The pitfalls of project finance in developing states

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The Republic of Seychelles is an archipelago in the Indian Ocean, north east of Madagascar with a population of only around 81,000 people. In the late 1980s, the government of the republic sought to improve its outdated electrical power infrastructure and generating capacity which had fallen behind demand.

To facilitate this, the Public Utilities Corporation (PUC), a state-owned company charged with maintaining the state's power generation and supply network, negotiated a finance package with CDC Group. CDC is a public company incorporated under the Companies Act 1985 in England and Wales.

At that time, CDC predominantly invested by way of loans for projects and infrastructure in countries and sectors where affordable sources of equity or capital are relatively scarce. Its role has, however, subsequently changed so that it now invests predominantly in private equity funds focussed on emerging markets. Two loans were negotiated between CDC and PUC, the first in 1990 for £0.45 million and the second in 1993 for £1.8 million. Both loans to PUC were backed by sovereign guarantees issued by the republic's government.

PUC applied the proceeds of the loans to expand the generating capacity of the Baie Ste Anne Power Station on the Island of Praslin and to upgrade the Victoria A power station on the Island of Mahé. PUC's upgrade plans included the purchase of a 4MW gas turbine generator. Unfortunately for PUC, the gas turbine seems never to have operated correctly.

In the dispute that followed between CDC and the republic, it was never in fact resolved whether the gas turbine generator failed through some fault in design for which the manufacturer might be held responsible, because of damage done to it through the use of contaminated fuel compounded by a general lack of care and maintenance, or because it was merely unsuitable for PUC's needs.

PUC defaulted on its repayment of principal and interest to CDC under the loan agreements. This may have been caused by PUC needing to purchase alternative power generating plant and equipment and also because the revenues it might have expected to receive from the new gas turbine generator never eventuated. A combination of both factors no doubt affected PUC's revenue stream and hence its ability to service its debts.

CDC recognised the challenges facing PUC and approached the matter of PUC's breach with considerable patience and flexibility. For a period it in fact appeared that PUC and the republic would honour their legal obligations and so, in reliance on the republic's assurances, CDC agreed to reschedule the loans.

As time passed, however, it became clear that PUC would not repay the loans, forcing CDC to seek to rely on the republic's sovereign guarantees. The republic refused to honour these, forcing CDC to bring legal claims, some 10 years or more after the initial project financing.

Calvin Walker, projects group partner at Allen & Overy, says: 'State guarantees are often an essential form of support in project financing in developing countries and may be used to support either financing or project-specific obligations.

'Usually, bankers will not look further than a country's credit rating in assessing the value of such guarantees to the overall financing package. However, many developing countries (including the Seychelles) do not have a sovereign credit rating and, in such cases, part of the lenders' analysis should be to look at available methods of enforcement of such guarantees.'

The loan and guarantee agreements were in each case governed by English law; a neutral legal system is often preferred by parties to international project financing, especially where the capital-receiving state is a party to the legal instruments.

In addition, CDC had inserted into each of its loan and guarantee agreements a provision recording the parties' agreement to submit all disputes arising out of the loan and guarantee agreements to resolution by an arbitral tribunal under the auspices of the International Centre for Settlement of Investment Disputes (ICSID).

ICSID is a facility designed specifically to administer arbitration proceedings concerning investment disputes between a state and a foreign investor having the nationality of another state. For that reason, the arbitration agreement further confirmed that CDC is a national of another contracting state (the UK) in line with the recommendation contained in ICSID's model arbitration clauses. Finally, the parties confirmed that hearings would be held in London and that any resulting award might be published.

ICSID was established by the 1965 Convention on the settlement of investment disputes between states and nationals of other states (the ICSID Convention) in response in part to the growing number of requests that the president of the International Bank for Reconstruction and Development (IBRD) was receiving to intervene in investment disputes and procure an amicable settlement and - more importantly - because IBRD member states recognised that international investment flows would increase if foreign investors had the security of a dedicated institution available to deal with complex public/private disputes arising between them and a state.

The convention entered into force for the UK in 1967, for the republic in 1978 and today boasts 142 states as contracting parties. ICSID is headquartered in Washington DC (although arbitrations need not be seated or take place there) and comprises one of the five institutions that form the World Bank Group (the other four being the IBRD, the Multilateral Investment Guarantee Agency, the International Finance Corporation and the International Development Agency).

Given the close affiliation between ICSID and the IBRD, it is unsurprising that the IBRD takes a close interest in states' compliance with ICSID awards.

The institution was relatively quiet for a number of decades as the international business and legal community were slow to recognise its unique advantages. Since 2000, however, the number of investor-state arbitrations administered by ICSID has exploded.

Parties to investment projects, such as the power project financing described in this case study, routinely include provisions to refer future disputes to ICSID arbitration and these account for a fairly constant proportion of ICSID's case load. The very large increase in the number of modern investment arbitrations has come about through investors' dramatic recognition of the significance and value of bilateral and multilateral investment protection treaties of which there are now approaching 2,500 worldwide.

These treaties typically express states' consent to use international arbitration to resolve investment disputes that may arise with investors of the other state party to the relevant treaty. A total of 183 investment treaty claims were known to have been made as at June 2005, embodying many tens of billions of dollars in claims. At least 56 different states have been named as respondents.

In a December 2003 award, the sole arbitrator appointed by ICSID, Sir Anthony Mason AC KBE, found in favour of CDC and rejected all defences put forward by the republic for failing to honour its sovereign guarantees.

Although the republic had never contested its liability under the 1990 loan and guarantee agreements, relating to the Baie Ste Anne project, the republic did belatedly proffer the argument that when CDC carried out an appraisal for the purposes of approving the loan to PUC for the Victoria A upgrade this amounted to an implied representation by CDC that the project as a whole was viable and suitable for PUC and the republic.

As such, the Republic argued that CDC ought to bear some share of the financial consequences of the project's failure. In support of its theory, the republic relied upon the very fact that CDC advanced the loan as an implied representation, as well as the fact that CDC had charged a negotiating fee. The tribunal rejected all of these arguments in the award.

The sole arbitrator found, consistent with English law, that CDC advanced the loan monies to PUC based on its own internal assessment of the risks involved, and that this could not, without more evidence, be construed as a favourable assessment of the actual project to which those monies were to be applied with the result that neither PUC nor the republic were entitled to rely upon it as such.

This rule was confirmed in the award in the following terms: There is a fundamental difference between a lender making an appraisal or study of a project for its own purpose in deciding whether it will make a loan and making an appraisal or study of a project for the benefit of the borrower. Furthermore, the negotiating fee that CDC had charged PUC was based on a fixed percentage and proved to be no more than the typical fee charged by financial institutions for arranging a loan. Nor did CDC owe any duty of care and responsibility to PUC and the republic to ensure that the project was suitable and well conceived. A borrower may be entitled to rely on a lender's approval of a loan where it is coupled with an actual representation to the borrower that the proposed transaction is viable and suitable for the borrower, or the lender knows that the borrower is relying on its skill and judgment. In this case, however, the tribunal confirmed that CDC never made any such representation.

A final complaint advanced by the republic was that there was an alleged inequality of bargaining power between the parties, which would therefore excuse its obligations under the loan and guarantee agreements. This proposition was rejected since the provision of a sovereign guarantee was an appropriate commercial term for the protection of the lender and CDC's activities were purely commercial in substance and nature and its loans were made on an ordinary commercial basis.

The tribunal found that there was no suggestion of any improper pressure brought to bear by CDC, which would of course have been most unlikely considering that it was the republic that approached CDC for the capital to fund the project.

The last point to note is that, as one would expect in standard project financing documents, the loan and guarantee agreements confirmed that the borrower's obligation to pay monies falling due was absolute and in no way impaired or affected by reason of any failure on the part of the project itself. A further clause confirmed that the parties made no representations other than those expressed in the formal documentation.

Under the ICSID Convention, the tribunal's award was final and not subject to any appeal in national courts. The convention strongly emphasises finality of awards; so for instance, an ICSID award may only be challenged through ICSID's own self-contained 'annulment' procedure. Even then, the grounds for annulment of an award are limited to just a few tightly defined errors in the decision making process as opposed to an open invitation to launch a broad-sweeping appeal into the question as to whether a tribunal's findings or conclusions are correct in fact or law.

Annulment is an extraordinary remedy reserved for unusual and important cases, namely where an award is so grossly illegitimate and its deficiencies so obvious that they could be stated in a few pages. A special ad hoc committee composed from three distinguished arbitrators is appointed by the chairman of the administrative council of ICSID (in effect, the president of the IBRD) to consider annulment applications. Understandably, ICSID annulment proceedings have been relatively rare to date, with only six known final decisions.

Undeterred by this very narrow scope for annulment, the republic applied to have the award annulled, alleging not less than 19 separate complaints against the award and the sole arbitrator's conduct. At their weakest, the republic's complaints were no more than a poorly disguised appeal against the merits of the award; at their most extreme, they included an unfortunate allegation that the sole arbitrator, a former chief justice of Australia, had showed bias.

The republic's complaints were not supported and all 19 of them were properly rejected by the committee formed to determine the annulment application (Judge Charles Brower, Michael Hwang SC, and David Williams QC).

The committee found that the tribunal had arrived at its decision soundly, answering the proper legal question before it based on the evidence and that it had not committed any error justifying annulment of the Award. The committee took care in resoundingly rejecting any suggestion that the sole arbitrator had displayed bias; to the contrary, the committee emphasised that the sole arbitrator had been 'at pains to accommodate to the maximum extent humanly possible the desires of a very small developing state'.

Stephen Jagusch, the Allen & Overy partner who represented CDC in these proceedings, says: 'The case against the Seychelles shows both the good and the bad of ICSID arbitration - but more good than bad.'

The bad, he says, was the 'seemingly cynical misuse of the annulment mechanism merely to delay the proceedings'. The good, however was 'the speed, efficiency and low cost of the ICSID proceedings before the sole arbitrator and also the pragmatic and robust approach of the ICSID ad hoc committee, whilst at the same time acting very sensitively towards the developing state party'.

That, Jagusch says, is always a challenging balance to achieve and it is to ICSID's credit that its sole arbitrator and committee members in this case were able to achieve this balance so expertly.

States that are party to the ICSID convention are required to recognise awards of ICSID arbitral tribunals as if they were final judgments of their own courts. ICSID awards therefore benefit from near world-wide recognition and enforcement in 142 States, making the ICSID Convention arguably the most effective regime for the recognition abroad of judgments or arbitral awards.

It is often said and widely believed, that the ICSID system achieves such high rates of voluntary compliance with awards because of the unique benefit that ICSID awards are perceived to come with the imprimatur of the IBRD. Indeed, it is a fact that the great majority of ICSID awards are complied with voluntarily. Over ICSID's 40 year history, it has only been a handful of pariah states - Liberia, Congo and Kazakhstan, among others - that have openly flouted the authority of ICSID and failed to observe ICSID awards that have gone against them.

Richard Laing, the chief executive of CDC comments: 'CDC has over a period of many years sought to negotiate an amicable settlement of this matter. It is unfortunate that it has been necessary to initiate and progress legal proceedings against the republic. We remain hopeful that it will be possible to bring this matter to a prompt conclusion.'

At the time of writing, the award against the Republic of Seychelles remains unsatisfied, the republic remains under an international law obligation set out in the convention to recognise the tribunal's award, as confirmed by the committee, as final and binding and it is required to satisfy its pecuniary obligations.

Refusal to comply with an ICSID Award is itself a serious breach of the ICSID convention. Unfortunately to date, the Republic of Seychelles has not acknowledged its obligations under the award and made no attempt to satisfy its obligations.

This failure will not escape the attention of the international business community, ICSID itself and the IBRD.

One is left to wonder whether this is a desirable position for any capital importing state to be in, not least because - according to its own operating manual - the IBRD will take an interest in disputes and unsatisfied ICSID awards, which may cause it to take an adverse view when assessing a state's suitability for future Bank financing.