

Arbitration - Ecuador

Tribunal Rules in Favour of State of Ecuador in Arbitral Dispute

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Introduction

In a case involving two US investors against the state of Ecuador, an International Centre for Settlement of Investment Disputes (ICSID) tribunal ruled that some facts concerning the claimants' investment could not be subject to the tribunal's scrutiny since they had occurred before the treaty entered into force. However, the tribunal declared that it had jurisdiction to examine such pre-treaty facts, as the examination would help it to understand and determine the scope and effects of the breaches, if any, of the bilateral investment treaty after that date. What would have been a complex task for the tribunal was simplified because the most critical element of the controversy - the termination of a power purchase agreement - had already happened while the treaty was not in force, and by the fact that at the time when Ecuador became bound by the treaty, both parties were in the process of liquidating the contract. In dealing with Ecuador's post-treaty conduct, the tribunal, following a strict interpretation of 'fair and equitable treatment', found that such conduct was not objectionable.

Facts

On November 17 1995, during a severe energy crisis, the Institute for Electricity (INECEL) - a corporation fully owned by the Ecuadorian state - signed a contract with Seacoast, a company established under Texan state law which was owned by MCI Power Group LC and New Turbines Inc, companies incorporated in the United States. Under the contract, Seacoast agreed to install and operate two electrical power plants and sell electricity to INECEL.

At the beginning of 1996, differences arose between the parties with respect to:

- the execution of the contract;
- the payment for energy under the 'take or pay' system;
- reimbursement for the cost of fuel; and
- the imposition of fines and penalties.

On April 12 1996 Seacoast suspended the operation of the two plants and delivery of power, invoking INECEL's non-payment of invoiced amounts payable under the terms of the contract.

On July 31 1996 Seacoast submitted a claim against INECEL to the Administrative Tribunal of the District of Quito, requesting approximately \$25 million in damages for breach of contract.

In April 1997 the first meeting of the liquidation commission for the contract was held. On February 8 1999 the superintendent of companies issued a resolution revoking Seacoast's operation permit. On March 31 1999 the liquidation commission was considered terminated.

In February 1999 Seacoast was notified by the superintendent of companies that its permit to operate in Ecuador had been revoked because it was no longer conducting activities related to the business purpose for which the permit was granted.

On October 21 1999 a civil judge for Pichincha Province (Quito) held that the claim

submitted by Seacoast against INECEL was null and void.

On December 16 2002 the ISCID received a request for arbitration from the plaintiffs against the state of Ecuador.

Objections to the Tribunal's Jurisdiction

From the outset, the respondent objected to the tribunal's jurisdiction to rule on the complaint on several grounds. The most significant was that the underlying facts took place prior to the entry into force of the bilateral investment treaty on May 11 1997.

The claimants contended that the tribunal did have jurisdiction to rule on the case because: (i) the claimants had an investment within the terms of the ICSID Convention and the bilateral investment treaty at all relevant times; and (ii) the tribunal must consider events attributable to Ecuador before the treaty's entry into force and events subsequent to that date.

The claimants stated that they were legal subjects of the United States and that Seacoast was a company, also from the United States, which was owned by them. Seacoast installed two electricity plants and sold the power to INECEL, an Ecuadorian state-owned entity. After the entry into force of the bilateral investment treaty, the claimants argued that they continued to own the Seacoast branch in Ecuador and an operating permit. Seacoast held and managed substantial receivable accounts and other contractual rights against INECEL. Consequently, the claimants alleged that Ecuador violated the treaty through acts committed after its entry into force.

Retroactivity

The tribunal first considered the problem of the retroactivity of the bilateral investment treaty. The claimants contended that acts commencing before the treaty entered into force could breach the treaty if the act continued past the entry date or had composite elements occurring beyond that date. As in *Tecmed v Mexico*, the claimant argued that what was at stake was the 'conduct' of Ecuador, which continued before and after the date of the treaty.

According to the claimants, Ecuador's policy of discriminating against Seacoast began on April 8 1996, when INECEL defaulted on the first invoice from Seacoast, and continued until Ecuador relied on the revocation of Seacoast's operating permit to reject Seacoast's claim in the Ecuadorian courts and refuse arbitration. The claimant argued that Ecuador's final refusal to pay took place when the liquidation commission proceedings terminated, which occurred after the treaty entered into force.

The respondent denied the composite and continuing nature of the alleged wrongful acts attributed to the Ecuadorian authorities. Ecuador contended that the existence of a composite act requires a series of acts or omissions defined as a whole as wrongful. The claimants, according to the respondent, were trying to circumvent the main issue of the non-existence of an investment at the time the treaty entered into force. For this reason, Ecuador argued, the *Tecmed* decision was inapplicable because in that case the tribunal found that an investment had actually existed at the time the treaty entered into force.

The tribunal began by declaring its adherence to the general principle of international law that governs this area: unless there is clear language to the contrary, a treaty will not be enforced with regard to facts that occurred before its entry into force and will not have retroactive effect. However, as several international rulings have shown, it is a principle significantly more difficult to apply than to define. The tribunal stressed that events or situations prior to the entry into force of the treaty may be relevant as preliminary to dispute arising after that date.

The tribunal regarded the claimant's argument as contradictory with respect to the relevance of prior events which are considered to breach the treaty, since before its entry into force there was no possibility of breaching it. The tribunal held that it had competence over events subsequent to the entry into force of the treaty when those acts were alleged violations of the treaty. Prior events may be considered by the tribunal only for the purpose of understanding the background or scope of treaty violations after its entry into force, but will not be subject to legal scrutiny by the tribunal. The tribunal concluded that it had jurisdiction to examine whether the claimants' investment - which occurred before the treaty came into force - qualified as such under the definition given by the ICSID Convention. The tribunal also observed that the existence of a breach of a norm of customary international law before a bilateral investment treaty enters into force does not give the right to have recourse to the treaty's arbitral jurisdiction.

The tribunal found that the conduct of Ecuador after the treaty entered into force did not constitute a breach. The disagreement of the claimants with the commission in charge of liquidating the contract did not amount to a breach of the treaty. Moreover, the tribunal found no grounds for the claimants' allegations that the revocation of Seacoast's licence to operate in Ecuador amounted to an expropriation. It noted that at the time of the revocation Seacoast had already transferred its rights and was not engaged in any

commercial activity as authorized under the original permit.

Fair and Equitable Treatment

The claimants also urged the tribunal to find Ecuador in violation of the bilateral investment treaty on the grounds that its conduct after the treaty entered into force violated the 'fair and equitable' clause. This included the negative attitude of the liquidation commission with regard to the investor's claims and the revocation of Seacoast's operation permit.

On the first issue, the tribunal noted that the fact that the liquidation commission was not amenable to the investor's viewpoint did not by itself constitute a breach of the fair and equitable standard.

The second issue was more complex. The claimants conceded that the Ecuadorian authorities may have been empowered to revoke the permit, especially since the company was no longer providing the public service for which the permit was granted. However, they urged the tribunal to see that decision not in isolation of the ongoing disagreement with the Ecuadorian government but in the context of such disputes. For the claimants, it was more than a coincidence that the Attorney General's Office invoked the revocation of Seacoast's permit for not going ahead with an alleged offer to submit their disagreement to local arbitration. They also said that the attorney general used the revocation of the permit as a pretext to request a local judge to dismiss an action for damages that the investor had initiated prior to the date when the treaty entered into force - an action that was eventually nullified by the judge. Finally, they observed that immediately after the request to nullify the action was filed by the attorney general, Seacoast's office was visited by auditors from the Internal Revenue Service, the Ministry of Labour and the Social Security Institute, in order to initiate investigations into the company's regulatory compliance. Moreover, they noted that the authorities announced their intention to collect through expeditious proceedings the disputed amount which Ecuador regarded as outstanding debt.

In assessing the claimants' arguments, the tribunal drew a distinction between the fair and equitable standard with the application of *ex aequo et bono* (ie, 'according to what is right and good'). The former, according to the tribunal, is a legal rule that "conventionally obliges the state parties to the bilateral investment treaty to respect the standards of treatment required by international law". It added that 'international law' refers to "customary international law (ie, the repeated, general and constant behaviour of states, which they observe because they are aware that it is obligatory)". For the tribunal, "unfair and inequitable treatment can be reasonably recognized by the tribunal as an act contrary to law". In contrast, the rule of *ex aequo et bono* "presupposes the broad exercise of discretion by arbitrators in seeking a solution to a dispute". The tribunal found that the nullification of the action initiated by Seacoast was not necessarily attributable to the revocation of its operation permit and that the visits of auditors of various agencies to Seacoast's offices were no more than routine procedure. It concluded that the acts:

“alleged by the claimants as continuing harassment by Ecuador against Seacoast may betray an unfriendly attitude but, when evaluated individually or as a whole, they do not constitute unfair or inequitable, discriminatory or arbitrary treatment in the parameters established by international law as reflected in the bilateral investment treaty.”

Comment

It is important to keep in mind that by the time the bilateral investment treaty entered into force (May 11 1997), the Seacoast contract was no longer in operation. It had been terminated by Seacoast because of the alleged failure of INECEL to pay some invoices. Moreover, the liquidation commission for the contract had already held its first meeting for the purpose of settling the accounts. As expected, the parties at that meeting disagreed with respect to their accounts.

The critical element of the controversy - the termination of the contract - had not only already occurred, but was also strongly disputed by the parties. The tribunal felt that it did not have jurisdiction to entertain a full examination of the pre-treaty controversy and restrained itself to the sole finding that Seacoast had made an 'investment' as defined by the ICSID Convention. This approach is similar to that adopted in the *Generation Ukraine Case*, where the tribunal considered pre-treaty facts for anything other than examination of the claimant's allegation that it had property rights before the treaty came into force which could have been expropriated at later stage.

The *Seacoast* award will join the growing number of international decisions that have dealt with the problem of applying bilateral investment treaties to facts that occurred before they entered into force, but are nonetheless connected with an alleged breach of treaty obligations which occurred after the host state became bound by the treaty. It will also join the number of awards that have taken a more restrictive approach with respect

to the fair and equitable standard, although this approach may have been influenced, again, by the fact that the core of the controversy had occurred before the treaty came into force.

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