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ABSTRACT

The lesson from abundant history is that, despite decades of constructive innovations in international loan and bond contracts involving sovereign financial obligations, lawyers, bankers, analysts and investors are best advised to operate under no illusions: Sovereigns are indeed sovereign. To those who harbored the hope that Argentina's bad behavior as a sovereign debtor was a major exception that would not soon be repeated, the case of Ecuador's latest default on shaky claims of the "illegitimacy" of some of its obligations demonstrates that while the absence of sovereign willingness to pay remains rare, it is not rare enough. These rogue sovereign debtors can be effectively restrained only by the forceful actions of other sovereigns, bilaterally or multilaterally, but in this case, in a repetition of attitudes shown toward Argentina since 2002, the international official community not only failed to condemn Ecuador's actions, but actually expressed verbal and provided financial support. The government in Quito gathered no plaudits from the many national and international NGOs that have been campaigning for the massive forgiveness of developing-country debt, but at least this attitude is understandable: the case of Ecuador did not lend itself to arguments in favor of repudiation on "odious debt" or any related grounds. Above all, the country provides a useful, cautionary tale of the bad things that can happen to good sovereign debt contracts.

Multinational corporations were meant to be reassured by the protections incorporated into bilateral and regional investment agreements, but judging from the growing number of claims filed with ICSID and other arbitration vehicles (such as the UNCITRAL conciliation rules) – more than 300 treaty-based, investor-State disputes as of the end of 2008 – it is evident that many corporations have found out the hard way that sovereign states are not always suitably restrained by the international treaties they have signed and ratified.[1]

Likewise, private-sector commercial bank creditors, bondholders and suppliers – even official (bilateral and multilateral) lenders – have come to learn by repeat experience that financial contracts entered into by sovereign borrowers, no matter how airtight and well intentioned at the time they were crafted and signed, can be perverted or ignored by governments lacking in ability or willingness to pay.

This article illustrates the point by focusing on the case of Ecuador, a country whose governments have defaulted nine times on foreign-currency bonds and numerous times to foreign commercial bank creditors and others, such that the sovereign has been in default for at least 109 out of the last 183 years – namely, at least sixty percent of the time from 1826 through 2009.[2] By its own reckoning, the government has been in arrears on interest payments to some foreign creditor or another in each and every year starting in 1987.[3]

The lesson from abundant history is that, despite decades of innovations in international loan and bond contracts involving sovereign financial obligations, courtesy of some of the best minds in New York, London and beyond, lawyers, bankers, analysts and investors are best advised to operate under no illusions: Sovereigns are indeed sovereign. To those who harbored the hope that Argentina's bad behavior as a sovereign debtor was a major exception that would not soon be repeated, the case of Ecuador should persuade them that while the absence of sovereign willingness to pay remains rare, it is not rare enough. As we have argued previously, notwithstanding the best of legal contracts and the surrender of sovereign immunities under New York, English or other foreign law, in actual practice, rogue sovereign debtors can be held to account or effectively restrained only by the forceful actions of other sovereigns.[4] During the 19th century, this was sometimes accomplished by the successful exercise of military force, and during the 20th century through the application of diplomatic, trade and financial sanctions or incentives, whether unilaterally or through multilateral organizations.

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1 UNCTAD, WORLD INVESTMENT REPORT 2009 (United Nations, 2009), 34.

2 Ecuador's first default took place when it was part of the Republic of Gran Colombia, which included what became the nations of Ecuador, Colombia and Venezuela in 1830 and thereafter; updated by the author to 2009 based on Standard & Poor's, *Commentary: Sovereign Defaults At 26-Year Low, To Show Little Change In 2007*, September 18, 2006, 18.

3 Banco Central del Ecuador, *80 Años de Información Estadística, Capítulo 2, Sector Externo*, Excel Table 2.12, and *Información Estadística Mensual #1893*, November 2009, *Movimiento de la Deuda Externa Pública*, Excel Table 3.3.1, both available at http://www.bce.fin.ec/frame.php?CNT=ARB0000006.

4 Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default*, CHICAGO JOURNAL OF INTERNATIONAL LAW, Summer 2005, 331.

I
THE GOOD INTENTIONS

After repeated refinancings and deferrals of debt service-obligations to foreign commercial banks, and the accumulation of sizeable interest arrears (particularly during 1987-1994), the government of Ecuador finally reached a comprehensive debt forgiveness and restructuring deal in 1995, under the aegis of the Brady Plan. The terms agreed reflected creditor concessions that were more generous than those granted to any other Latin American government up to that moment; in particular, the Discount bond accepted by creditors willing to give up claims on principal owed involved a 45 percent "haircut" rather than the usual 35 percent. As was the case in other Brady Plan applications, the various securities issued in exchange for old defaulted loans (in this instance, the Par, Discount, Past-Due Interest and Interest Equalization bonds) incorporated a number of legal innovations designed to make them virtually inviolable in any future economic emergency. First, they were freely transferrable bonds listed on the Luxembourg Stock Exchange, precisely so their ownership could change over time and they would not be easily traceable for the purpose of getting them restructured again. Second, the bonds that involved debt forgiveness or concessional interest rates and had very long grace periods and maturities (the Pars and Discounts) were backed in part with good collateral (U.S. government zero-coupon bonds), such that future governments would not be tempted to default merely to avoid servicing them. And third, the new bonds contained "exit covenants" by which the obligor pledged neither to ask for a future restructuring of the securities nor to request additional funding from the holders of the bonds.[5]

In addition, the Ecuador and other loan-for-Brady-bond exchanges were accompanied by concrete steps and pledges of improved macroeconomic policies and market-friendly structural reforms that would enhance the ability of governments and their successors to service the new financial obligations until their eventual maturity. In Ecuador's case, good progress in terms of economic stabilization and structural reforms was made ahead of the Brady Plan's implementation, with the support of the Washington-based multilateral agencies, such that the IMF was twice moved (in 1992 and 1994) to endorse a rescheduling of debts owed by the government of Ecuador to the official foreign aid and export financing agencies represented at the Paris Club. However, in 1995, the debt relief obtained was squandered via increased military spending following a brief border war with Peru, and what had been a duly balanced government budget during 1993-94 became a string of deepening fiscal deficits – and renewed foreign indebtedness, including for armaments. Battered also by drought-related power shortages and the adverse repercussions of the financial crisis in Mexico, the economy stagnated that year and the country's vice president, who had been the driver of market-friendly economic

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[5] Lee C. Buchheit, *The Evolution of Debt Restructuring Techniques*, INTERNATIONAL FINANCIAL LAW REVIEW, August 1992, 12.

reforms, fled Ecuador to evade arrest on charges of corruption.[6]

Notwithstanding the good intentions incorporated into the 1995 debt relief operation, by 1999 Ecuador was in very serious – indeed, far more serious – financial trouble. A decline in world oil prices, damaging floods occasioned by the El Niño weather phenomenon, a drop in capital inflows in the wake of the Asian and Russian financial woes, a major domestic banking crisis, and loose fiscal and monetary policies all combined to push the economy to the brink of ruin. During the second half of that year, Ecuador became the world's first government to default on its Brady bonds, as well as on two Eurobonds that had been issued in better days (1997), and on dollar-denominated domestic obligations maturing in the short run. In a desperate move, the economy was officially dollarized (as of January 2000), and soon after the president was deposed and replaced by his vice president, but as financial stability and improved macroeconomic policies took hold, the IMF offered its financial support in April of that year – provided that substantial debt relief was obtained from foreign private creditors.[7]

In July of 2000, and with the IMF's backing, the government sought and obtained a second round of principal forgiveness from its creditors estimated at around 40 percent of face value. Bondholders were presented with a take-it-or-leave-it exchange offer whereby they would get new, uncollateralized obligations due in 2030 paying very little interest, at least in the initial years, in exchange for their long-dated Brady bonds to which a heavy discount was applied, and also in exchange for their short-dated Eurobonds to which no discount was applied. If creditors opted instead for a bond paying a high interest rate and maturing in 2012, they had to concede an additional 35 percent "haircut" on the principal owed by Ecuador. Some 97 percent of all bondholders accepted the exchange offer, which gave Ecuador substantial debt reduction as well as significant cash-flow relief in the initial years.[8]

The new bonds incorporated contractual innovations meant to reassure investors that the risk of future losses would be minimized, and that the new securities had upside potential. As recounted by the venerable Lee Buchheit, New York counsel to the Republic of Ecuador, "A deliberate effort was … made to include structural features in the new bonds that would reduce the likelihood that the debt stock would become the subject of a third round of debt relief in the future."[9] The first legal

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[6] Stanley Fisher, *Ecuador and the IMF*, May 19, 2000; edited version of remarks made by the then First Deputy Managing Director of the IMF, available at http://www.imf.org/external/np/speeches/2000/051900.htm.

[7] "The country needed both cash flow relief and debt reduction to secure a sustainable external and fiscal position for the medium term." Fisher, *supra* note 6.

[8] For additional details, see Lee C. Buchheit, *How Ecuador Escaped the Brady Bond Trap*, INTERNATIONAL FINANCIAL LAW REVIEW, December 2000, 17-20. For example, a ceiling was placed on the overall issuance of 2012 bonds, and a cash payment was made on past-due interest and principal, funded by the collateral set aside when the Brady bonds had originally been issued. Also, there was an innovative, aggressive use of "exit consents" to penalize bondholders who might choose to retain their existing bonds; they would be rendered substantially inferior by the consent to various prejudicial amendments granted by bondholders entering into the debt exchange. The application of these exit consents surely helps to explain the high bondholder participation rate.

[9] *Id.* at 19.

innovation was to incorporate a pledge that if there should be a default on the 2030 bonds during the first decade after issuance that was not cured within one year, Ecuador would compensate bondholders: it would grant them additional 2030 bonds under a sliding scale starting with an extra 30 percent of bonds if the default took place in the first four years after their original issuance. This principal reinstatement provision sought not only to reassure investors that granted debt forgiveness that a meaningful portion of their original claims against Ecuador would be restored in case of a default, but also to discourage future governments from defaulting by making it expensive for them to do so.

The second legal novelty was to include a binding commitment that Ecuador would repurchase both the 2012 and 2030 bonds by a specified percentage of the amount outstanding in each year starting six and eleven years after their issuance, respectively. These mandatory buybacks (at secondary-market prices) were to set investors' minds at rest that the aggregate amount of the government's bonded debt would be gradually reduced to a smaller, more manageable size before their maturity, and to reassure them that by its actions the government would help to bolster the price of these securities in the secondary market. Ecuador's failure to meet the debt reduction targets in any one year would trigger a mandatory partial redemption of the bonds at par. However, this novelty was potentially quite advantageous also for Ecuador, because it allowed the government to satisfy its amortization commitments by purchasing the bonds and retiring them whenever they traded at a discount in the secondary market – which they usually did, at prices in the range of 50-60 cents on the dollar. If ever the 2012 or 2030 bonds were to trade above par, the government could always make the amortization payments at par.[10]

With the IMF's blessing, the Paris Club subsequently refinanced accumulated arrears and maturities through April 2001, but it did not grant any debt forgiveness, just as it had not done so in the early 1990s. And yet, Ecuador's interest and principal arrears to official creditors were more than twice as large as they had been to commercial banks and bondholders.[11] Evidently, while Ecuador was deemed (by the United States and European governments, as well as the IMF's management) to be insolvent enough to deserve major write-offs from private creditors twice in five years, it was considered solvent enough not to deserve write-offs from official creditors even once – despite being in the midst of arguably the country's worst economic crisis. As we have pointed out elsewhere, this was one of several instances where the Paris Club's principle of "comparable treatment" proved to be a highly discretionary, one-way street.[12]

In the event, it would take less than a decade for investors in Ecuador bonds

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[10] *Id.* This was one of the motivations for the government to set up a fund known as the FEIREP, which is explained below -- to provide a pool of cash to repurchase the 2012 and 2030 bonds opportunistically, whenever they would trade at a deeper-than-usual discount. The government could also achieve the promised reduction in the stock of outstanding bonds by other means, such as debt-for-equity exchanges.

[11] IMF, *Ecuador: Selected Issues and Statistical Annex*, October 2000, 141, available at http://www.imf.org/external/pubs/ft/scr/2000/cr00125.pdf.

[12] Arturo C. Porzecanski, *Debt Relief by Private and Official Creditors: The Record Speaks*, INTERNATIONAL FINANCE, Summer 2007, 204.

(vintage 2000) to come to regret ever owning the new and supposedly much-improved securities.

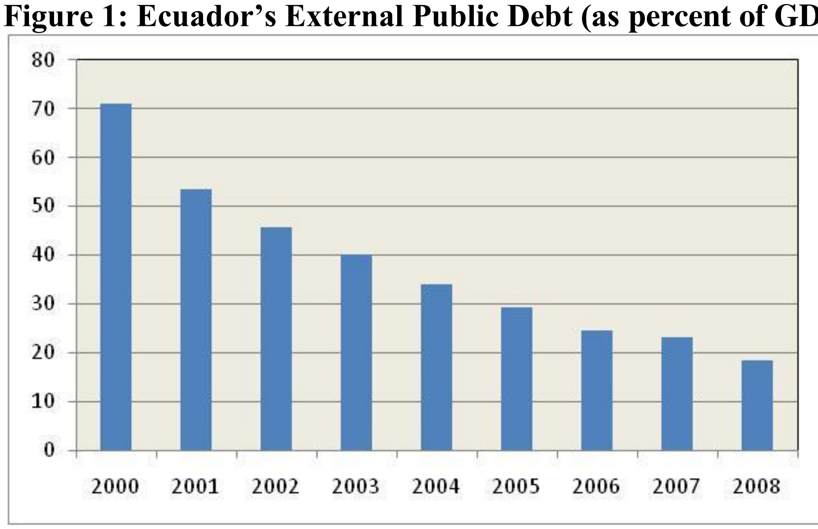
II

THE BAD OUTCOMES

In late 2008, the current populist government of Ecuador headed by President Rafael Correa defaulted on the 2012 and 2030 sovereign bonds, claiming they were immoral and illegitimate obligations. At no point before or after the default, when said bonds were repurchased by the government indirectly (through the secondary market) and also directly (through a buyback for 35 cents on the dollar), as explained below, did the government assert that servicing these obligations posed a financial hardship. There was no objective basis for doing so: in 2008, the public external debt was the least burdensome it had been in over three decades, relative to government revenues or the gross domestic product. Moreover, the country's central bank held more freely disposable international reserves ($6.5 billion) than it had ever accumulated before. Thus, the default was not the (usual) consequence of a sovereign's inability to pay. It was also out of character relative to Ecuador's many prior defaults, which had taken place during fiscal and economic emergencies.

During the period 2000-2005, the government's external public indebtedness remained fairly steady at about $11.25 billion, and then declined $10.1 billion by the time of the default, as repayments exceeded new disbursements because rising world oil prices provided a fiscal windfall that minimized its borrowing needs. Since 2000, the economy expanded steadily and the market value of Ecuador's gross domestic product ballooned from an abnormally depressed $16 billion in 2000 to $55 billion by 2008. Consequently, by the time President Correa announced the default, the ratio of external public debt to GDP had dropped sharply from over 70 percent in 2000 to a very manageable proportion of under 20 percent in 2008 (see Figure 1)

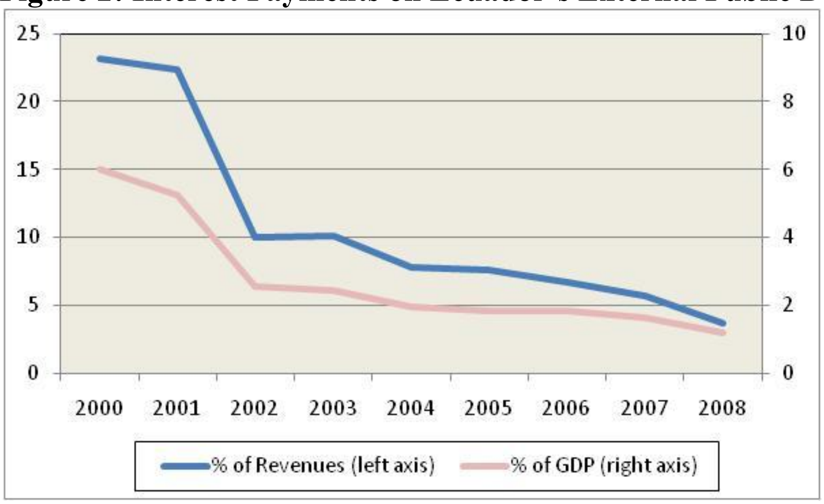
Figure 1: Ecuador's External Public Debt (as percent of GDP)*



** Including any interest or principal arrears.*
Source: Banco Central del Ecuador, authors' calculations.

Servicing this external indebtedness imposed an increasingly lighter burden on the country and its public finances, especially given the rapid growth of government revenues during the intervening years, from $4.1 billion in 2000 to an estimated $17.8 billion by 2008. The interest bill averaged $1 billion in 2000-2001, but then started to drop and settled at less than $700 million per annum during 2002-2008. As a proportion of government revenues, interest payments dropped from over 23 percent in 2000 to under four percent by 2008, and in relation to GDP, they fell from six percent to nearly one percent (see Figure 2).

Figure 2: Interest Payments on Ecuador's External Public Debt*



** Including any interest arrears.*
Source: Banco Central del Ecuador, authors' calculations.

In particular, 2012 and 2030 bonds, which accounted for nearly one-third of the external public debt as of end-2008, required annual interest payments of $331 million, the equivalent of a mere 1.9 percent of 2008 government revenues and 0.6 percent of 2008 GDP – a relatively insignificant amount by any standards. Even though revenues and GDP are estimated to have dropped somewhat in 2009, the burden of interest payments on the 2012 and 2030 bonds would not have increased appreciably in the absence of a default.

To understand the genesis of this decision to default out of unwillingness rather than inability to pay it is necessary to paint a brief profile of President Correa. He was born in 1963 in the coastal city of Guayaquil to a family of modest means, and throughout his formative years – until age 28, in fact – he attended, or was otherwise affiliated with, Catholic schools and universities, mostly run by the Salesians, the largest Catholic missionary order. This upbringing included spending one year in a mission at a social center run by the Salesians in Cotopaxi province, where Correa empathized with the native population when he saw their extreme poverty up close. In a speech delivered recently at Oxford, entitled "My Experience as a Leftist Christian in a Secular World," President Correa stated that his "economic principles are based on the Social Doctrine of the Catholic Church and on Liberation Theology." He denounced the very unequal distribution of income in Latin America and said that, "as a practicing Catholic, I will always believe in the importance of charity and solidarity," and he pledged to keep ruling "with a clear preferential option for [helping] the poorest and the forgotten and [for] prioritizing human beings over [the owners of] capital."[13]

Vice President Alfredo Palacio, a cardiologist with no business experience, "discovered" Correa in 2003, at which time Correa was an economics professor and consultant, and he retained him as his economic advisor on the issue of how to set up and pay for a universal health-care system, which had been an electoral campaign promise that Palacio had made. At the time, funding for social programs was limited, and resources that might otherwise be available were not within reach because a portion of oil-related revenues were being deposited into a government fund known as the FEIREP. It was set up in 2002 largely for the purpose of generating the fiscal savings necessary to pay for the debt buybacks committed to as part of the debt restructuring of 2000. Palacio and Correa tried to tap into the FEIREP but were unsuccessful.[14]

In March 2005, Correa presented a foreboding paper at a meeting held in Quito to discuss Latin America's foreign debt problems sponsored by CLAI, a regional council of Christian churches. It was entitled "Debt Exchange: It's All About the Creditors," and in it Correa denounced the 2000 restructuring as having delivered insufficient relief because, to begin with, Ecuador's obligations should have been written down to then-prevailing prices in the secondary market – precisely the kind of massive forgiveness that, he wrote, Argentina was rightly demanding at the time from its creditors. Correa went on to denounce the FEIREP for starving the country of funds for social programs and for enriching bondholders by having boosted the market price of Ecuador's debt.[15]

A few weeks later, on April 20, 2005, Palacio was appointed to the presidency when the legislature removed the incumbent, Lucio Gutiérrez, following a week of growing popular unrest with his government, and as political retribution against what was perceived as dictatorial decisions made by President Gutiérrez in prior months. And Palacio, in turn, appointed Rafael Correa as his finance minister. As such, Correa wasted no time in proposing to the legislature the abolition of the FEIREP, which it did in June while setting up an alternate fund (named CEREPS) largely to underwrite social spending. This was done even though the FEIREP, which had accumulated $1.1 billion during its nineteen months of existence, had not spent a single dollar to buy back any foreign debt. According to the World Bank, the fund had been turned into "the piggy bank to finance the liquidity needs of the central

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[13] Rafael Correa, *My Experience as a Leftist Christian in a Secular World*, address before the Oxford Union Society, October 26, 2009, available at http://www.presidencia.gov.ec/pdf/Discurso%20ingles.pdf.

[14] FEIREP stood for "Fondo de Estabilización e Inversión de los Recursos Petroleros" (Stabilization and Investment Fund for Petroleum Resources). See Alfredo Palacio, *Vida Política*, available at http://www.dralfredopalacio.org/actividades.htm.

[15] Rafael Correa, *Canje de Deuda: Todo en Función de los Acreedores*, LA INSIGNIA, June 20, 2005, available at http://www.lainsignia.org/2005/junio/econ_008.htm.

government."[16] Correa also denounced the prior administration's supposedly secret consent to various policy conditions imposed by the IMF and the World Bank; threatened to withhold debt-service payments to the multilateral agencies if they did not fulfill their loan commitments; and raised the possibility of bypassing the multilateral agencies altogether and selling bonds to Venezuela, instead.

In late July, the World Bank made it known to Minister Correa that it would not authorize the disbursement of a $100 million loan he was counting on. Correa fired off an angry letter to World Bank President Paul Wolfowitz, telling him that the Bank had offended Ecuador by reneging on the loan and demanding to know precisely why the disbursement had been cancelled. A couple of days later, having set himself proverbially ablaze, Minister Correa tendered his resignation at the request of President Palacio, whose office let it be known that the minister had failed to keep his superior properly informed of his (inflammatory) activities. During his 106 days in office, Correa managed to ruin the government's access to external funding, but by wrapping himself in the national flag to confront the Washington multilateral agencies supposedly on behalf of the dispossessed of Ecuador, he had also succeeded in gaining national name recognition – thereby setting the stage for his candidacy in the next presidential elections. Upon departure, Correa's popular approval rating was 57 percent, the highest among cabinet members and nearly twenty percentage points higher than President Palacio's own.[17]

Rafael Correa would go on to win the presidential elections held in November 2006, and his inaugural address on January 15, 2007 presaged his get-tough attitude with foreign bondholders. He stated that one of the main challenges facing Ecuador was to overcome a culture of issuing debt abroad, which had left the country saddled with "a very costly overindebtedness" – a gross factual misrepresentation. He said that a country's debt service should be subject to a sustainability criterion; for example, debt service burdens should not be incompatible with the achievement of the United Nations' Millennium Development Goals. And third, he stated that part of Ecuador's foreign debt was illegitimate, had been acquired under dubious circumstances, was not used for its intended purposes, and had been "repaid several times" already. Ideally, President Correa acknowledged, governments should be able to appeal to an impartial and transparent international tribunal that would decide which obligations should be serviced and what was a country's objective capacity to pay. He noted, however, that such an impartial third party forum does not exist, and there is only the IMF, "which represents the creditors." This is why, Correa concluded, his administration would engage in a "firm and sovereign renegotiation of the external debt, in particular of the inadmissible conditions that were imposed on us in the debt exchange of 2000."[18]

Nearly six months later, on July 9, 2007, President Correa issued a decree

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[16] World Bank, *Ecuador Country Economic Memorandum*, May 15, 2006, 33, available at http://siteresources.worldbank.org/EXTEXPCOMNET/Resources/2463593-1213987636514/02_Ecuador.pdf.

[17] Choike, *La Renuncia de Rafael Correa, Ministro de Economía de Ecuador: ¿Un Ejemplo de la Influencia de las IFIs?*, August 16, 2005, available at http://ifis.choike.org/esp/informes/134.html.

[18] Radio La Primerísima, *Discurso Completo del Presidente de Ecuador Rafael Correa*, January 15, 2007, available at http://www.radiolaprimerisima.com/noticias/8555.

authorizing the creation of an "Integral Auditing Commission for the Public Credit" (known by its Spanish acronym, CAIC), and charged it with determining the "legitimacy, legality, transparency, quality, efficacy and efficiency" of the domestic and foreign public debt contracted between 1976 and 2006, taking into consideration "the legal and financial aspects, and its economic and social impact on regions, the ecology and various nationalities and peoples." It was to analyze not just each bond issued at home and abroad, but also each and every loan contracted with official bilateral and multilateral agencies, as well as with commercial banks and suppliers, during the past three decades. The CAIC was to determine who had authorized the indebtedness in question; whether the requisite feasibility studies had been conducted; what conditions had been imposed; to which purpose the funds had been allocated in actual practice; the comprehensive ("integral") impact of each project thus underwritten; and so on and so forth. And it was to accomplish this mission within one year, although later on the CAIC was given an extra couple of months – until the end of September 2008 – to achieve what any reasonable observer would regard as a "Mission Impossible."[19] The CAIC was not even allocated any funding to hire a staff until December 2007. Nevertheless, it managed to deliver a preliminary report in February 2008, a second draft in July, and its final report in November 2008.

The CAIC's designated members were four representatives of the Correa administration, including the then finance minister, plus six Ecuadorians and three foreigners from social organizations who had worked on debt issues. However, none were professional auditors and all had a long history of militancy in the debt forgiveness/repudiation movement (e.g., in Jubilee, Eurodad and LATINDADD). The CAIC was chaired by then Finance Minister Ricardo Patiño, an extreme leftist who in his early years had joined the Sandinista revolution in Nicaragua and had later held a post in the Sandinista government's land reform agency. Upon returning to Ecuador, he set up the country's Jubilee 2000 office, a member of the international coalition movement that called for the cancellation of Third World debt by the year 2000.[20] Minister Patiño was forced to resign as finance minister within weeks because of a scandal involving the alleged manipulation of Ecuador's bonded debt, but he was given another cabinet post by Correa, and despite the appearance of impropriety and of a conflict of interest, he was kept as the chairman of the CAIC.[21]

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[19] CAIC, available at http://www.auditoriadeuda.org.ec/index.php?option=com_content&view=article&catid=35&id=51&Itemid=55.

[20] Diario Hoy, *Funcionarios "Clave" Están Más Cerca de Correa*, available at http://www.hoy.com.ec/noticias-ecuador/funcionarios-clave-estan-mas-cerca-de-correa-284778-284778.html.

[21] A month after becoming finance minister, Patiño had said he might delay a $135 million interest payment on the foreign debt, but then he did not, which led to wild swings in the value of Ecuador's bonds and of derivatives linked to them, raising suspicions of a deliberate market manipulation. In May 2007, a video surfaced of a meeting between Patiño and three others in which the minister appeared to discuss a plan that would enable certain investors to make a great deal of money from the bond price swings. Minister Patiño denied any wrongdoing, but after Congress censured him in July 2007, another video surfaced showing him arranging a backroom

The CAIC's report was written in great haste, without the benefit of having hired professional auditors, interviewing public credit officers, finance ministers or living presidents from the 1976-2006 period, and obtaining access to many important documents.[22] The report's authors reveal that they requested information from eighteen government agencies but never heard back from three of them, were given information that was not relevant by eleven of them, and only obtained the documents they were seeking from just four agencies. In particular, the armed forces, known to have contracted many a foreign loan for the purchase of armaments, as confirmed by documents held by the finance ministry, had the audacity to issue a statement to the CAIC stating that they "had not found any documentation that details any loans received from foreign commercial banks during the period 1976-2006."[23]

As was to be expected given the circumstances, the CAIC report is incomplete, biased, and inaccurate. For example, the first misdeed it identifies involves none other than the United States Federal Reserve, which is accused of "illegally raising interest rates" and thereby causing Ecuador's debt to snowball during the late 1970s and early 1980s.[24] The accusation of illegality is ridiculous, of course. Moreover, a factual analysis based on official Ecuadorian statistics that are publicly available reveals that the temporary hike in U.S. interest rates under Chairman Paul Volcker might be related to only a fraction of the debt build-up that took place in those years. Ecuador's public external indebtedness grew to $5 billion as of end-1982 from less than $2 billion as of end-1978, but only about one-third of this increase could be justified by the need to borrow to cover the higher interest payments.[25] Besides, while U.S. interest rates were being hiked, Ecuador was simultaneously benefiting from a doubling in its oil export revenues, such that the government should have been

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deal with the head of Congress. Patiño remains a member of President Correa's cabinet, as Minister of Political Coordination. The Economist, *Ecuador: Caught on Camera*, July 26, 2007, available at http://www.economist.com/world/americas/displaystory.cfm?story_id=E1_JVQGQGN.

[22] For example, former President Sixto Durán Ballén (1992-1996) said he was never contacted by the CAIC to hear his version of events surrounding the issuance of Brady bonds, and that the CAIC report was full of inaccuracies. El Comercio, *Sixto Durán Ballén Indignado por Informe de Deuda*, November 21, 2008, available at http://ww1.elcomercio.com/solo_texto_search.asp?id_noticia=153269&anio=2008&mes=11&dia=21.

[23] The CAIC produced an English version of its report (available at http://www.auditoriadeuda.org.ec/images/stories/documentos/Libro_CAIC_English.pdf.zip), but the translation is so poor that all quotes from the report are translations by this author from the Spanish original, which is 172 pages long. See CAIC, INFORME FINAL DE LA AUDITORÍA INTEGRAL DE LA DEUDA ECUATORIANA: RESUMEN EJECUTIVO, November 2008, 28, available at http://www.auditoriadeuda.org.ec/images/stories/documentos/Libro_CAIC_Espanol.pdf.zip.

[24] *Id.*, 26.

[25] If the average interest rate paid by the government on its external debt had remained at its 1987 level of 7.4 percent, the cumulative interest bill during 1979-1982 would have been $1.1 billion lower than it actually was; however, the stock of indebtedness during this period jumped by $3.2 billion. Calculated by the author on the basis of data in Banco Central del Ecuador, *supra* note 3, Excel Table 2.12.

able to afford the higher interest bill without recourse to extra borrowing.[26] Moreover, despite a near halving of U.S. rates between the end of 1982 and the end of 1987, the government's external debt went on to double to $10 billion. In sum, there is no basis for pinning Ecuador's debt snowball on the Federal Reserve.

The other accusations of "illegality" made in the CAIC report target prior administrations, which are charged with having violated either mostly unspecified Ecuadorian laws or "basic principles of international law." Some examples of these transgressions are that prior administrations agreed to submit debt contracts to foreign jurisdiction (namely, New York and English law), waive Ecuador's sovereign immunity, and accept conditions imposed by official multilateral agencies "in violation of basic principles of international law such as the equality of sovereign states, the self-determination of peoples, the non-interference in the internal affairs of nations, the right to [economic] development, and the respect of human rights."[27] There are also multiple accusations of "irregularities," like the fact that prior administrations pre-paid debts (in the context of debt refinancing agreements) when they were under no obligation to do so, or that the government took over private-sector obligations in 1983-84, in the midst of a major economic crisis, without auditing the beneficiaries to check whether their obligations indeed were still outstanding.[28]

The CAIC report also censures loans obtained from foreign bilateral and multilateral agencies on a variety of grounds. For example, funding from the World Bank and the Inter-American Development Bank was used to purchase collateral to back the Brady bonds, "thereby aiding and abetting the reallocation of funds for purposes other than those contemplated in the lending programs previously agreed." Also, prior administrations accepted various conditionalities imposed by official foreign creditors, did not prevent cost overruns in various projects funded by foreign loans, and did not carry out the necessary environmental and other impact studies. A number of specific projects were examined and sufficient objections were raised about how they were implemented that the CAIC report recommends the repudiation of the multilateral loans involved.[29]

Ominously, the CAIC report criticized prior administrations for having "overpaid" greatly when they restructured their foreign obligations, particularly during the two bond exchanges in 1995 and 2000. In a mindset that surely was inspired by Argentina's harsh treatment of its bondholders, the report points out the costly mistake of recognizing and capitalizing interest arrears, and the failure to negotiate with creditors on the basis of prices for Ecuador's defaulted debt observed

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[26] In fact, the central government's interest bill on foreign debt went up by $110 million between 1978 and 1981, but its oil-related revenues meanwhile increased by $360 million. Banco Central del Ecuador, *80 Años de Información Estadística*, Capítulo 3, Finanzas Públicas, Excel Table 3.5, available at http://www.bce.fin.ec/frame.php?CNT=ARB0000006.

[27] CAIC, *supra* note 23, 34 and 42. Interestingly, prior governments are also accused of having failed to register Ecuador's bonds with the U.S. Securities and Exchange Commission – because they were issued under Rule 144A and Regulation S, in full compliance with U.S. securities laws. The CAIC took this type of bond issuance as evidence of a lack of transparency. *Id.*, 42 and 59.

[28] *Id.*, 28 and 38.

[29] *Id.*, 104, 151-152.

in the secondary market. Prior to the Brady bond exchange, the report's authors point out, Ecuador owed $4.5 billion of principal plus $2.5 billion of past-due interest, but its obligations were trading in the secondary market at around 25 cents on the dollar, so that should have been the discount applied during the debt-for-Brady bonds exchange. Likewise, in 2000 the Brady bonds and Eurobonds were trading at around 30 cents on the dollar, so they should have been restructured on that basis, in which case, the report estimates, only $1 billion of 2012 and 2030 bonds would have been issued instead of nearly $4 billion.[30]

III
THE DEFAULT AND ITS AFTERMATH

The CAIC report was formally delivered to President Correa on November 20, 2008, but by then he was well aware of its contents and he had already ordered that an upcoming, $31 million coupon payment on the 2012 bonds be skipped. A formal default on the foreign debt was declared on December 12, and starting that day, Correa would justify the country's moratorium on the basis that Ecuador's debt obligations were "immoral," "illegal" or "illegitimate"– preferably, all of the above. On December 15, it was announced that an upcoming $30.5 million coupon payment on a 10-year sovereign bond that had been issued in December 2005 would likewise not be made. However, as the weeks and months passed, it became apparent that Ecuador's default would be highly selective rather than indiscriminate, and that it would lead neither to a repudiation of obligations on odious or other grounds, nor to a negotiated or even unilateral debt exchange, Argentine-style, for the purpose of obtaining massive debt relief.

President Correa made it clear on December 20 that all obligations to official bilateral and multilateral agencies would continue to be serviced in full and on time, notwithstanding the CAIC's damning report and his own prior announcement that even debts deemed "legitimate" would be subject to a restructuring. He and his finance minister, María Elsa Viteri, explained before and after that New Year's that the default would be confined to the "commercial" debt, meaning Ecuador's three sovereign bonds. However, in mid-January 2009, the government surprisingly decided to pay the coupon on the 2015 bond just before the grace period ran out, saying that this issue was different from the other two – despite the fact that the CAIC report had condemned the 2015 bond right along the others.[31] By February it became clear that the government was really only targeting the two bonds that Correa had been despising for years, and thus it came as no surprise when the government failed to pay $135 million in interest due on the 2030 bonds.

The way the Correa administration went about dealing with these undesirable obligations was to buy them back from intimidated investors, indirectly at first and

[30] *Id.*, 41-42 and 46-47.

[31] The proceeds of that issue had been devoted by a prior administration (in mid-2006) to repurchase a portion of the 2012 bonds at par, as per the commitment made at the time of the 2000 debt exchange, so the 2015 bond could have been regarded by President Correa as guilty of immorality, illegality or illegitimacy by association – which was the view adopted by the CAIC.

then directly, paying cash for a fraction of their face value (or, rather, pre-default market value), for the purpose of extinguishing them. The government reportedly began to purchase the 2012 bonds in the secondary market after their price collapsed following the mid-November decision to default on them, using an Ecuadorian bank (allegedly, Banco del Pacífico, acting through a broker) as the front man.[32] It then continued repurchasing its securities after defaulting on the 2030 bond, such that by one estimate the government picked up as much as half of the two bond issues in this manner.[33] On April 20, 2009, the government announced a buyback offer to repurchase the 2012 and 2030 bonds through a modified Dutch auction with a base price of 30 cents on the dollar of face value.[34] A disclosure document was circulated by the deal's manager, Lazard Frères, with an expiration date of May 15 for all offers, and it made it plain that Ecuador had "no intention of resuming payments on these bonds following the expiration date."[35] Despite an attempt to organize resistance among bondholders, in the event, 91percent of the bonds outstanding were tendered – including those in government hands, presumably – and were bought back at a discount of between 65 and 70 percent, thereby retiring nearly $3 billion in bonds for around $900 million in cash payments. Holdouts were then offered another chance to tender at 35 cents on the dollar, and in November 2009, an offer aimed at Italian investors was launched on identical terms, such that, by the end of 2009, the government had successfully bought back about 95 percent of the 2012 and 2030 bonds.[36]

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[32] El Comercio, *Ecuador Habría Comprado su Deuda*, December 11, 2008, available at http://ww1.elcomercio.com/solo_texto_search.asp?id_noticia=156235&anio=2008&mes=12&dia=11.

[33] Lester Pimentel, Bloomberg News, *Ecuador Plays Bond Market for Fools, Aberdeen Says (Update2)*, June 16, 2009, available at http://www.bloomberg.com/apps/news?pid=20601013&sid=aQ7ZViOQQ4mI. The Correa administration has yet to admit or deny the allegations of these back-door purchases, but if they did they take place, that might help explain a portion of the precipitous drop in the central bank's international reserves, from over $6 billion just prior to the mid-November 2008 announcement (that the 2012 bond coupon would not be paid) to less than $3.5 billion by mid-March 2009 (after the 2030 bond coupon went unpaid). However, capital flight in the wake of the default announcement probably accounts for most of this drop in dollar reserves. For data on said reserves, see Banco Central del Ecuador, *Información Monetaria Semanal #155*, January 8, 2010, Excel Table IMS2, available at http://www.bce.fin.ec/home1/estadisticas/bolsemanal/Coyuntura.jsp.

[34] "It was the first time in modern history that a sovereign debtor had demanded that its external commercial creditors write off most of their claims … without advancing a plausible argument that financial distress warranted such extraordinary debt relief." Lee C. Buchheit and G. Mitu Gulati, *The Coroner's Inquest*, INTERNATIONAL FINANCIAL LAW REVIEW, September 2009, 2.

[35] The Republic of Ecuador Noteholder Circular, April 20, 2009, 15, available at http://blogs.reuters.com/felix-salmon/files/2009/04/noteholder-circular-goe-bond-offer.pdf. For a discussion of why the bonds' trustee did not exercise its discretion to accelerate either bond or to start an enforcement action, and on the lessons learned about how a trustee indenture in sovereign documentation should read in the future, see Buchheit and Gulati, *supra* note 34.

[36] El Comercio, *USD 55 Millones Menos de Deuda*, December 31, 2009, available at http://ww1.elcomercio.com/noticiaEC.asp?id_noticia=325666&id_seccion=6. According to official statistics, the government's principal due on 2012 and 2030 bonds dropped from a combined $3.21

Obviously, this manner of dealing with a sovereign's debt burden hinges on having more ample cash resources on hand than necessary to meet the interest payments falling due. It is neither an affordable strategy for a sovereign that is experiencing an acute liquidity crisis, nor a smart strategy for a solvent sovereign able to refinance its obligations at lower interest rates – the far more common situations encountered in the practice of sovereign international finance. It also presupposes attaching little cost to damaging Ecuador's (already tattered) reputation as a debtor, as well as having no intention of regaining access to the international bond markets – at least not for many years. The government of Ecuador had been able to tap the international bond markets on one occasion (in December 2005), six years after its prior (1999) default, when the bond maturing in 2015 was issued. And indeed, the Correa administration has made it known that it does not intend to return to the international private capital markets, but to rely instead on external financing from governments such as China, Iran and Russia, and from official multilateral agencies – preferably other than the IMF and the World Bank, regarded with long-standing animosity by President Correa.[37]

Evidently, the authorities did not care that their default would cause collateral damage, triggering capital flight and impairing the ability of Ecuadorian banks and corporations to access financing from foreign commercial creditors at a time of global financial turmoil. According to central bank data, the private sector in Ecuador was able to borrow much less from abroad after the default than it had borrowed before, such that the stock of its external debt obligations dropped by over 15 percent between September 2008 and December 2009 (because repayments exceeded disbursements).[38] And surveys of foreign banks' exposure to banks and corporations in Ecuador reveal an absolute drop of 12 percent in the year after September 2008, versus a fall of 6 percent to these obligors throughout Latin America during the same period.[39]

As concerns the posture of the United States and other leading governments, and also of the multilateral organizations based in Washington and in Latin America, the deplorable fact is that no government or official multilateral agency went on record to express any dismay at Ecuador's latest default and related bond market manipulation. On the contrary, the local representatives of the regional development

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billion at the end of 2008 to $223 million as of end-2009, a 93 percent reduction; see Ministerio de Finanzas del Ecuador, *Boletines Deuda Externa*, December 2008 and December 2009, Excel Table #1, available at
http://mef.gov.ec/stgcPortal/inicio.jsp?page=/faces/common/resumenEjecutivo.jsp&id=90.

[37] Ministerio de Finanzas del Ecuador, *Boletín de Prensa #32*, November 18, 2009, available at http://mef.gov.ec/pls/portal/docs/PAGE/MINISTERIO_ECONOMIA_FINANZAS_ECUADOR/SUBSECRETARIAS/SUBSECRETARIA_GENERAL_DE_COORDINACION/COORDINACION_DE_COMUNICACION_SOCIAL/PRODUCTOS_COMUNICACION_PRENSA/BOLETINES_DE_PRENSA/BOLETINES_2009/BOLETINES/BOLETIN32_19_NOV_2009.PDF. In 2007, President Correa expelled both the World Bank's and the IMF's resident representatives in Ecuador.

[38] Banco Central del Ecuador, *Información Estadística Mensual #1895*, January 2010, Excel Table 3.3.2, available at http://www.bce.fin.ec/frame.php?CNT=ARB0000006.

[39] Calculated by the author on the basis of data in Bank for International Settlements, *Consolidated International Claims of BIS Reporting Banks*, Tables 9A:A and 9A:G up to 2009Q3, available at http://www.bis.org/statistics/consstats.htm.

banks uttered words of moral support, and their headquarters provided an indirect blessing to the default and debt buyback by ramping up their lending to the government – despite an obvious deterioration in Ecuador's creditworthiness and macroeconomic fundamentals during 2009. "The good results obtained [in the restructuring] will benefit all Ecuadorians during difficult times," the Inter-American Development Bank's representative in Quito, Carlos Melo, said in a statement. "The IADB reiterates its predisposition to work alongside Ecuadorians to promote economic development."[40] Sure enough, the IADB stepped up its approvals of new loans for Ecuador – nearly thirty projects since the December 2008 default and through the end of 2009, including the first tranche of a $1 billion loan for a road-building and maintenance program. The IADB approved $515 million in new loans during 2009, versus a mere $50 million in 2008, and it disbursed nearly twice as much to Ecuador in 2009 as it had done in 2008.

The Colombia-based Latin American Reserve Fund (FLAR), for its part, made a general-purpose $480 million loan to Ecuador in July 2009, whereas it had not lent anything to the government in 2008. And the Venezuela-headquartered Andean Development Corporation (CAF) approved $460 million in loans to the Correa administration during 2009, plus another $259 million in early January 2010 – a meaningful increase from loan approvals of $345 million during 2008. The CAF's representative in Quito, Luis Palau-Rivas, was quoted as saying in May 2009 that the regional lender saw the defaulted debt restructuring "positively because it's a voluntary process [that is] helping to solve a difficult situation ... and will benefit everyone."[41] The idea that what Ecuador's bondholders were participants in "a voluntary process" is ludicrous, of course, as one veteran financial reporter rightly commented at the time, since the bondholders had no say whatsoever in the unilateral destruction of the value of their investments, and their only "choice" was whether to accept Ecuador's risible offer or to hold onto defaulted Ecuadorian paper indefinitely.[42] All told, the multilateral agencies disbursed nearly $860 million to the government of Ecuador in 2009, 152 percent more than the $340 million they had disbursed during 2008.[43]

The Correa administration requested no loans or other support from the International Monetary Fund and World Bank during 2008 or 2009, and probably did not consult with them, either. However, when a reporter asked the Fund about its attitude towards Ecuador's default, the institution's spokeswoman lamely said: "It is longstanding Fund policy to encourage our members to, wherever possible, be current in servicing debt obligations, and when they are economically unsustainable to enter into productive negotiations [with their creditors]. We understand that

[40] Alexandra Valecia and Alonso Soto, *Regional Lenders Back Ecuador in Debt Talks*, Thomson Reuters, May 18, 2009, available at http://www.reuters.com/assets/print?aid=USTRE54H58220090518.
[41] *Id*.
[42] Felix Salmon, *Is the Obama Administration Condoning Ecuador's Default?*, Thomson Reuters, May 18, 2009, available at http://blogs.reuters.com/felix-salmon/2009/05/18/is-the-obama-administration-condoning-ecuadors-default/.
[43] Ministerio de Finanzas del Ecuador, *supra* note 36.

Ecuador's decision to default on these bonds is based on a dispute about [their] legal validity rather than [on] debt sustainability [grounds], and of course we don't take sides on the merits."[44]

All things considered, the tacit approval of Ecuador's default on the part of the official community is deeply troubling, because as mentioned at the outset of this essay, in practice only governments and multilateral organizations, rather than any group of private-sector bondholders, banks or suppliers, could have tried to rein in a wayward sovereign debtor such as Ecuador in 2008-09 – or such as Argentina during 2002 to the present, for that matter. As became evident in the 1980s and 1990s, and again during the recent global financial crisis, the official community is the only one that can exercise the kind of collective diplomatic pressure, and put forth the financial incentives and disincentives bilaterally and through the multilateral agencies, to motivate sovereigns to comply with their financial obligations – or at least to treat private creditors in a relatively responsible manner. This much was obvious even before the many pyrrhic victories obtained in the courts in New York and Europe by bondholders in the wake of Argentina's gigantic default. Legal precedents and plenty of indenture innovations notwithstanding, even the best of contract intentions cannot prevent investors from going through a hellish experience at the hands of a sovereign debtor unwilling to honor the spirit and the letter of its legal commitments.

Interestingly, just as Ecuador's selective default and buyback attracted no opprobrium in official or multilateral circles, it did not gather any plaudits from the debt cancellation movement, either. During 2007-08, virtually all national, regional and international NGOs agitating for the massive forgiveness of developing-country debt hailed Ecuador's decision to conduct a thorough "independent" audit of its external indebtedness. Dozens of such organizations sent an open letter to President Correa in 2008 expressing their support for the audit, and favorable declarations along the same lines were made by, among others, legal experts meeting in Quito that July as well as by participants in a symposium on illegitimate debt that gathered in Oslo in October 2008.[45] However, to our knowledge, not one of these organizations has expressed its approval of how Ecuador went about dealing with the results and recommendations of the CAIC audit. In fact, a November 2009 meeting of nearly thirty organizations (including CADTM, CLAI, Jubilee and LATINDADD) – in Ecuador, of all places – made no mention in its "Guayaquil Declaration" of how the host country had dealt with its "immoral," "illegal" and "illegitimate" debt obligations.[46]

This deafening silence on the part of the advocates of across-the-board debt cancellation is understandable. The case of Ecuador is not one that lends itself to

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[44] Transcript of the Regular Press Briefing by Caroline Atkinson, Director of the IMF's External Relations Department, December 18, 2008, available at http://www.imf.org/external/np/tr/2008/tr121808.htm.

[45] CAIC, *supra* note 23, 161-164; other declarations of support appear only in the English version of the CAIC report, 165-168.

[46] LATINDADD, *Declaración de Guayaquil*, November 13, 2009, available at http://www.latindadd.org/index.php?option=com_content&view=article&id=552:declaracion-de-guayaquil&catid=37:pronunc&Itemid=115.

argue in favor of repudiation on “odious debt” or related grounds. To begin with, the country has been under continuous civilian, constitutional rule since mid-1979, and while it has been mismanaged, it was not plundered by an egomaniacal dictator. The greatest build-up in foreign public indebtedness took place during 1980-1994, when the stock of obligations (including arrears) skyrocketed from less than $3 billion to nearly $14 billion, even tripling in relation to rising government revenues and GDP. During this extended period, duly elected civilians were in charge, none of whom has been found guilty of any illegal conduct. Issues of state succession, war-related debts, widespread corruption, the absence of informed consent, or collusion on the part of creditors to divert funds for contrary purposes – none of these criteria seem applicable here. And the charges of illegitimacy made by the CAIC and President Correa are not the ones that are usually offered as strong arguments for debt cancellation, such as obligations that involve predatory terms, cannot be serviced without violating basic human rights, or go against widely accepted legal, financial or ethical standards.

Besides, what is a supporter of debt cancellation to make of the very arbitrary manner in which the Correa administration proceeded, accepting responsibility for every loan made to Ecuador by every official foreign lender, even though the CAIC documented plenty of irregularities involving many of them? And what about the decision to default selectively on two bonds but not on a third one, which the CAIC had tarred and feathered just the same? How could someone from that camp express approval for a government that spent its “hard-earned money” buying back supposedly immoral, illegal and illegitimate obligations, thereby validating them?

This is the cautionary tale of the bad things that can happen to good sovereign debt contracts.