

## Ecuador's Sovereign Default: A Pyrrhic Victory for Odious Debt?

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The fall of Saddam Hussein's regime in Iraq in 2003 led to a small explosion of interest in legal strategies by which sovereigns might repudiate "odious" or "illegitimate" obligations. Before helping to engineer quick and generous debt relief for the new Iraqi regime, the U.S. administration proposed that Hussein's debts might not be enforceable under a doctrine of odious debt. Debt relief proponents seized upon this official support for debt-repudiation and advocated a much broader application of the doctrine in other contexts.

Given the uncertain status of the odious debt doctrine under international law,<sup>1</sup> various writers and advocates proposed alternate strategies for addressing odious or "illegitimate" debt. These included other, more familiar, doctrines under public international law and private law;<sup>2</sup> the creation of international tribunals or institutions;<sup>3</sup> and contractual devices.<sup>4</sup> As these writers and advocates generally

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<sup>1</sup> See, e.g., James V. Feinerman, *Odious Debt Old and New: The Legal Intellectual History of an Idea*, 70 LAW & CONTEMP. PROBS. 193 (2007); Andrew Yianni & David Tinkler, *Is There a Recognized Legal Doctrine of Odious Debts?*, 32 N.C. J. INT'L L. & COMM. REG. 749 (2007).

<sup>2</sup> See, e.g., Lee C. Buchheit *et al.*, *The Dilemma of Odious Debts*, 56 DUKE L.J 1201 (2007); Adam Feibelman, *Equitable Subordination, Fraudulent Transfer, and Sovereign Debt*, 70 LAW & CONTEMP. PROBS. 171 (2007).

<sup>3</sup> See, e.g., Michael Kremer & Seema Jayachandran, *Odious Debt*, 96 AM. ECON. REV. 82 (2006).

<sup>4</sup> See, e.g., Adam Feibelman, *Contract, Priority, and Odious Debt*, 85 N.C. L. REV. 727 (2007).

acknowledged, however, all of these approaches face significant hurdles. Some of these hurdles are substantive or doctrinal -- i.e, Is there a doctrine of odious debt? What defines odiousness or illegitimacy? -- while others arise from political constraints and/or logistical challenges of creating a legal regime. Given these seemingly intractable challenges, academic interest in the topic waned almost as quickly as it had surged.

In late 2008, Ecuador brought the topic of odious or illegitimate debt back to the world's attention by announcing that it would not make payments due on two of its Global bonds. The country's president, Rafael Correa, asserted that this action was justified because these obligations were illegitimate.<sup>5</sup> While sovereign defaults are not uncommon events, it is extremely rare, arguably unprecedented in the contemporary period, for a sovereign with a sustainable level of debt to refuse to honor existing obligations.

Not surprisingly, financial market participants and commentators initially excoriated Ecuador for its action,<sup>6</sup> while debt relief advocates reacted with enthusiasm.<sup>7</sup> What is more surprising, however, is that official actors were almost uniformly silent.<sup>8</sup> In retrospect, even critics of Ecuador's actions have acknowledged the strategic success of Ecuador's maneuvers.<sup>9</sup> Meanwhile, legal and

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<sup>5</sup> Specifically, Ecuador announced in December 2008 that it would suspend payments on its 2012 and 2030 Global bond issues.

<sup>6</sup> See, e.g., Felix Salmon, *Ecuador's Idiotic Default*, Dec. 12, 2008, available at <http://www.portfolio.com/views/blogs/market-movers/2008/12/12/ecuadors-idiotic-default/>

<sup>7</sup> See *infra* note 22 and accompanying text.

<sup>8</sup> See Arturo C. Porzecanski, *When Bad Things Happen to Good Sovereign Debt Contracts: The Case of Ecuador*, forthcoming L. & CONT. PROBS., at 14, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1557040](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1557040)

<sup>9</sup> See Felix Salmon, *Lessons From Ecuador's Bond Default*, May 29, 2009, available at <http://blogs.reuters.com/felix-salmon/2009/05/29/lessons-from-ecuadors-bond->

financial commentators are left to puzzle over what effects, if any, the Ecuador episode will have on other sovereigns with burdensome external obligations, especially in a period of looming potential sovereign debt crises.

One question that has received relatively little consideration in the wake of Ecuador's default, however, is whether the episode will influence the viability of odiousness or illegitimacy as a defense to enforcement of sovereign obligations.<sup>10</sup> It may seem that this question is of less importance now that Ecuador has arguably provided a practical model for strategic default. Yet, even if Ecuador's action proves to have been a viable approach, it is not at all clear that this approach will be available for other sovereigns with potentially odious or illegitimate debt. It may be that some such sovereigns will not have the resources available to conduct a similar campaign. It may also be that Ecuador's success was due in significant part to unique economic and financial circumstances of the moment. Thus, some states will likely continue to have a stake in efforts to advance a formal mechanism to address odious or illegitimate obligations.

There are good reasons to believe that Ecuador's actions will ultimately prove detrimental such efforts.<sup>11</sup> This episode will likely confirm and augment skepticism that any such mechanism can be carefully crafted and limited to narrow definitional

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default. See also Wade Mansell & Karen Openshaw, *Suturing the Open Veins of Ecuador: Debt, Default and Democracy*, LAW & DEV. REV. (online), available at <http://www.bepress.com/ldr/vol2/iss1/art7>; Porzecanski, *supra* note 8, at 14 (noting that Ecuador was able to obtain official sector loans in the immediate aftermath of its default).

<sup>10</sup> For one of the rare discussions of this question, see Porzecanski, *supra* note 8, at 15.

<sup>11</sup> This Essay does not consider whether these actions might provide evidence of a doctrine of odious debt under customary international law. It is worth noting, however, that this is an unlikely result. While other sovereigns have yet to object to Ecuador's action, neither have they recognized it as legitimate under customary practice.

constraints. While the obligations the Ecuador effectively restructured may have been the product of mismanagement and inequitable policies of prior Ecuadorean administrations, they can only be understood as odious or illegitimate under a broad definition of these terms. It is hardly clear, for example, that the citizens of Ecuador did not benefit from the resources that their government initially obtained in exchange for these obligations or from the their government's ability to restructure earlier obligations. Furthermore, at least some of the terms and circumstances that Ecuador cited as odious or illegitimate are predictable and conventionally acceptable aspects of sovereign borrowing, default, and forbearance. As discussed below in more detail, the viability of a formal mechanism for repudiating odious or illegitimate debt depends on a narrowly-drawn definition of odiousness or illegitimacy. Given such definitional concerns, it is hard to imagine that Ecuador's actions will not make legal actors and policymakers all the more hesitant to unleash such a mechanism.

## I. The Ecuador episode

Ecuador's president Rafael Correa campaigned in 2006 on a promise to refuse to pay some of the country's external debts. Correa explicitly stated at the time that he would opt to spend available funds on public sector projects like education and health rather than to make full payments on the country's external obligations. He asserted at that time that Ecuador was justified in doing so because the bonds represent obligations that were illegally incurred by previous oppressive regimes and because the obligations were substantively unfair and illegitimate.<sup>12</sup>

After taking office, Correa created a Public Debt Audit Commission to evaluate the country's obligations incurred between 1976 and 2006.<sup>13</sup> The commission

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<sup>12</sup> See Porzecanski, *supra* note 8, at 8.

emphasized various aspects of Ecuador's obligations that made them illegitimate. It found that proceeds of various rounds of borrowing and restructuring had been used to unfairly benefit powerful interests in the country and beyond, especially foreign lenders. The Commission asserted that the particular transactions leading to the creating of the Global bonds were legally infirm because the government had ceded to oppressive terms (e.g., waiving sovereign immunity and stipulating to foreign law, etc.).<sup>14</sup> It noted that the service on the debt in 2007, for example, was greater than public expenditure on health, "social wellbeing," urban development and housing, the environment, and education.<sup>15</sup> It also noted that the amount flowing from Ecuador to service external debt was greater than the amount that Ecuador had received from external lenders.<sup>16</sup> It emphasized that the restructuring of Brady bond debt for Global bonds was based on the Brady bonds' nominal value, despite the fact that the Brady bonds were trading at a lower price in the market.<sup>17</sup> It also criticized the fact that private commercial debt to external creditors had been taken over by the state at the behest of the IMF and thus became a further burden on the public fisc; the debt became especially burdensome because interest rates were tied to market rates and this was a period in which the U.S. Federal Reserve was raising rates dramatically.<sup>18</sup>

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<sup>13</sup>See [http://www.jubileeusa.org/fileadmin/user\\_upload/Ecuador/Internal\\_Auditing\\_Commission\\_for\\_Public\\_Credit\\_of\\_Ecuador\\_Commission.pdf](http://www.jubileeusa.org/fileadmin/user_upload/Ecuador/Internal_Auditing_Commission_for_Public_Credit_of_Ecuador_Commission.pdf)

<sup>14</sup> See *id.* at 48-49.

<sup>15</sup> See *id.* at 14.

<sup>16</sup> See *id.* at 15 ("This proves that the commercial debt has not been a source of financing for the development of the country, but a perverse mechanism to pillage its limited resources.")

<sup>17</sup> See *id.* at 16

<sup>18</sup> See *id.* at 17-32

Armed with the report by the Committee, and despite widespread international concern and disapproval, Ecuador suspended payments on the 2012 and 2030 Global bonds last year (though it did not suspend payments on a third issuance, the 2015 Global bonds). It then offered to purchase the defaulted bonds for a 35% discount. It is widely believed that Ecuador acted aggressively to purchase a substantial portion of the defaulted bonds, which were trading at a discount. Though reluctant, 91% of the bondholders sold their bonds in the exchange. The bonds allowed for acceleration if 25% of bondholders agreed, but the trustee had the exclusive right to enforce the acceleration or to challenge voting of shares repurchased by the sovereign issuer.<sup>19</sup> The trustee for the issue, U.S. Bancorp, did not exercise its authority to accelerate the enforcement rights or to otherwise challenge the exchange.<sup>20</sup> As Buchheit and Gulati have observed, unlike trustees for commercial bonds under U.S. law, the bond contracts did not impose a fiduciary duty upon the trustee.<sup>21</sup>

## II. Legal impact

Ecuador's actions could be viewed as a success for the movement to enable sovereigns to effectively repudiate odious or illegitimate debts. After all, it is a dramatic instance of an apparently successful strategic default of sovereign obligations that was not premised on the sovereign's inability to pay, unprecedented in recent memory, and it has been hailed by some debt relief advocates as such.<sup>22</sup>

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<sup>19</sup> See Mitu Gulati & Lee Buchheit, *The Coroner's Inquest: Ecuador's Default and Sovereign Bond Documentation*, INT'L FIN. L. REV., available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1470232](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1470232).

<sup>20</sup> See *id.*

<sup>21</sup> See *id.*

<sup>22</sup> See, e.g., Mansell & Openshaw, *supra* note 9; Ecuador Declares Foreign Debt Illegitimate, available at <http://www.projectcensored.org/top-stories/articles/10-ecuador-declares-foreign-debt-illegitimate/> (mentioning, in an update by Neil Watkins and Sarah

This episode may in fact provide other sovereign debtors with a practical model for refusing to pay burdensome obligations, especially if Ecuador is not perceived to suffer any market or reputation penalty as result of its actions. Nonetheless, Ecuador's may prove detrimental to the longer-term effort to create a mechanism to allow sovereigns to repudiate or discharge some debts on equitable grounds.

#### A. Picking the definitional scab

One of the fundamental challenges for any legal mechanism that would address odious debt is definitional: How should any relevant doctrine or institution define debt that is odious or illegitimate and therefore subject to repudiation or restructuring?<sup>23</sup> All proposals for a mechanism to address odious or illegitimate debt rest, explicitly or implicitly, on the assumption that it is possible to determine whether a government is incurring obligations that benefit its citizens, obligations for which it is reasonable to hold them accountable.<sup>24</sup> As numerous commentators have observed, it is rarely the case that an obligation will have no arguable benefit

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Anderson, approval from debt-relief advocates); *Ecuador Hangs Tough*, available at <http://www.probeinternational.org/odious-debts/ecuador-hangs-tough>. Some advocates had applauded Ecuador for establishing the public debt audit commission, though stopped short of applauding the default. See *Wipe Out Illegitimate Debt*, Report From the International Symposium on Illegitimate Debt (2009), available at [http://www.kirkensnodhjelp.no/Documents/Kirkens%20N%c3%b8dhjelp/Tematske%20filer/Gjeld/Symposium%20report\\_english\\_lr.pdf](http://www.kirkensnodhjelp.no/Documents/Kirkens%20N%c3%b8dhjelp/Tematske%20filer/Gjeld/Symposium%20report_english_lr.pdf) (strongly approving of Ecuador's audit commission). Other commentators had applauded or encouraged the creation of the commission as a step toward default. See *Ecuador at the Crossroads: An Integral Audit of the Public Debt*, AFRODAD, available at <http://www.afrodad.org/downloads/Ecuador%20FTA%20Final.pdf> ("All these are illegitimate debts that the Ecuadorian State must refuse to pay.")

<sup>23</sup> See generally, Omri Ben-Shahar & Mitu Gulati, *Partially Odious Debts?*, 70 LAW & CONTEMP. PROBS. 47 (2007); Patrick Bolton & David Skeel, *Odious Debts or Odious Regimes?*, 70 LAW & CONTEMP. PROBS. 83 (2007); Feibelman, *supra* note 4.

<sup>24</sup> See generally, Kremer & Jayachandran, *supra* note 3; Feibelman, *supra* note 4.

for the citizenry.<sup>25</sup> Thus, determining whether citizens of a sovereign borrower received any benefit from an obligation will be an extremely difficult project. How would an observer or decision-maker determine, for example, whether the citizens of a sovereign obtained any benefit from borrowing to build a fancy vanity palace for the president? Some writers respond to this challenge by proposing that a mechanism focus on the legitimacy of the government that incurs obligation,<sup>26</sup> but such an inquiry tends to beg similar questions. When is a regime so oppressive that lending sanctions or discharge of its debts is warranted? Again, such unambiguously oppressive regimes have existed throughout history, but they are relatively rare.

This pervasive ambiguity is particularly challenging for any mechanism that would address odious or illegitimate debt because it is essential that any operational definition of odious or illegitimate debt be both predictable and narrow. A regime that authorizes discharge or restructuring of sovereign obligations would likely prove destabilizing if creditors and other parties cannot have a very clear understanding, *ex ante*, about whether particular debts might be subject to the regime. This suggests that such a mechanism should apply only to exceptional, unambiguous cases of odiousness and/or illegitimacy. Examples of such cases would presumably include, for example, obligations incurred for funds that were used exclusively to personally enrich government officials or to inflict abuse upon citizens.

An odious debt mechanism would ideally make creditors much more hesitant to provide financial support for such activities. If it applied more broadly, however, creditors might be similarly hesitant to provide support for valuable, beneficial projects, the wisdom or benefits of which could be questioned retrospectively. If

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<sup>25</sup> See generally, Albert Choi & Eric Posner, *A Critique of the Odious Debt Doctrine*, 70 LAW & CONTEMP. PROBS. 33 (2007); Ben-Shahar & Gulati, *supra* note 17; Feibelman, *supra* note 4.

<sup>26</sup> See, e.g., Bolton & Skeel, *supra* note 17.

there is uncertainty about whether an obligation would fall within the scope of the mechanism, it may deter parties from extending credit or cause them to charge substantially more for the facility. In other words, if the mechanism potentially covered obligations that were in fact beneficial for the sovereign's citizens, then it might hinder the ability of sovereigns to borrow in their citizens' interest. This would likely harm countries that have the greatest need for external financing. Under a narrowly drawn definition of odiousness or illegitimacy, there will inevitably be some room for debate about the nature of particular transactions, but it is essential for any mechanism that allows repudiation or discharge to reduce and circumscribe this zone of uncertainty and ambiguity as much as possible.

The obligations that Ecuador refused to honor appear to fall outside of even this zone of ambiguity. As noted above, the factors the Ecuador relied upon to support its actions boil down to these: the funds borrowed from external sources disproportionately benefited privileged interests in the country; the government took over private obligations, shifting burdens to the broader population; the country spent more on debt service than it received from external creditors; the government acted illegally in accepting contractual provisions that waived sovereign rights and assented to foreign courts and foreign jurisdiction; the government failed to purchase discounted obligations on secondary markets and restructured obligations based on nominal values; and current debt service is greater than public expenditure on other essential public goods. Taken together, these factors may indicate that previous Ecuadorean governments were, at least, poor stewards of the public welfare and, at worst, distributing wealth in the country upwards from poorer citizens toward richer and better-connected ones.

On the other hand, these factors are hardly unambiguous markers of odiousness or illegitimacy. Most of the funds received from creditors were employed by the private sector or for public projects (however ill-conceived or tainted with corruption). Waiving sovereign immunity and submitting to foreign jurisdiction is, in most contexts, consistent with legitimate external borrowing. Government take-over of private sector debt is, in at last some circumstances, often

a beneficial and justifiable strategy for debt-crisis prevention/resolution. Debtors in distress or default often end up paying significant, seemingly disproportionate, amounts to service their obligations; restructurings can reduce these servicing costs, but usually do not eliminate them altogether. When the cost of servicing debt overwhelms essential public expenditures, voluntary restructuring may be justified; but this does not, in itself, indicate that the underlying obligations were odious or illegitimate. The factors identified by Correa and catalogued by the Audit Committee may arguably reflect significant inequities in prior governmental policy and mismanagement of fiscal, monetary, and social policy. Yet, they do not indicate that the Ecuadorean state knowingly incurred obligations that were not for the benefit of the country's citizens or that creditors extended resources knowing that to be the case.

If the foregoing is true, what does this mean for the future of efforts to promote an odious- or illegitimate-debt mechanism? Ecuador's actions may prove to be a cautionary tale for those who might be in a position to create or recognize a mechanism for discharging sovereign debt on equitable grounds. Imagine, for example, the U.S. federal judge who is asked in the future to apply the doctrine of odious debt. It may be that the Ecuador episode will bolster an argument that the doctrine is part of international customary law.<sup>27</sup> If the judge is not convinced, however, that Ecuador's obligations were odious or illegitimate, she may be even more hesitant to apply the doctrine than she would otherwise have been. After all, creditors will be able to make a stronger case that the doctrine, once unleashed, cannot be limited to obligations for which sovereigns' citizens obtained little or no benefit. Similarly, the Ecuador experience will likely make proposals for a legal institution specifically designed to police for odious or illegitimate debts much less appealing. To the extent that definitional concerns were already a significant hurdle for advancing such an institution, the basis for Ecuador's claims of illegitimacy may simply serve to exacerbate those concerns. In sum, by significantly broadening the

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<sup>27</sup> But, again, probably not.

definition of odious and illegitimacy in the sovereign debt context, Ecuador and its enthusiasts may have confirmed many of the deep concerns that sympathetic skeptics have had about providing a mechanism for addressing odious or illegitimate sovereign debt.

Alternatively, it is possible that concern over Ecuador's action could increase enthusiasm for an odious or illegitimate debt mechanism, if only to clarify that the Ecuadorean episode should fall beyond the scope of such a mechanism. Rather than insist that debt is not dischargeable on equitable grounds, the official sector and financial markets might find it strategically preferable to admit that some debt should be discharged if it is odious or illegitimate, but only if it is unambiguously so. If so, then the Ecuador experience could end up accelerating efforts to create a formal odious-debt mechanism in order to define borderline cases outside of scope of potential relief. In that case, Ecuador's recent action would not be a pyrrhic victory, but it would still not represent the kind of advance that debt-relief advocates appear to envision.

#### B. Law notwithstanding

It is certainly possible that contemplating the legal dimensions of Ecuador's action is missing the point. It may be that Ecuador asserted a legal basis for refusing to honor its Global bonds as pretext for a purely strategic act of unilateral debt restructuring. On this account, as noted above, Ecuador effectively outmaneuvered its creditors, boldly refusing to honor a subset of its obligations, purchasing significant amounts of its undervalued debt, taking advantage of a weak bondholder trustee, and promising to pay affected creditors enough to make any serious challenge unprofitable. Furthermore, the defaulted debt may have been initially priced high enough to include the risk of default or restructuring. Ecuador also took its action at a point of market instability, when other parties were suffering broader losses, disguising the effect of the loss of income from the Ecuador bonds. Finally, it is not clear how much, if any, effect Ecuador's action will have on its ability to

borrow in the future, especially if it was already deemed to be an unreliable borrower.

In such a context, the legal grounds for repudiation may simply have been irrelevant. If Ecuador had given no justification for the repudiation, it would not have changed the practical or strategic calculation for any of the parties. Thus, Mansell & Openshaw, generally applauding Ecuador's action, have observed that episode may provide similarly situated sovereigns a strategic model for reducing burdensome yet sustainable obligations.<sup>28</sup>

If this is the primary lesson of the Ecuador episode, however, the episode may be even more disruptive to financial markets than it would be if it were understood as a successful assertion of the theory of odious or illegitimate debt. It provides no guidance to creditors and counter-parties of the circumstances under which a sovereign might try to unilaterally restructure its obligations. Counter-parties will have reason to be concerned that a sovereign borrower will feel emboldened to strategically repudiate obligations in the future. Because it will be hard for sovereigns to credibly commit not to take such actions, creditors will presumably charge more to lend to a broad range of sovereigns, even some with sustainable levels of debt and no intent to repudiate. This higher cost of credit may be efficient if it effectively insures sovereigns against burdensome debt levels by pricing the market cost of repudiation into each transaction. But it is more likely that such insurance, even if reduced the restructuring costs to sovereigns, may over-insure many or most sovereign borrowers.

An odious or illegitimate debt mechanism would, however broad its scope, provide at least some measure of notice to creditors and counter-parties and somewhat reduce distortions in the pricing and availability of credit. Furthermore, as noted above, Ecuador's model of default may not be available to other sovereigns with burdensome levels of external debt, including those with potentially odious or

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<sup>28</sup> Mansell & Openshaw, *supra* note 16.

illegitimate obligations. The latter group of sovereigns may bear pricing effects of Ecuador's actions and yet may have less of a chance now to benefit from a formal mechanism that would allow them to assert equitable grounds for repudiating or discharging odious or illegitimate obligations.

### III. Conclusion

Ecuador's strategic default on some of its external debt last year has drawn much commentary and created much uncertainty. Some commentators who advocate creating a mechanism for addressing odious or illegitimate debt encouraged Ecuador to repudiate its obligations and have generally applauded its decision to do so. For those who are sympathetic to efforts to create such a mechanism, however, such enthusiasm may be misplaced. Articulating a narrow definition of odious or illegitimate debt is one of the primary challenges for advancing any doctrine or an institution that would enable sovereigns to repudiate or discharge such obligations. The obligations that were the subject of Ecuador's default may have been the product governmental mismanagement, corruption, or policies designed to benefit wealthier interests in the country over poorer ones. Yet the justifications given for its default do not come close to establishing that its citizens did not obtain a benefit from the underlying transactions or the various debt restructurings that the country experienced in recent decades. In fact, many of the aspects of Ecuador's indebtedness appear to be conventional results of sovereign borrowing, debtor default, and creditor forbearance. If so, Ecuador's episode may end up heightening concerns that a mechanism for addressing odious or illegitimate debt would inevitably implicate transactions that are potentially beneficial to sovereigns and their citizens, making it harder for sovereigns to borrow for productive purposes. Heightening such concerns only serves to undermine efforts to convince legal actors and policymakers to adopt such a mechanism.