more complex legal and economic issues, which span from criminal law, to banking supervision, contract law, and conflict of laws. The goal of this paper is to provide

[31] Lee C. Buchheit and G. Mitu Gulati, "Responsible Sovereign Lending and Borrowing", (2010) UNCTAD Discussion Paper No 198, at 616

[32] For a recent overview, see Brian Akins et al., "Corruption in Bank Lending: The Role of Timely Loan Loss Provisioning" (2015), Research Collection School of Accountancy 1-56; J. Barth, C. Lin, P. Lin, and F. Song, "Corruption in bank lending to firms: cross-country micro evidence on the beneficial role of competition and information sharing", (2009) Journal of Financial Economics 91, 361-388; T. Beck, , A., Demirguc-Kunt, and R. Levine, "Bank supervision and corruption in lending", (2006) Journal of Monetary Economics 53, 2131-2163;

[33] Susan Block-Lieb and W. Mark C. Weidemaier, 'Lenders' Roles and Responsibilities in Sovereign Debt Markets', (2019) University of Illinois Law Review 1589, at 1600; Yuefen Li and Ugo Panizza, "The Economic Rationale for the Principles on Promoting Responsible Sovereign Lending and Borrowing", in *Sovereign Financing and International Law* 15 (Oxford University Press 2013), at 30; Christian Barry and Lydia Tomitova, Fairness in Sovereign Debt, (2006) Social Research 649,

a conceptual framework to help legal and financial communities to frame the legal analysis on hidden debt, and to analyse current and future legal reforms. In this regard, I identify three different angles: regulation, contracts, and criminal law. Each one of them is necessary if we want to tackle the problem in its entirety.

The first pillar of the broader legal framework is transparency regulation. Over the last thirty years, disclosure requirement fell heavily on the shoulders of borrowers, which have been required to report their debt positions to international organizations, such as the IMF, the World Bank, the OECD, and the BIS. I leave the discussion of this to the seminal paper by Gelpern.[34] More recently, however, pressure has increased to make lenders also responsible for disclosing their loans to sovereigns. I will discuss the new transparency requirements, and the G20 *Principles for Debt Transparency* in particular, in the next section.

Second, we can qualify hidden finance as a contract law issue. From a commercial law perspective, one of the key characteristics of hidden debt transactions is that they are in violation of the borrower's domestic public debt management laws.[35] The law on public debt management, which we will discuss later on, deals with two key aspects of the debt process. On the one hand, hidden debt deals are in violation of the internal accountability and reporting mechanisms, which guarantee the long-term sustainability of public debt in light of debt ceilings. On the other hand, the violation of the reporting process might sometimes entail a more serious violation of the broader procedure governing the authorization of the debt. Indeed, very often, the reporting of the debt is a necessary step in the broader authorization process.

Third, hidden sovereign finance might entail a more serious violation of criminal law, and corruption in particular. Hidden finance deals might sometimes involve the payment of bribes or other forms of corruption linked to the non-disclosure of the funds. While corruption is not an absolute and necessary element of hidden debt deals, anti-bribery legislation in the lenders' home jurisdictions, and the presence of safeguards in civil litigation against illicit contract might help in deterring rogue lenders.

3. THE RISE OF TRANSPARENCY REQUIREMENTS FOR LENDERS

Hidden debt has mostly been perceived as a public governance problem. Accordingly, most of the policy and regulatory initiatives for public debt and fiscal transparency promoted by international financial organizations have typically been addressed to borrowers. States are required to periodically supply data on the status of their finances to international organizations, and to implement a number of domestic governance initiatives to increase scrutiny on public spending and borrowing. However, reporting mechanisms are patchy and confusing at best.[36] Disclosure standards and data collection procedures are plagued by a multitude of different approaches, often within the same organization, that ultimately make an overall debt analysis impossible. Given the limits of the current debtors' public debt transparency mechanisms, the attention of the debt policy

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[34] Gelpern (n 6)
[35] Elsie Addo Awadzi, "Designing Legal Frameworks for Public Debt Management", IMF Working Paper WP/15/147 (2015)
[36] Kropp et al., (n 6); Gelpern, (n 6)

community has moved to lenders. In this section, I will introduce the new voluntary transparency standard for lenders.

Non-disclosure Is Not Illegal (yet) For Lenders

At the outset, it is fundamental to say that financial institutions, unlike states and public bodies, are not in principle required to disclose their transactions to the public. While states are bound to transparency by virtue of their constitutional, administrative, and public budget laws, companies can rely on their duty of confidentiality when dealing with clients. Thus, a lending transaction between a UK-licensed bank and a state-owned enterprise in the Philippines, does not bind the lender to any particular disclosure obligation to the public by virtue of English law. Thus, save for the possible reporting obligations that might be imposed on the borrower by virtue of local law, the lending transaction could remain totally confidential between the parties of the contract.

The right of confidentiality does not mean that financial institutions, and companies more generally, might abscond the transaction from their balance sheet. First, listed companies must periodically report to shareholders on the status of their finances and any major issue that might affect their business and profitability. Authorized lending institutions are also required by their national supervisory authorities to periodically report their debit and credit exposures. In the UK, for instance, the Prudential Regulation Authority mandates authorized entities to periodically submit data on a range of issues, including large exposures, liquidity, assets encumbrance, capital, bank balance-sheet, risk positions and remuneration.[37] Yet, the reporting requirements that banks are subject to do not actually cover the individual legal and financial contracts that banks enter into with their clients, as these are confidential.

Commodity traders and companies working in the energy sectors are somehow bound to a higher degree of transparency compared to banks. Under EU law,[38] EU-registered energy companies are required to annually disclose their payments to governments, which also include also commodity-backed loans.[39] Moreover, under the auspices of the *Extractive Industries Transparency Initiatives* – which are now joined by commodities companies – participating countries committed to disclose contracts in the oil and gas sector. While these new legislative measures have dramatically increased public scrutiny on lenders, they still fall short of the level of detail required to assess the financial risks of the loans. Indeed, they invariably lack reference to key financial conditions, legal terms, or the presence of guarantees.[40]

To sum up, while lenders – both official and shadow – are subject to certain disclosure standards, these fall short of what would be required for the public to have a good understanding of the financial and legal implications of the loan. The status quo on loan transparency is firmly set on the lender's non-disclosure of the debt contract. The non-disclosure of the terms of the loan can nonetheless underline much more serious issues. These are the violation of domestic administrative laws regarding the power of state agents to bind the state to a financial contract, the

[37] For a detailed description of the reporting requirements in the United Kingdom, see https://www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-banking-sector/banks-building-societies-and-investment-firms

[38] EU Accounting Directive, Chapter 10; EU Transparency Directive

[39] See, Glencore, *Payments to Governments Report 2018*, at 32

[40] Mihalyi et al. (n 16), at 19-21

potential use of bribes and the consequent violation of anti-bribery legislation, and the financial burden on the borrower's public debt obligation.

The G20 *Voluntary Principles for Debt Transparency*

The hidden loan scandals suddenly put the spotlight of civil society and international organizations on the risks associated with hidden debt. Long-term advocates of sovereign debt relief such as the Jubilee Campaign, together with other organizations, started a campaign to address the issue, this time focusing on the need to increase lenders' disclosure.[41] As a result of the efforts, the Institute of International Finance (IIF) agreed to work with lenders to draft a new voluntary standard for public debt transparency. This work culminated in the adoption of the *Voluntary Principles for Debt Transparency* (the Principles) at the 2019 G20 meeting.

This new disclosure standard, which has been prepared under the auspices of the Group of Trustees administering the 2004 *Principles for Stable Capital Flows and Fair Debt Restructuring*, provide a disclosure framework to which banks will be subject with regards to transactions with sovereigns and sub-sovereigns. The Principles are meant to complement other public initiatives, including the *G20 Operational Guidelines for Sustainable Finance*, and mimic the earlier efforts by commodity traders to increase transparency and disclosure through the *Extractive Industries Transparency Initiatives*.

The goal of the Principles is to incentivize private lenders to disclose certain terms of the contract they have entered into with sovereigns and sub-sovereigns to a reporting entity.[42] The transactions entered with public sector entities include any financial arrangement that has the economic effect of borrowing as well as financial guarantees. Thus, it includes loans, debt securities, repurchase agreements (repos), derivatives, asset backed lending, debt-related Islamic finance transactions, and financial transactions with private parties in PPP projects.[43] The scope of disclosure for each financial transaction is also potentially quite extensive. The reporting entity will have to disclose the borrower or the guarantor, the lender(s), the type of transaction (bonds, repo, loan), the applicable agent, intermediary, or trustee, and the collateral. In addition, the disclosure will cover the key terms of the contract, which in sovereign debt transactions has proven to be the most contentious issue. For instance, reporting entities will be required to disclose the ranking of the debt, the maturity and repayment arrangements, the waiving of sovereign immunity, the governing law and dispute settlement mechanism. Certain key terms of the contract, like interest rates, will not be disclosed fully but, instead, they will be reported in a bracket range (1 to 3%, 4 to 7%, etc.).

Yet, the standard does contain quite a few loopholes that might reduce their effectiveness. For instance, the Principles exclude transactions in local currency of the counterparty and are subject to national law, and transactions with the Central Bank in the context of monetary policy, which are meant to protect moral hazard.[44] The exemption of local currency loans could nonetheless permit lenders to bypass the disclosure requirement. Lawyers from Cleary Gottlieb showed that, "a state-owned oil company with dollar revenues could borrow in its domestic currency with cross-

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[41] Mark Plant, 'Principles for Debt Transparency: A Few Steps Forward, a Few Questions Linger', Center for Global Development (May 29, 2019)

[42] The Principles define sub-sovereigns as "state, provincial, or regional government or local government) or any other public corporations", in the light of the IMF's Public Sector Debt Statistics Guide for Compilers and Users.

[43] *Voluntary Principles for Debt Transparency*, Section 4.

[44] Ibid.

currency swap to hedge the loan into dollars to match its own revenues".[45] Moreover, transparency does not extend to trade financing transactions and short-term overdrafts with maturity of less than one year, which are shown to be very common in resource-backed loans.

One of the main shortcomings of the Principles is that they require the reporting of a loan only when the funds actually move, rather than the moment when the agreement is signed. This would make it very difficult to truly understand the real financial commitments of borrowers with regard to public sector guarantees or derivatives.[46] More importantly, in order to be operational, the Principles envisage a 'reporting host' – a public agency – that would collect and disseminate the data. The host would essentially act as a repository of debt contracts. After more than one year since the Principles were signed, such agency has yet to be agreed. Above all, the adoption of the Principles is, at present, purely voluntary. Thus, while peer-pressure from within the industry might compel lenders to comply with the requirements, failure to do so would not expose them to any legal action from regulators.

Will the New Transparency System Work?

Transparency brings many potential benefits to the sovereign debt market. The literature on fiscal transparency has demonstrated that the disclosure of debt exposures increases the sustainability of sovereign debt and reduces risks of debt defaults. As shown by Gelpern, the disclosure of legal terms can make debt restructuring much easier.[47]

When it comes to the issues at the heart of hidden sovereign finance, the voluntary nature of the transparency initiative is not effective alone in deterring corruption and illegal loans. Given the sometimes-illicit motivations behind those deals, the voluntary disclosure method of the Principles will arguably do very little to reduce the opportunistic behaviour of certain parties. It will also do little to prevent the signing of a debt deal that might be financially unsustainable for the debtor.

Yet the literature on corruption shows that transparency, while ineffective by itself as a regulatory tool, is actually fundamental in making the prosecution of financial crime more efficient or in creating the conditions for subsequent civil litigation. Indeed, donors and international organizations put fiscal transparency and anti-corruption measures as one of the key conditions for the disbursement of foreign aid. In their push for increased transparency and good governance, they are often supported by NGOs, civil society organizations, and various advocacy groups.[48]

The literature on corruption also shows that reputational costs for lenders can be extremely high if the public perceives the behaviour of the lender as particularly bad. As the various corporate scandals with regard to car diesel emission, sexual misconduct, or product safety demonstrate, consumers' anger can spread very quickly and impact negatively on firms' profitability and

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[45] Shutter et al., (n 4)
[46] Plant, (n 41)
[47] Gelpern, (n 6)
[48] Sanjeev Khagram, James V. Riker, and Kathryn Sikkink. *Restructuring World Politics: Transnational Social Movements, Networks, and Norms (Social Movements, Protest, and Contention)* (University of Minnesota Press, 2002); John Meyer, John Boli, George M. Thomas, and Francisco O. Ramirez, "World Society and the Nation-State." (1997) American Journal of Sociology 103, 144–81

financing options.[49] In a study on the application of the OECD Anti-Bribery Convention by non-state actors, Jensen and Maleski demonstrate that the fear of being exposed as corruptor by an international organization is often sufficient to deter firms from the countries subject to peer-review from engaging in corruption.[50] In another recent study on the compliance with the US FCPA, Perlman and Sykes' interviews with corporations and law firms suggest that reputational fears are behind the decision of US firms to comply with the statute, despite it being detrimental to the firms competitiveness abroad.[51] Being exposed in the press or in a report issued by a reputable international organization might hinder the possibilities of the firm to find business partners in foreign markets, or even delay or prevent the obtaining of licences and permits.[52]

4. HIDDEN FINANCE AS AN INTERNATIONAL COMMERCIAL LAW ISSUE

All sovereign finance transactions discussed earlier are primarily private commercial contracts of a cross-border nature. This means that they are necessarily subject to the conflict of law rules governing the applicable law, the jurisdiction of the forum competent to hear the dispute, and the question of recognition and enforcement of the judgment. In this regard, the violation of the borrower's rules on the issuance and disclosure of the debt might raise a few legal questions on the validity of the underlying contract. Thus, civil litigation might provide an avenue to challenge the legitimacy of the debt. For simplicity, I will now assume that the loan contract has English law as the applicable law and England and Wales as the forum for the dispute.

The Role of Public Budget Laws

What makes hidden loans unique from a commercial law perspective is the fact that they are very often obtained in violation of the borrower's internal laws on public debt management. These are the laws that discipline the most important aspects of public sector borrowing, from the legal mandate to borrow, to the adoption of debt ceilings, or the accountability mechanisms.[53] The body of norms governing public borrowing can be scattered across various levels, including the Constitution, secondary legislation, and the statutes of agencies of the government.[54]

In many countries, Constitutions typically set out the broader institutional structure of public borrowing. They set the power of public entities to negotiate commercial contracts, the allocation of fiscal power among different levels of government, and the broader accounting and reporting framework. Yet, most of the rules on public borrowings are set in secondary legislation. In many countries, there is a dedicated comprehensive legislation on public debt. This piece of legislation deals with all aspects of government debt, from the status of the debt obligation in domestic law

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[49] Melissa Baucus, and David A. Baucus. "Paying the Piper: An Empirical Examination of Longer- Term Financial Consequences of Illegal Corporate Behavior" (1997) Academy of Management Journal 40 (1): 129–51.
[50] Nathan M. Jensen and Edmund J. Malesky, 'Nonstate Actors and Compliance with International Agreements: An Empirical Analysis of the OECD Anti-Bribery Convention', 72 International Organization 33 (2018)
[51] Rebecca Perlman and Alan O. Sykes, 'The Political Economy of the Foreign Corrupt Practices Act: An Exploratory Analysis', 9 Journal of Legal Analysis 153 (2017), at 160-161
[52] Rhee, Mooweon, and Michael E. Valdez, "Contextual Factors Surrounding Reputation Damage with Potential Implications for Reputation Repair", (2009) Academy of Management Review 34 (1):146–68, at 160
[53] Elsie Addo Awadzi, "Designing Legal Frameworks for Public Debt Management", IMF Working Paper WP/15/147 (2015)
[54] Ibid, at 5-9

to the purposes for which it can be raised. In particular, public debt laws define the persons and entities authorized to assume financial obligations on behalf of the State – typically the Minister of Finance – and the type of financial liabilities covered, including public guarantees. In addition, the Public Debt law deals with the capacity of sub-national entities including state owned enterprises to assume financial obligations autonomously, and the legal status of those obligations in domestic law. Finally, sometimes public budget laws directly discipline fiscal limits – the level of total borrowing allowed in any given year.

When it comes to hidden debt, two sets of norms are particularly relevant. First are the laws governing the internal debt accounting and reporting process, whose violation is the quintessential feature of hidden debt. These are the laws requiring the borrowing entity to report the deal to a specific unit of the government in charge of collecting the debt statistics, typically the Debt Management Office under the Ministry of Finance or the Central Bank.[55] In certain countries, the Parliament too provides an oversight role. While peripheral to the overall debt deal, compliance with internal disclosure and reporting is fundamental to achieve medium and long-term debt sustainability. Indeed, it guarantees that the debt transaction does not violate the debt ceilings set in the primary or secondary legislation.[56]

The second set of norms concerns the debt approval process. These norms, which are strictly related to the internal disclosure requirements discussed above, determine the capacity of the borrower's entity to enter into the debt contract, or the authority of the borrower's agent to bind the principal.[57] The lack of proper authorization is not always present when we talk of hidden debt. An undisclosed debt can, in theory, be compliant with the rules governing the approval process.[58] However, in most cases, the internal reporting of the transaction to the competent office or agency is imposed by law as a necessary formality for the validity of the act.[59] For instance, in the case of Mozambique, the loan was approved by Mozambique's Minister of Finance, but without going through the normal parliamentary approval procedures. In the case of Malaysia, the entire bond offering by 1MDB – the Malaysian sovereign wealth fund at the centre of the scandal – had been managed by Goldman Sachs without the approval of the Malaysian Parliament and the Malaysian Central Bank.[60]

In light of the above, a question arises as to whether the violation of the internal public budget laws might affect the validity of the underlying debt contract. This issue is particularly important from a policy perspective as it would allow the borrowing entity a legal avenue to challenge the entire debt transaction. Unfortunately, the answer to this question is far from clear, and it largely depends on the conflict of law solution applicable in the case, and on whether the violation of the internal rules concerns the entity's borrowing power or a minor procedural error.[61] Only in the

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[55] Ibid, at 43-44
[56] Ibid, at 24
[57] The difference between capacity and authority is a legal one and varies among jurisdiction. In the UK, the question was recently decided in *The Law Debenture v Ukraine*.
[58] Similarly, a debt that is not hidden might not be properly authorised, as in the recent *The Law Debenture v Ukraine* case.
[59] Awadzi (n 53), at 50-53
[60] See, Better Markets, 'Goldman Sachs' 1MBD "Four Monkeys" Defense and CEO Solomon's Golden Opportunity', Special Report (April 25 2019)
[61] In most cases, this would be the governing law of the contract. On this see, W. Mark C. Weidemaier and Mitu Gulati, "Unlawfully Issued Sovereign Debt" (2020), UNC Legal Studies Research Paper, Duke Law School Public Law & Legal Theory Series No. 2020-49, Available at SSRN: https://ssrn.com/abstract=3647283

presence of a violation of the entity's borrowing power could the debt transaction be successfully challenged. Yet, distinguishing between minor procedural mistakes and substantive violations is a very challenging task as it requires a delicate interpretation of the administrative mechanisms in place in the borrower's jurisdiction. This difficulty is compounded by the fact that an annulment of the contract would also put the interests of innocent creditors at risk. It is precisely this challenge to find a satisfactory trade-off between protecting the legitimate expectations of innocent investors and the right of borrowers to protect their own internal administrative and constitutional principles that make this a legal conundrum.

The *Ultra Vires* Defence

At the outset, it is important to say that as a matter of public international law, the violation of local laws is not sufficient to justify the prima facie invalidity of a commercial obligation. Under international law, a state is responsible for the actions of its sub-entities, including ministries, municipalities, and state-owned enterprises.[62] Hence, the question of whether the transaction is valid has to be answered according to the rules found in the governing law of the contract.

In English law two doctrines come into play.[63] On the one side, we have the rules governing the capacity of the public entity to enter into the debt transaction. On the other, we have the rules on the authority of the agent representing that entity to bind it to the transaction.[64] Neither of those doctrines is able to address a simple violation of internal disclosure rules, unless the lack of disclosure was essential for the validity of the borrower's internal authorization process.[65] Yet, even if that does not apply, since many hidden debt transactions might also lack proper authorization, it is worth discussing the status of an international debt contract that are ultra vires.[66] The English courts have developed a rich jurisprudence on both doctrines. However, only in a recent dispute - *Law Debenture Trust Corporation plc v Ukraine* – issues of capacity and authority were discussed with reference to a sovereign debt contract.[67]

Capacity

According to English law, if a party enters into a transaction without having the capacity to do so, the transaction is null and void as if it never existed, with no possibility for either party to validate it. Whether the creditors were aware or not of this factor is totally immaterial. In a hidden debt situation, this would mean that the debt contract would be set aside, and any sum would have to

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[62] As clearly stated by International Law Commission, "…the question of attribution concerns only with establishing when there is an act of the State, when it is the State which must be considered as to have acted". International Law Commission, YLC Yearbook 1973, vol. II, 189, para 5

[63] But the same applies in other common law jurisdictions. See, Weidmaier and Gulati (n 61); On the doctrine of authority in sovereign debt, see Daniel P. Roy III, "(Don't) Take Another Little Piece of My Immunity, Baby: The Application of Agency Principles to Claims of Foreign Sovereign Immunity", 84 *Fordham Law Review* 1283 (2015)

[64] See, *Chitty on Contracts 33rd Ed* (2018), at 11-001 to 11-051

[65] This largely depends on the borrower's internal administrative and budget laws. For instance, on whether the transaction had to be disclosed to the budget office before being approved by the competent minister.

[66] Hayk Kupelyants, *Sovereign Defaults Before Domestic Courts* (Oxford University Press, 2018), at 196-201

[67] It is worth mentioning that this dispute does not concern a hidden debt per se. *Law Debenture Trust Corporation plc v Ukraine* [2017] EWHC 655 (hereinafter, *Law Debenture*); *Ukraine v The Law Debenture Trust Corporation Plc* [2018] EWCA Civ 2026. An appeal to the U.K. Supreme Court on the dispute was heard in December 2019. As of 9th of February 2021, the Supreme Court has not handed down its judgment.

be returned by both sides. In practice, an annulment of the contract would probably hurt both creditors and debtors. Given that the debt would be unaccounted for and would not have featured in the official budget, it is probably safe to assume that in most situations the money would not have been used to finance legitimate projects.[68] Debtors would still have to find enough budgetary resources to repay the creditors of any sum received. Lenders too would have to adjust their balance sheet and discount any possible losses.

Given the consequences attached to incapacity, it is not surprising that in international financial contracts the bar for determining that lack of capacity of the borrower is extremely high. This is especially so where the borrower is a foreign central government. English law indeed differentiates between ultra vires financial transactions of a foreign public authority, such a municipality or a state-owned enterprise, and those of a foreign central government. Only the former transactions are null and void if they are outside of the authority's statutory powers.[69] While the capacity to borrow by foreign local governments and public corporations has been subject to a few disputes over the years, that of foreign central governments was raised for the first time in *Law Debenture v Ukraine*. In this case, both the High Court and the Court of Appeal, have stated that the capacity of states to borrow is unlimited.[70] In other words, a foreign state is by default always capable to borrow, irrespective of what its internal laws on public debt say. It is difficult to make sense of the distinction. The approach of English courts on capacity undoubtedly protects foreign governments against financial risks coming from local government entities and state-owned-enterprises, for which they might be acting as guarantors. However, it is not entirely clear why central governments should be treated differently, especially considering that this would not happen with regards to ultra vires acts of the UK Government and the Crown.

Authority

If no issue of capacity arises, then the rules on authority come into play. The doctrine of authority is part of the law on agency and it deals with the power of an agent to bind the principal. It is particularly apt to address the complexity of hidden sovereign finance. Indeed, it provides a set of rules to tackle situations where a government representative (the agent) acting outside his mandate enters into a contract with a third party (the lender), thus binding an innocent principal (the public entity). The doctrine of authority has already been analysed extensively in commercial law and, sometimes, sovereign debt jurisprudence. In English law, various cases from *Attorney-General for Ceylon v Silva* to the more recent *Marubeni v Mongolia* have established the standards for the determination of authority and the contractual consequences attached to it. Similar cases were also litigated in New York courts, notably in *First Fidelity v Antigua & Barbuda* and in *Themis Capital, LLC v. Democratic Republic of Congo*, but only with respect to the authority of the agent to bind the government.[71]

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[68] Otherwise, it would be difficult to explain why the debt contract was not disclosed according to the normal accountability mechanisms.

[69] *Haugesund Kommune v Depfa ACS Bank*, 2010 WL 1990732 (2010); *Credit Suisse International v Stichting Vestia Groep* [2014] EWHC 3103

[70] *Law Debenture*, at 129; *Ukraine v The Law Debenture* (Appeal), at 59-73

[71] *First Fidelity Bank v. Government of Antigua and Barbuda*, 877 F.2d 189, 191 (2d Cir. 1989); *Themis Capital, LLC v. Democratic Republic of Congo* (Themis Capital I), 881 F. Supp. 2d 508 (S.D.N.Y. 2012). Other cases are *Northrop Grumman*

Without entering into the technicalities of the doctrine in English law, there are a few issues that are worth discussing. First of all, the lack of authority of the agent, entitles the principal to invalidate the transaction between the third party and the agent. However, contrary to what occurs if lack of capacity is demonstrated, a contract lacking authority is only voidable and can thus be rectified by the positive conduct of the principal. This can pose a challenge for the innocent borrower whenever the lender demonstrates that a few instalments of the loan have been repaid. In that case, even the partial fulfilment of the debt obligation will likely be interpreted as a ratification of the contract.[72]

Secondly, if the principal has openly authorized an agent to enter into a particular transaction or class of transactions by way of decree or other provisions of domestic law, there is no violation of authority. The same occurs when the principal appoints the agent to a position that is generally understood to confer authority to contract, thereby implicitly authorizing him to enter into transaction that usually fall within the scope of its office.[73] Transposed to hidden finance, if an agent of the borrower contracts in manifest violation of the laws governing its role and powers, the borrower can invalidate the transaction. This would somehow protect innocent borrowers against the abuse of power by some politicians or civil servants which might abuse their position of control. At the same time, it also puts a burden on the lenders to ensure that the agent acts according to local law. While navigating budget legislation is not easy and inevitably requires the assistance of a local lawyer, a lender is presumed to know local legislation, including any limits on external borrowing that derive from local law and administrative procedures and the effect that current borrowing has on those limits.[74] As clearly stated in *Ukraine v the Law Debenture*, if there are suspicious circumstances or abnormalities in the transaction, or if the transaction is manifestly disadvantageous for the principal, the lender ought to enquire as to the actual authority of the agent.[75]

The Jubilee Campaign's Proposal

Overall, the current law on capacity and authority is overly convoluted and not able to tackle the complexities of hidden sovereign finance. Given the current judicial interpretation on the unlimited and permanent capacity of foreign central governments to borrow, the only option for borrowers left exposed by the acts of rogue government agents is to rely on the law on authority. However, while the law on the authority of agents does generally protect innocent principals, it still sometimes leaves them exposed when the authority of the agent is only apparent.

In order to overcome this problem, the Jubilee Campaign advanced a legislative proposal that would change the way the law of authority operates in English law with regard to sovereign finance.[76] Accordingly, the lack of disclosure by the lender would create a legal presumption that the transaction has been approved without proper government authorization, thus making the

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Ship Sys., Inc. v. Ministry of Defence of the Republic of Venezuela, 575 F.3d 491 (5th Cir. 2009), *Phaneuf v. Republic of Indonesia,* 106 F.3d 302 (9th Cir. 1997).

[72] *Bowstead and Reynolds on Agency,* 21st Edition, 2-047 – 2-100

[73] *Ukraine v The Law Debenture Trust Corporation PLC* [2018] EWCA Civ 2026, para 79

[74] *Ukraine v The Law Debenture Trust Corporation PLC* [2018] EWCA Civ 2026, para 121

[75] See, *Criterion Properties plc v Stratford UK Properties LLC* [2004] UKHL 28, [2004] 1 WLR 1846 [31] (Lord Scott); *Midland Bank Ltd v Reckitt* [1933] AC 1 (HL).

[76] Jubilee Debt Campaign (n 3), at 4

contract voidable. This proposal, which did not make it to the voting stage in the UK Parliament, would have solved the jurisprudential loopholes in current English law on authority.[77] However, as some commentators argued, it would have had little practical relevance if adopted by only one jurisdiction. Indeed, the lender and the agent of the borrower could simply subject the contract to New York law or other national laws.[78] Having said that, the same proposal might succeed if adopted in a few key jurisdictions under a treaty or voluntarily.

4. THE ROLE OF CORRUPTION

Corruption is, probably, the real elephant in the room when it comes to hidden sovereign finance. It is very difficult to gauge the size and the precise contours of the phenomenon. It is even more complicated to say with certainly that all episodes of hidden sovereign finance entail some sort of illicit relationship between the borrower's representatives and the lenders. While corruption was investigated as a key element in the Mozambique tuna bond case and in the 1MDB scandal,[79] anecdotal evidence suggests that it might be a factor in other sovereign financing deals, including the Standard Bank case settled between the UK bank and the Serious Fraud Office in 2015.[80]

One could probably allege that the actual active hiding of the debt transaction, the key element in all hidden finance deals, might suggest that an inappropriate relationship between the borrower and the lender or their representatives was in place. However, motives other than personal gain – perhaps, internal political manoeuvrings – might have played a part in the decision of the borrower to bypass the normal procedural requirements. For the same reason, it is also impossible to discount the possibility that the lender was oblivious to the actual requirements in place for the disclosure and approval of the financial transaction. In this case, while it could probably be easy to demonstrate an illegitimate intent by the borrower, for what concerns the lender, it would more actually be an issue of failed compliance and poor legal advice which would limit the issue to civil litigation.[81]

As usual when we talk about corruption, the key challenge is to prove it. Corruption, being a two-party crime where both the offeror of the bribe and the offeree often collude in the crime, none of the parties in the botched transaction has any incentive to report it and, often, collude to hide it.[82] Moreover, the bribery methods used by financial institutions to corrupt foreign government officials are different and sometimes far more sophisticated than the brute transfer of cash or other classical schemes such as higher invoicing. In a series of cases prosecuted under the FCPA, commonly known as the "princeling' hiring programs, a number of banks were investigated for

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[77] UK Parliament, Transparency of Developing Country Debts EDM (Early Day Motion) 158: Tabled in the 2017-19 session on 11 July 2017, accessible at https://edm.parliament.uk/early-day-motion/50619

[78] Shutter et al. (n 4)

[79] CNBC, 'US Charges Former Goldman Bankers for 1MDB', CNBC News (1 November 2018), https://www.cnbc.com/2018/11/01/us-charges-former-goldman-bankers-for-1mdb.html

[80] The case involved directly the Tanzanian local bank partner of Standard Bank in the context of a bond issuance. Allen & Overy, 'First UK Deferred Prosecution Agreement between the SFO and a Bank', Allen & Overy Litigation and Dispute Resolution Review (14 April 2016)

[81] See the discussion on authority in the previous section.

[82] For an analysis of corruption in global banking see, Transparency International, 'Anti-Corruption and Transparency in Global Banks', Anti-Corruption Helpdesk (14 July 2017)

their hiring practices.[83] According to the SEC and the DoJ, various companies, including Bank New York Mellon and JPMorgan have resorted to preferential and less-rigorous hiring of sons and daughters of key government officials in key Asian jurisdictions as a way to get preferential access to government contracts.[84]

The Power of Anti-Bribery Laws

All financial centres, and OECD countries generally, have established very strong anti-bribery frameworks to tackle international corruption. According to Stanford Law School's Foreign Corrupt Practices Clearinghouse, a comprehensive database on all enforcements of the US Foreign Corrupt Practices Act (FCPA), since 1980, financial institutions have been subject to forty-six enforcement actions by the United States Department of Justice and the Securities and Exchange Commission. Only eight of the forty-six enforcement actions were initiated before 2011.[85] In the United Kingdom, like many other European countries, the number of corruption cases involving banks is also on the rise.

The extraterritorial dimension of international bribery laws is at the core of their success and undoubtedly also helps in tackling hidden finance. Since the adoption of the US *Foreign Corrupt Practices Act* in 1977,[86] and the OECD *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions,* the extraterritorial reach of criminal statutes allows investigative authorities to tackle episodes of corruption outside national borders, thus reaching jurisdictions where the prosecution of the crime would be more challenging.[87] By adopting extraterritorial jurisdiction of criminal prosecution as the key legal tool in the fight for international corruption, the various legal instruments in the hands of prosecuting authorities are able to expand the reach of the law to every single country where the corruption takes place. One of the core arguments in support of the extraterritorial application of anti-corruption law is that it allows countries where judicial institution and economic governance are weak to benefit from serious anti-corruption measures.

Moreover, as Davis clearly points out, prosecuting and investigating white collar crime requires extensive financial resources and expertise, well beyond the simple adoption of state-of-the-art

[83] See Beverley Earle and Anita Cava, "The "Princelings" and the Banks: When Does a Legitimate Business Practice Become Criminal Corruption in Violation of the Foreign Corrupt Practices Act?", 37 North Western Journal of International Law and Business 107, 114-16 (2016); Suzanne Barlyn, "U.S. Fines Qualcomm for Hiring Relatives of China Officials", REUTERS (Mar. 1, 2016)

[84] Press Release, US Department of Justice, "JPMorgan's Investment Bank in Hong Kong Agrees to Pay $72 Million Penalty for Corrupt Hiring Scheme" (Nov. 17, 2016), https://www.justice.gov/opa/pr/jpmorgansinvestment-bank-hong-kong-agrees-pay-72-million-penalty-corrupt-hiring-scheme; Press Release, US Securities and Exchange Commission, "JPMorgan Chase Paying $264 Million to Settle FCPA Charges" (Nov. 17, 2016), https://www.sec.gov/news/pressrelease/2016-241.html;

[85] This, however, does not necessarily reflect a surge in international corruption by international banks, but rather the more active role of US authorities to enforce the FCPA as reflected in higher number of enforcement actions across all industries. See, Stephen Choi, and Kevin E. Davis. "Foreign Affairs and Enforcement of the Foreign Corrupt Practices Act" (2014) 11 Empirical Legal Studies 409–445

[86] See, Wesley Cragg and William Woof, "Legislating against Corruption in International Markets: The Story of the US Foreign Corrupt Practices Act", in Arvind K. Jain (ed*) The Political Economy of Corruption* (Routledge, 2001), at 182-187

[87] On the question of jurisdiction in international corruption treaties and legislation see, Marco Arnone and Leonardo Borlini, *Corruption: Economic Analysis and International Law* (Edward Elgar, 2014), at 377-393

corruption laws.[88] In addition, locating the investigative and prosecutorial centre of the anti-corruption action in the firm's home country entails a strategic advantage. Foreign prosecutors and courts are impartial and disengaged from the political dynamics of the country, where the corruption takes place.[89] In this case, the law forces the corruptor's country to internalize the cost of failed economic governance in the countries where the corruption takes place. By doing so, the burden to prosecute is transferred to the party that is more able to carry it out.[90]

Enforceability of a Contract Tainted by Corruption

The power of anti-bribery laws is also particularly important from a civil law perspective. A question that English courts had to deal with was whether an international contract procured by bribery could automatically be set aside on grounds of public policy. The issue was discussed in two notable cases *Honeywell International Middle East Ltd v Meydan Group LLC*, and *National Iranian Oil Company v Crescent Petroleum Company International Ltd & Crescent Gas Corporation Ltd.* [91] The approach of English courts to the issue limits the public policy defence only to illegal contracts – ie. contract to commit an illegal act – which are automatically void. A contract procured or tainted by corruption, on the other hand, is only voidable at the election of the innocent party: arguably the sovereign borrower's government.

When it comes to hidden debt, this would nevertheless offer a useful legal tool the borrower. Especially when the debt deal was negotiated by a government official who received bribes for its role in the transaction. The key issue is, as usual, to demonstrate the presence of a crime, bearing in mind that English courts impose a very high bar to demonstrate the presence of corruption. Yet, the adoption of more stringent disclosure standards by lenders such as the G20 Principles, and increased transparency in public finance, could ease the work of civil society in uncovering malfeasance by government officials.

6. CONCLUSIONS

The slow emergence of hidden sovereign finance has put a spotlight on the practices of certain lenders which collude with borrowers to structure a financial transaction in violation of the borrower's local laws and to abscond it from the public. While corruption is not always present, the peculiarities of hidden debt undoubtedly suggest that it could easily be a possibility.

This essay argues that the voluntary nature of disclosure standards for lenders, particularly, the Principles, make them unsuitable by themselves to tackle the problem of hidden debt. However, if properly implemented, disclosure standards can indeed help by putting sovereign financing deals under closer scrutiny. Civil society organizations could then offer their help to highlight possible dark spots and put murky financing deals under the spotlight.

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[88] This includes specialised skills in forensic accounting, treatment of whistle-blowers, and other legal tactics. See Kevin Davis, 'Does the Globalization of Anti-corruption Law Help Developing Countries?', in Julio Faundez & Celine Tan eds., *International Economic Law, Globalization and Developing Countries*, 283 (Edward Elgar, 2010), at 289-290

[89] Ibid.

[90] Ibid.

[91] *Honeywell International Middle East Ltd v Meydan Group LLC* [2014] EWHC 1344 (TCC), and *National Iranian Oil Company v Crescent Petroleum Company International Ltd & Crescent Gas Corporation Ltd* [2016] EWHC 510,

The real solution to hidden debt comes from criminal and civil law litigation, which are already equipped to deal with the legal aspects of murky debt. OECD countries all have strong anti-bribery statutes and corruption laws in place which would target episodes of corruption in the borrower's jurisdiction. If found, corruption could also invalidate the underlying contract. Moreover, borrowers can challenge the validity of the contract if it was signed in violation of local budget laws. While the jurisprudence of English courts on the incapacity of foreign public entities is far from clear, currently differentiating between the capacity of foreign central governments and that of municipalities and public organizations, that on authority is much more stable. The principles of agency law governing the authority of agents can indeed offer a legal anchor to contest the contractual legality of a transaction procured by rogue civil servants or politicians.